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**Assessment of the 2019 Stability Programme for  
Cyprus**

*(Note prepared by DG ECFIN staff)*

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## **1. EXECUTIVE SUMMARY**

Cyprus is subject to the preventive arm of the Stability and Growth Pact. Since Cyprus' public debt is above the 60% of GDP reference value of the Treaty, it also needs to ensure sufficient progress towards compliance with the debt reduction benchmark.

Cyprus continues enjoying a remarkable post-crisis rebound. Real GDP growth in 2018 was 3.9%. It is projected to ease to 3.1% in 2019 and 2.7% in 2020, according to the Commission 2019 spring forecast, but remain above the potential throughout the forecast horizon. Growth is expected to be driven by domestic demand, while the external outlook turns less favourable. Rapid employment and moderate wage increases amid low inflation are expected to boost household real disposable incomes and support private consumption, which is a key contributor to growth. Investment is projected to be dynamic, growing more strongly than the overall economic activity, consisting mainly of ongoing tourism-related projects, buoyant residential construction, and ship registration. The macroeconomic scenario included in the Stability Programme is more favourable than the Commission 2019 spring forecast.

The general government headline deficit turned out at 4.8% of GDP in 2018, including the one-off impact of the government support in the sale and orderly winding down of the Cyprus Cooperative Bank. Net of one-offs, the headline balance amounted to a surplus of 3.5% of GDP in 2018. According to the Stability Programme, the headline balance is set to reach a surplus of 3.0% of GDP in 2019, before slightly falling to 2.6% of GDP in 2020 and 2.2% of GDP by 2022. In structural terms, based on recalculated output gaps, the budget balance amounted to 2.0% of potential GDP in 2018, above the medium-term budgetary objective (set at 0% of GDP). The structural budget surplus is expected to decline to 1.5% in 2019 and 1.0% in 2020. There are no major differences between the Stability Programme and the Commission forecast assessments. Risks to the fiscal outlook mainly stem from uncertainties surrounding the macroeconomic outlook, the fiscal implications of court rulings on past measures related to the public sector wage bill and the potential financing needs of public hospitals during the first years of implementation of the national health system.

Based on the Commission forecast, Cyprus is expected to remain above its medium-term objective in 2019 and 2020. Furthermore, Cyprus is expected to respect the debt reduction benchmark in 2019 and 2020. In view of the breach of the 3%-of-GDP Treaty reference value in 2018, the Commission issued a report under Article 126(3) of the Treaty to assess whether an excessive deficit exists in Cyprus. The report concluded that further steps leading to a decision on the existence of an excessive deficit should not be taken.

## **2. INTRODUCTION**

On 30 April 2019, Cyprus submitted its 2019 Stability Programme (hereafter called Stability Programme), covering the period 2019-2022. The Council of Ministers approved the programme on 17 April 2019.

Cyprus is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the Medium-Term Budgetary Objective (MTO). As the debt ratio was 108.0% of GDP in 2015 (the year in which Cyprus corrected its excessive deficit), exceeding the 60% of GDP reference value, Cyprus is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (transitional debt rule). In this period it should ensure sufficient progress towards compliance with the debt reduction benchmark. After the transition period, as of 2019, Cyprus is subject to the debt reduction benchmark.

This document complements the Country Report published on 27 February 2019 and updates it with the information included in the Stability Programme. Section 3 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2019 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on the Commission 2019 spring forecast. Section 5 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 6 provides an overview on long-term sustainability risks and Section 7 on recent developments and plans regarding the fiscal framework. Section 8 provides a summary.

## **3. MACROECONOMIC DEVELOPMENTS**

The economy of Cyprus expanded by 3.9% in real terms in 2018. The macroeconomic scenario underlying the Stability Programme also projects a very strong growth in 2019, at 3.6%, and some slowdown in 2020, to 3.2%. In 2020-2021 growth is expected to ease further but still remain quite solid at 3.0% each year. Domestic demand is expected to be the main driver for growth, with private consumption and gross fixed capital formation providing the largest contributions (the latter growing well above the overall economic activity). Positive contribution is also expected from government consumption. Net exports are set to weigh on growth negatively.

Real GDP growth for 2018 in the Stability Programme compared to the Draft Budgetary Plan projections is revised marginally down, by respectively 0.1 percentage point for 2018 and 0.2 percentage points for the 2019.

The 2018-2019 projections underlying the Stability Programme are more optimistic than the Commission 2019 spring forecast, by 0.5 percentage points in 2019 and equally in 2020. The composition of growth in both years differ - the Commission projects somewhat stronger domestic demand but much weaker net exports than the Stability Programme. The unemployment outlook for 2019 in the Stability Programme, at 7% for 2019 and 6% in 2020 are fairly similar to the Commission's forecast (respectively 6.7% and 5.9%).

Inflation in Cyprus has been very subdued for a several years and is expected to remain so. In 2018, HICP recorded 0.8% inflation. The Stability Programme projects an even lower inflation in 2019, at 0.5%. Then inflation is expected to increase to 1.2% in 2020 and then

further to 1.5% in both 2021 and 2022. The assumptions underpinning the Stability Programme therefore slightly differ from the Commission 2019 spring forecast, where inflation is projected at 0.9% in 2019 and 1.1% in 2020. The higher real growth combined with weaker inflation in the Stability Programme minimises the differences in nominal GDP projections between the Stability Programme and the Commission 2019 spring forecast for the year 2019.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2018		2019		2020		2021	2022
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	3.9	3.9	3.1	3.6	2.7	3.2	3.0	3.0
Private consumption (% change)	3.7	3.7	3.5	3.3	2.8	2.8	2.5	2.5
Gross fixed capital formation (% change)	-7.1	-7.1	10.2	9.4	8.1	7.8	7.0	6.4
Exports of goods and services (% change)	3.3	3.3	0.8	2.7	0.8	2.4	2.4	2.4
Imports of goods and services (% change)	2.0	2.0	3.5	4.0	3.0	3.4	3.1	3.0
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	1.7	3.1	4.9	4.6	4.2	4.0	3.6	3.5
- Change in inventories	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.8	0.7	-1.8	-1.0	-1.5	-0.8	-0.6	-0.5
Output gap <sup>1</sup>	2.8	2.1	3.8	3.0	4.3	3.1	3.1	3.2
Employment (% change)	4.0	4.0	2.6	3.5	2.0	3.0	2.5	2.5
Unemployment rate (%)	8.4	8.4	6.7	7.0	5.9	6.0	5.5	5.0
Labour productivity (% change)	-0.2	-0.1	0.5	0.1	0.7	0.2	0.5	0.5
HICP inflation (%)	0.8	0.8	0.9	0.5	1.1	1.2	1.5	1.5
GDP deflator (% change)	1.6	1.6	1.1	1.0	1.3	1.2	1.5	1.5
Comp. of employees (per head, % change)	0.1	0.1	2.5	0.5	2.8	1.3	1.8	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-6.9	-7.0	-7.1	-7.8	-8.6	-8.2	-8.7	-9.2

Note:

<sup>1</sup>In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Commission 2019 spring forecast (COM); Stability Programme (SP).

The output gap, as recalculated by the Commission based on the information in the Stability Programme and according to the commonly agreed methodology (recalculated output gap), was 2.1% in 2018. This indicates that Cyprus is in the upswing phase of the economic cycle. For 2019, the output gap is expected to widen to 3.0% and continue widening in 2020 reaching 3.1%. The Commission 2019 spring forecast envisages a positive and slightly higher output gap, at respectively 3.8% and 4.3% in 2019-2020.

Overall, the Stability Programme presents favourable macroeconomic assumptions for both years under consideration, compared to the macroeconomic outlook of the Commission 2019 spring forecast. The risks associated with the macroeconomic assumptions presented in the Stability Programme are tilted to the downside. Main downside risks to projections are linked to the worsening external environment. The ongoing ratification process of the withdrawal agreement in the EU and the UK is one of the biggest challenges facing Cyprus, which has close historic and economic links with the UK. As a small open economy, Cyprus

would also be exposed to strong headwinds from slowing global growth. The economy's heavy reliance on foreign funding also leaves it vulnerable to external developments. Other risks, such as still very high share of non-performing loans and low profitability of banks, have subsided but remain present. Concentration of investment in construction and in transport equipment (ship registration in particular) sheds doubts on positive impact on potential growth in the medium to long term.

#### **4. RECENT AND PLANNED BUDGETARY DEVELOPMENTS**

##### **4.1. DEFICIT DEVELOPMENTS IN 2018 AND 2019**

The 2018 general government headline deficit was notified at 4.8% of GDP<sup>1</sup>, significantly down from the headline surplus of 2.9% of GDP planned in the 2019 Draft Budgetary Plan. The difference was mostly due to the 8.3% of GDP (i.e. EUR 1.7 billion) one-off impact of the government support for the sale and orderly winding down of the Cyprus Cooperative Bank. Net of one-offs, the headline balance amounted to a surplus of 3.5% of GDP in 2018, recording an improvement of 1.7 percentage points of GDP compared to the year before.<sup>2</sup>

Compared to 2017, total revenue increased by 7.7% in 2018, amounting to 39.9% of GDP. Tax revenue surged by 7% compared to the year before, reflecting the strong economic environment and the improving labour market. This was mainly the result of the sizable increase in tax revenue on production and imports (by 8.0%), due to the surge in value-added tax receipts (by 13.5%). Tax revenue on income and wealth also increased strongly (by 4.6%), of which corporate income tax and capital gains tax revenues rose significantly (by 8.5% and 4.9%, respectively). Revenue from social security contributions increased markedly (by 7.8%). Furthermore, non-tax revenue also increased (by 15.7%), mainly reflecting the continued pick-up in the rate of absorption from the EU Structural and Cohesion Funds. Total expenditure soared in 2017, amounting to 44.7% of GDP compared to 37.4% of GDP in 2017. On the one hand, total current expenditure increased by 4.9% compared to the previous year, below nominal GDP growth. The rise in current expenditure was mainly attributed to an increase in intermediate consumption (by 15.4%), partly due to one-off water-related and pharmaceutical expenditure; compensation of employees (by 4.3%), mostly driven by the start of the gradual reversal of wage cuts implemented since the crisis, increases in public employment and the granting of the cost of living allowance; and social transfers (by 3.4%). Interest expenditure also increased (by 2.5%), mostly due to the bond issuances related to the Cyprus Cooperative Bank sale. On the other hand, total capital expenditure surged in 2018 due to the one-off impact of the government support measures for the sale and orderly winding down of the Cyprus Cooperative Bank. The fiscal impact of these deficit-increasing measures was notified at EUR 1.7 billion (8.3% of GDP), increasing significantly the

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<sup>1</sup> Based on data reported to Eurostat in spring 2019, see April 2019 EDP notification.

<sup>2</sup> The analysis and projections of the Stability Programme are based on data available up to 8 April 2019 and, therefore, they are not based on notified data for 2018. This leads to discrepancies in revenue and expenditure items, such as gross fixed capital formation, capital transfers, intermediate consumption and interest expenditure. It also needs to be noted that the notified fiscal impact of the government support for the sale and orderly winding down of the Cyprus Cooperative Banks in 2018 is slightly higher than the one reported in the Stability Programme by around EUR 70 million. Overall, the discrepancy in terms of headline balance in 2018 is relatively small, of EUR 0.4 million, while the differences in terms of primary balance and interest expenditure are of around EUR 2 million, respectively. The changes projected in the Stability Programme are thus partly explained by a different base level.

expenditure items of capital transfers and gross fixed capital formation.<sup>3</sup> According to the Stability Programme, Cyprus' (recalculated) structural balance<sup>4</sup> is estimated to have improved (by 0.8 percentage points of GDP) in 2018, partly due to the improvement in the headline balance net of one-offs. The output gap is estimated to widen to 2.1% of GDP in 2018, up from 0.6% of GDP in 2017.

For 2019, the Stability Programme presents a headline surplus target of 3.0% of GDP, similar to the target in the 2019 Draft Budgetary Plan (a reduction by 0.1 percentage point of GDP). Total revenues are projected to slightly increase as a share of GDP in 2019 (by 0.8 percentage points of GDP), compared to the year before. The projected budgetary adjustment in 2019 is thus mainly driven by government expenditure, which is expected to significantly decline (by 7 percentage points of GDP). The slight increase of revenue as a proportion of GDP mostly results from projected revenue increases in social contributions (by 2.1 percentage points of GDP), mainly as a result of the sizable increase in social security contributions as from January 2019 and the contributions of taxpayers and employers to the national health system as of March 2019. This is partly offset by a projected revenue drop in taxes on production and imports (by 0.7 percentage points of GDP), to some extent due to the reduction of excise duties on fuels and the abolition of the excise tax on vehicles, as well as other revenue (by 0.5 percentage points of GDP). In turn, the significant decrease of expenditure as a proportion of GDP is mainly due to the base effect following the high costs for the support to the sale and orderly winding down of the Cyprus Cooperative Bank in 2018. Thus, the Stability Programme projects marked decreases in gross fixed capital formation (by 3.4 percentage points of GDP) and other expenditure (by 5 percentage points of GDP, mostly related to a reduction in capital transfers). This is partly offset by projected expenditure increase in compensation of employees (by 0.3 percentage points of GDP), as a result of the gradual reversal of wage cuts, the contribution of the government as an employer to the national health system, as well as the unfreezing of promotions, the provision of cost of living allowance and annual increments. Furthermore, social payments are expected to increase (by 1.3 percentage points of GDP) mostly due to the social payments related to the national health system, the Estia scheme involving government support for the repayment of non-performing loans backed by primary residences, as well as the government's support for low-income pensioners. According to the Stability Programme, the (recalculated) structural balance is estimated at around 1.5% of GDP in 2019. This is notably explained by the increase of the positive output gap and the deterioration of the planned headline surplus, compared to the headline surplus net of one-offs in 2018.

The Commission 2019 spring forecast projects a similar headline surplus for 2019 at 3.0% of GDP, compared to projection in the Stability Programme. The small difference vis-à-vis the programme's projections notably stems from a higher forecast for the non-tax revenue item

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<sup>3</sup> According to Cystat's press release of 19 April 2019, the impact of the banking support measures related to the Cyprus Cooperative Bank on the general government fiscal accounts for 2018 is estimated at EUR 1.7 billion. This figure is mainly calculated as follows: (i) a capital transfer of EUR 710 million, as a result of the acquisition value (EUR 2.17 billion) minus the real economic value of the non-performing loans received by the new entities (EUR 1.46 billion, resulting from the real economic value of the nominal value of non-performing loans, i.e. 20.94% of EUR 6.97 billion); (ii) an investment of around EUR 670 million, which corresponds to the fixed assets received as collateral from the former Cyprus Cooperative Bank; (iii) the guarantee received by Hellenic Bank (i.e. capital transfer) of EUR 155 million, and (iv) the voluntary retirement scheme for Cyprus Cooperative Bank's employees (i.e. capital transfer) of EUR 133 million.

<sup>4</sup> Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Stability Programme according to the commonly agreed methodology.

(i.e. other revenue, by 0.2 percentage points of GDP) and slightly more conservative assumptions on some expenditure items such as gross fixed capital formation, interest expenditure and other expenditure (by 0.1 percentage point of GDP each of them). Finally, according to the Commission 2019 spring forecast, the structural surplus is also expected to narrow in 2019 (by 0.9 percentage points of GDP) compared to the year before, although remaining above the MTO.

#### **4.2. MEDIUM-TERM STRATEGY AND TARGETS**

The Stability Programme projects headline surpluses of above 2.0% of GDP over the period 2020-2022. More specifically, it expects the headline balance to be in surplus of 2.6% of GDP in 2019 and to steadily decrease over the programme period, reaching a headline surplus of 2.2% of GDP in 2022. This, together with a widening output gap in the Stability Programme, is consistent with a gradual deterioration of the structural balance. The structural balance is estimated to reach 1.5% of GDP in 2019 and to remain above Cyprus' MTO of 0% of GDP over the programme horizon. The Stability Programme states that the MTO remains unchanged and targets a balanced structural position, more stringent<sup>5</sup> than required by the Pact.

On the basis of the information in the Stability Programme, the recalculated structural balance is estimated at 1.5% of GDP in 2019, after the 2.3% of GDP in 2018, and set to narrow further over the programme horizon, but to remain above the MTO throughout.

Compared to the 2019 Draft Budgetary Plan, the Stability Programme has broadly maintained the planned headline surplus and structural balance for 2019. The Commission 2019 spring forecast also plans a similar structural balance of 1.1% of GDP compared to the Stability Programme.

The Stability Programme targets the headline surplus to slightly decrease to 2.6% of GDP in 2020 and to narrow further although remaining above 2.0% of GDP over the programme period. The revenue-to-GDP ratio is set to slightly increase to 40.9% of GDP in 2020, notably due to the contributions to the national health system, and averaging at 40.5% of GDP over the 2020-2022 period. As reported in the Stability Programme, tax revenue on production and imports is planned to decrease in 2020-2022, amounting to 14.8% of GDP on average compared to the projected 15.2% of GDP in 2019. Tax revenue on income and wealth are expected to average at 9.1% of GDP over the same period, similar to the projected revenue in 2019. Non-tax revenues are projected to drop significantly in 2020 (by 0.7 percentage points of GDP). The expenditure-to-GDP ratio is projected to increase to 38.3% of GDP in 2020, mainly as a result of the social transfers related to the national health system, and gradually decrease to 38.0% of GDP by 2022. Over the programme period, compensation of employees and social payments are projected to increase as a proportion of GDP. According to the Stability Programme, these increases mainly stem from the gradual reversal of wage cuts and the government's contribution as an employer to the national health system, on the one hand, and social payments related to the national health system, on the other hand. The authorities' project the gross fixed capital formation to remain steady at 2% of GDP during the period 2020-2022.

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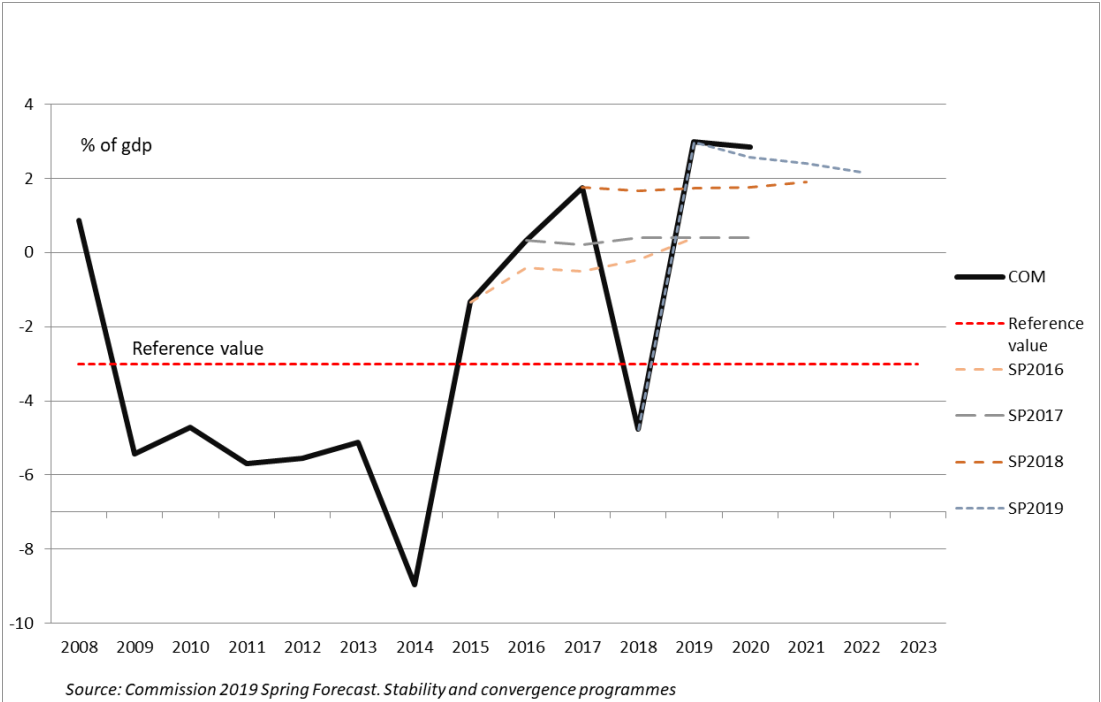
<sup>5</sup> The MTO selected by the Member State is more ambitious than the minimum MTO by more than ½ percentage point. The minimum MTOs are country-specific and calculated based on an agreed methodology.



The Commission 2019 spring forecast, based on a no-policy change assumption, projects a headline surplus of 2.8% of GDP in 2020, 0.2 percentage points above the authorities' projections. Compared with the Stability Programme, the Commission projections reflect a somewhat different macroeconomic outlook, more dynamic revenue given the track-record (by 1.0 percentage point of GDP against the Stability Programme) and more conservative assumptions on expenditure by extrapolating trends with past policy orientations (by 0.7 percentage points of GDP compared to the Stability Programme). In particular, the Stability Programme presents, on the revenue side, as significantly lower forecast for the non-tax revenue item (i.e. other revenue, by 0.5 percentage points of GDP) and a lower projection for tax revenue on production and imports (by 0.3 percentage points of GDP). On the expenditure side, the Stability Programme shows a lower forecast for gross fixed capital formation, intermediate consumption and other expenditure (by 0.2 percentage points of GDP each of the expenditure items). Finally, the structural balance is projected to decline to 0.7% of GDP in 2020, according to the Commission 2019 spring forecast. The 0.3 percentage points divergence compared to the Stability Programme is due to the difference in the projected headline surpluses and a more positive output gap projection in the Commission forecast resulting in a higher cyclical adjustment than in the Stability Programme.

Following the strongly negative one-off impact related to the government support for the sale and winding down of the Cyprus Cooperative Bank on the 2018 headline balance (of 8.3% of GDP), the Stability Programme does not mention any one-off measure impacting the budget balance over the programme period.

**Figure 1: Government balance projections in successive programmes (% of GDP)**



**Table 2: Composition of the budgetary adjustment**

(% of GDP)	2018	2019		2020		2021	2022	Change: 2018-2022
	COM	COM	SP	COM	SP	SP	SP	SP
<b>Revenue</b>	<b>39.9</b>	<b>41.0</b>	<b>40.7</b>	<b>41.8</b>	<b>40.9</b>	<b>40.6</b>	<b>40.1</b>	<b>0.4</b>
<i>of which:</i>								
- Taxes on production and imports	15.9	15.3	15.2	15.3	15.0	14.9	14.7	-1.2
- Current taxes on income, wealth, etc.	9.3	9.2	9.2	9.1	9.2	9.1	9.0	-0.3
- Social contributions	8.9	11.0	10.9	12.3	12.1	12.2	12.2	3.3
- Other (residual)	5.9	5.6	5.3	5.1	4.6	4.4	4.2	-1.4
<b>Expenditure</b>	<b>44.7</b>	<b>38.0</b>	<b>37.7</b>	<b>39.0</b>	<b>38.3</b>	<b>38.2</b>	<b>38.0</b>	<b>-6.5</b>
<i>of which:</i>								
- Primary expenditure	42.2	35.6	35.4	36.9	36.1	36.2	36.0	-5.9
<i>of which:</i>								
Compensation of employees	11.8	12.1	12.1	12.4	12.4	12.6	12.7	0.9
Intermediate consumption	3.9	4.0	4.0	3.9	3.7	3.6	3.4	-0.6
Social payments	13.1	14.4	14.4	15.5	15.4	15.5	15.5	2.5
Subsidies	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.0
Gross fixed capital formation	5.5	2.2	2.1	2.2	2.0	2.0	2.0	-3.3
Other (residual)	7.5	2.6	2.5	2.6	2.4	2.2	2.1	-5.4
- Interest expenditure	2.5	2.4	2.3	2.1	2.2	2.0	1.9	-0.6
<b>General government balance (GGB)</b>	<b>-4.8</b>	<b>3.0</b>	<b>3.0</b>	<b>2.8</b>	<b>2.6</b>	<b>2.4</b>	<b>2.2</b>	<b>6.9</b>
<b>Primary balance</b>	<b>-2.3</b>	<b>5.4</b>	<b>5.3</b>	<b>4.9</b>	<b>4.8</b>	<b>4.4</b>	<b>4.1</b>	<b>6.4</b>
One-off and other temporary measures	-8.2	0.0	0.0	0.0	0.0	0.0	0.0	8.1
<b>GGB excl. one-offs</b>	<b>3.4</b>	<b>3.0</b>	<b>3.0</b>	<b>2.8</b>	<b>2.6</b>	<b>2.4</b>	<b>2.2</b>	<b>-1.2</b>
Output gap <sup>1</sup>	2.8	3.8	3.0	4.3	3.1	3.1	3.2	1.0
Cyclically-adjusted balance <sup>1</sup>	-6.2	1.1	1.5	0.7	1.0	0.8	0.6	6.4
<b>Structural balance<sup>2</sup></b>	<b>2.0</b>	<b>1.1</b>	<b>1.5</b>	<b>0.7</b>	<b>1.0</b>	<b>0.8</b>	<b>0.6</b>	<b>-1.7</b>
Structural primary balance <sup>2</sup>	4.5	3.5	3.8	2.7	3.2	2.9	2.5	-2.3

**Notes:**

<sup>1</sup>Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

<sup>2</sup>Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

**Source:**

Stability Programme (SP); Commission 2019 spring forecasts (COM); Commission calculations.

### 4.3. MEASURES UNDERPINNING THE PROGRAMME

The Stability Programme reports the one-off deficit-increasing measures related to the sale and orderly winding down of the Cyprus Cooperative Bank in 2018, which entailed the inclusion in the general government sector of the two entities resulting from the sale of the bank (i.e. Sedipes and Kedipes). The fiscal impact of these measures was estimated at 8.3% of GDP on the expenditure side, affecting both capital transfers and gross fixed capital formation (see footnote 4). Moreover, the Stability Programme records the activities of Kedipes starting from September 2018, with an estimated impact of 0.3% of GDP in 2018 and 0.2% in 2019

on the revenue side, and around 0.1% of GDP in 2018 and 0.2% of GDP in 2019 on the expenditure side.

The measures underpinning the Stability Programme include the discretionary measures reported in the 2019 Draft Budgetary Plan. On the revenue side, it includes the introduction of the VAT rate on property land in 2018, the rise in social security contributions in 2019 and bonus related to production sharing contracts for the exploration and exploitation of hydrocarbon reserves for the 2017-2019 period. On the expenditure side, it involves the gradual withdrawal of wage cuts in the public sector starting from 2018 until 2023 and the introduction of the Estia scheme in 2019 for a period of 25 years. According to the Stability Programme, the fiscal impact of the deficit-decreasing measures related to the VAT and the social security contributions are estimated at around 0.1% of GDP in 2018 and 0.4% of GDP in 2019, respectively. The fiscal impact of the deficit-increasing measures related to the gradual reversal of wage cuts is estimated at around at 0.1% of GDP in 2018 and about 0.2% of GDP for the next five years, while the impact of the Estia scheme is estimated at 0.1% of GDP in 2019 and 2020.

The Stability Programme includes other measures on the revenue side that were reported in the 2019 Draft Budgetary Plan. These measures were not factored in the projections of the Draft Budgetary Plan, as they were still to be adopted at the time of its submission. In particular, it concerns a reform in the framework of vehicle taxation in 2019, entailing a revision of the calculation of road tax for newly registered cars and the abolition of vehicle excise tax, with an overall fiscal impact estimated of -0.04% of GDP on the revenue side.

Furthermore, the Stability Programme reports a series of additional discretionary measures. A deficit-increasing measure concerning the reduction of excise duties on fuels as of December 2018, with an estimated impact of -0.3% of GDP on the revenue side. Furthermore, in the context of the introduction of the national health system in Cyprus, contributions to the system started to be collected as of March 2019. The contributions were set to balance the budget of the system, namely the contributions of the taxpayers and employers (with an estimated impact of 1.5% of GDP in 2019, 1.2% of GDP in 2020 and averaging 0.2% of GDP in 2021-2022 on the revenue side) are projected to be offset by the contributions of the government as an employer (with an estimated impact of 0.2% of GDP in 2019 and 0.1% of GDP in 2020 on the expenditure side) and the social payments related to the national health system (with an estimated impact of 1.4% of GDP in 2019, 1.1% of GDP in 2020 and averaging 0.2% of GDP in 2021-2022 on the expenditure side).

The estimates of the budgetary impact of the measures appear plausible and are in line with the Commission 2019 spring forecast.

Despite the expansionary measures taken, Cyprus reached a structural surplus in 2018.<sup>6</sup> According to the Stability Programme, and despite the expansionary measures mentioned above, the recalculated structural balance is projected to remain in surplus in 2019 and 2020, and to continue to be above its MTO over the programme horizon. This is also in line with the Commission 2019 spring forecast.

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<sup>6</sup> It needs to be noted that the 8.3% of GDP impact of the banking support measures in 2018 is excluded from the structural balance calculations, as they are deemed to be one-off measures.

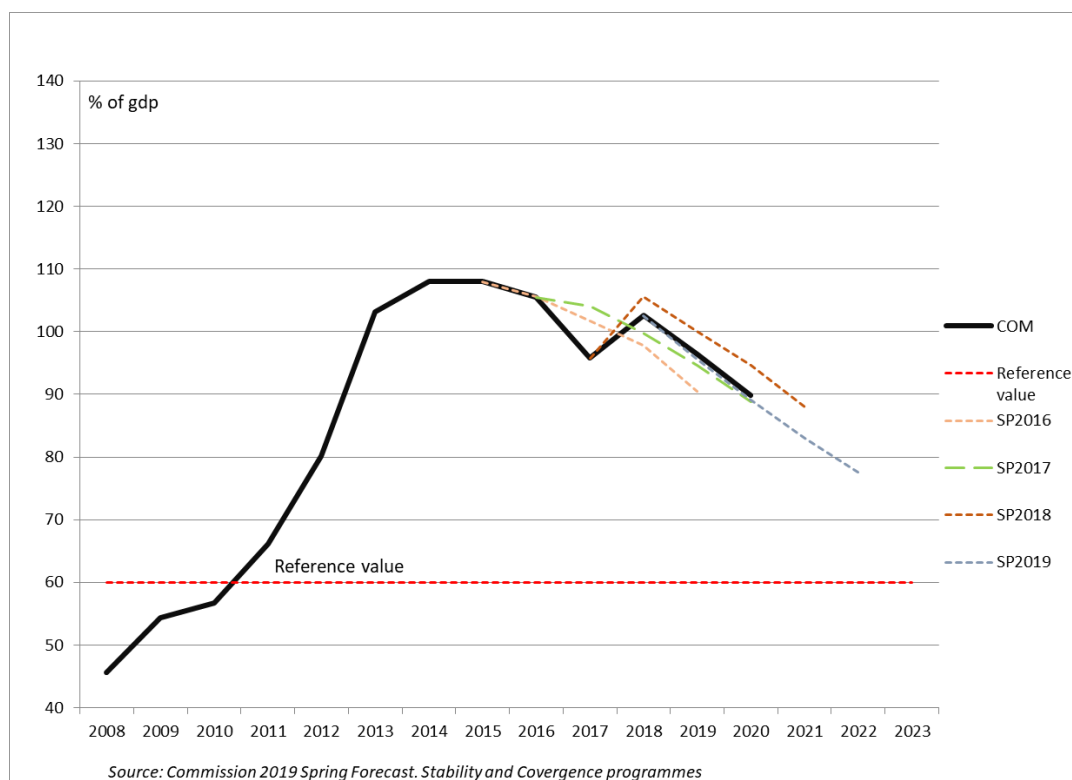
## Main budgetary measures included in the Programme

Revenue	Expenditure
<b>2018</b>	
<ul style="list-style-type: none"> <li>• VAT rate on property land (0.1% of GDP)</li> <li>• Kedipes' activities (0.3% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• gradual withdrawal of wage cuts in the public sector (0.1% of GDP)</li> <li>• one-off banking support measures (8.3% of GDP)</li> <li>• Kedipes' activities (0.1% of GDP)</li> </ul>
<b>2019</b>	
<ul style="list-style-type: none"> <li>• rise in social security contributions (0.4% of GDP)</li> <li>• road tax reform (0.02% of GDP)</li> <li>• abolition of vehicles excise tax (-0.1% of GDP)</li> <li>• reduction of excise duties on fuels (-0.3% of GDP)</li> <li>• contributions of taxpayers and employers to the national health system (1.5% of GDP)</li> <li>• Kedipes' activities (0.2% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• gradual withdrawal of wage cuts in the public sector (0.2% of GDP)</li> <li>• Estia scheme (0.1% of GDP)</li> <li>• contributions of the government as an employer to the national health system (0.2% of GDP)</li> <li>• social payments to the national health system (1.4% of GDP)</li> <li>• Kedipes' activities (0.2% of GDP)</li> </ul>
<b>2020</b>	
<ul style="list-style-type: none"> <li>• contributions of taxpayers and employers to the national health system (1.2% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• gradual withdrawal of wage cuts in the public sector (0.2% of GDP)</li> <li>• Estia scheme (0.1% of GDP)</li> <li>• contributions of the government as an employer to the national health system (0.1% of GDP)</li> <li>• social payments to the national health system (1.1% of GDP)</li> </ul>
<b>2021</b>	
<ul style="list-style-type: none"> <li>• contributions of taxpayers and employers to the national health system (0.3% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• gradual withdrawal of wage cuts in the public sector (0.2% of GDP)</li> <li>• social payments to the national health system (0.3% of GDP)</li> </ul>
<b>2022</b>	
<ul style="list-style-type: none"> <li>• contributions of taxpayers and employers to the national health system (0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• gradual withdrawal of wage cuts in the public sector (0.2% of GDP)</li> <li>• social payments to the national health system (0.1% of GDP)</li> </ul>
<p><u>Note:</u> The table refers to the main measures included in the 2019 Stability Programme that have an incremental budgetary impact over the programme period. The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

#### 4.4. DEBT DEVELOPMENTS

Public debt increased significantly to 102.5% of GDP in 2018 due to the one-off government support for the sale and orderly winding down of the Cyprus Cooperative Bank, compared to 95.8% of GDP in 2017. This increase is mainly due to the issuance of a series of government bonds in April and July 2018 related to the government support measures for the Cyprus Cooperative Bank sale, which amounted to EUR 3.2 billion (15% of GDP). This is reflected in a sizeable positive stock-flow adjustment in 2018, representing a level-shift upwards for the public debt trajectory. However, the debt-to-GDP ratio in 2018 increased by only 7 percentage points of GDP from the previous year, as the strong underlying fiscal performance, the snowball effect (i.e. changes in the debt-to-GDP ratio related to the difference between nominal growth and the interest rate) and active debt management operations partially compensated for the Cyprus Cooperative Bank-related debt increase. The later entailed repaying part of the debt from the accumulated cash balances, in particular the government fully repaid the debt owed to the Central Bank of Cyprus (amounting to EUR 483 million or 2.3% of GDP) in December 2018.

**Figure 2: Government debt projections in successive programmes (% of GDP)**



Based on the Stability Programme, public debt-to-GDP ratio is projected to sharply decline over 2019-2022, mainly due to projected high primary surpluses (above 4.0% of GDP) and strong nominal GDP growth. Public debt is projected to sharply decrease to 95.7% of GDP in 2019 and further to below 90% in 2020. The Stability Programme expected public debt to be reduced to below 80% of GDP over the programme horizon.

According to the Commission 2019 spring forecast, government debt is expected to follow similar dynamics, decreasing to 96.4% of GDP in 2019. The decline in 2019 is projected by the Commission to be somewhat smaller compared to the Stability Programme projections, mainly due to more conservative projections of growth and inflation, as well as a higher

stock-flow adjustment (in the form of accumulation of financial assets). The Commission spring forecast also projects public debt to decline to below 90% of GDP in 2020.

**Table 3: Debt developments**

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022
			COM	SP	COM	SP	SP	SP
<b>Gross debt ratio<sup>1</sup></b>	<b>104.1</b>	<b>102.5</b>	<b>96.4</b>	<b>95.7</b>	<b>89.9</b>	<b>89.1</b>	<b>83.0</b>	<b>77.5</b>
Change in the ratio	3.1	6.8	-6.1	-6.9	-6.5	-6.6	-6.1	-5.4
<i>Contributions<sup>2</sup>:</i>								
<b>1. Primary balance</b>	<b>-0.3</b>	<b>2.3</b>	<b>-5.4</b>	<b>-5.3</b>	<b>-4.9</b>	<b>-4.8</b>	<b>-4.4</b>	<b>-4.1</b>
<b>2. “Snow-ball” effect</b>	<b>2.6</b>	<b>-2.4</b>	<b>-1.8</b>	<b>-2.2</b>	<b>-1.6</b>	<b>-1.8</b>	<b>-1.8</b>	<b>-1.6</b>
<i>Of which:</i>								
Interest expenditure	3.0	2.5	2.4	2.3	2.1	2.2	2.0	1.9
Growth effect	-1.0	-3.5	-3.0	-3.6	-2.5	-2.9	-2.6	-2.4
Inflation effect	0.6	-1.4	-1.1	-0.9	-1.2	-1.1	-1.3	-1.2
<b>3. Stock-flow adjustment</b>	<b>0.9</b>	<b>7.0</b>	<b>1.1</b>	<b>0.6</b>	<b>0.0</b>	<b>0.0</b>	<b>0.2</b>	<b>0.3</b>
<i>Of which:</i>								
Cash/accruals diff.				0.1		0.0	0.0	0.0
Acc. financial assets				0.6		0.0	0.2	0.3
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				0.0		0.0	0.0	0.0

Notes:

<sup>1</sup>End of period.

<sup>2</sup>The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Commission 2019 spring forecast (COM); Stability Programme (SP), Commission calculations.

#### 4.5. RISK ASSESSMENT

As analysed in Section 3, the idiosyncratic downside risks to macroeconomic projections stem from the country’s heavy reliance on foreign funding, still very high share of non-performing loans, low profitability of banks, and concentration of investment in activities that have limited positive impact on potential growth in the medium to long term.

As analysed in Section 4, the Stability Programme and the Commission 2018 spring forecast project similar budgetary developments for 2019. The fiscal projections in the Stability Programme for 2020 are however more conservative than the Commission 2019 spring forecast, both on the revenue and expenditure sides.

However, risks to the baseline fiscal projections remain and are mostly on the downside, mainly stemming from (i) the outcome of court rulings on past measures related to the public sector wage bill, (ii) the potential financing needs of public hospitals in the first years of implementation of the national health system, (iii) the potential realisation of explicit contingent liabilities, (iv) the recent amendment to the income tax law on deferred tax assets and (v) the sustainability of the strong tax revenue growth performance.

More specifically, on the expenditure side, the potential fiscal implications of recent Administrative Court decisions ruling that both public sector payroll and pension cuts implemented since the crisis are unconstitutional remains uncertain at this stage. While the government intends to appeal these decisions at the Supreme Court, a confirmation of these rulings in favour of claimants could significantly impact public finances, in particular if the ruling is extended to all civil servants. Furthermore, the absence of a permanent mechanism that regulates growth of the public sector wage bill increases the risk of fiscal slippages.<sup>7</sup> In addition, the potential financing needs of public hospitals might create additional budgetary pressures. The law on the new organisation of public hospitals stipulates that the State will finance any potential deficit of public healthcare providers in the first 5 years of implementation of the national health system (as of June 2019).<sup>8</sup> Finally, the potential realisation of explicit contingent liabilities, namely in relation to State-owned enterprises and the guarantees created for the sale of the Cyprus Cooperative Bank,<sup>9</sup> and the recent amendment to the income tax law governing the treatment of deferred tax assets are additional risks to the fiscal outlook.

On the revenue side, it is uncertain to which extent the recent strong tax revenue increases from value-added and corporate income taxes can be sustained. On the one hand, value-added tax revenues are expected to increase but at a slower pace on the back of a strong although decelerating macroeconomic outlook. However, this revenue increase might decelerate further in the future due to changes in the economic cycle and a potential slowdown in the value-added tax most dynamic component (i.e. construction activity). On the other hand, corporate tax revenue is an inherently volatile source of revenue, which might be impacted by possible relocation decisions by (large) companies currently benefiting from Cyprus' tax jurisdiction.<sup>10</sup>

As an upside risk to the fiscal projections, the Stability Programme refers to the proceeds from Kedipes, i.e. the resulting Cyprus Cooperative Bank entity in the general government sector. The potential proceeds are not taken into account in the projections of the Stability Programme and the Commission spring forecast. Finally, it is important to note that the forecasts in previous Stability Programmes have proven to be more conservative than the actual fiscal outturns, mainly due to higher-than-expected economic growth.

Regarding risks related to public debt developments, Cyprus' still high level of public debt makes government debt projections sensitive to variations in economic growth and to the expected size of budget surpluses. In addition, there are downside risks linked to potential future changes to market conditions, such as higher interest expenditure due to unanticipated increases in the borrowing costs. However, the refinancing risk is mitigated by contained financing needs in the medium term (below 7% of GDP by 2020) and increased investors'

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<sup>7</sup> The overall wage bill developments in the public and broader public sector are governed by collective agreements with the Unions, whereby a wage setting mechanism monitors and regulates wage bill growth below nominal GDP growth.

<sup>8</sup> For further information on the potential fiscal impact of the national health system, see the 2019 Country Report for Cyprus, pages 27-28. [https://ec.europa.eu/info/sites/info/files/file\\_import/2019-european-semester-country-report-cyprus\\_en.pdf](https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf)

<sup>9</sup> As explained in section 4.1.2 of the 2019 Country Report for Cyprus, the State's exposure to explicit contingent liabilities increased in 2018, mainly due to the establishment of asset protection schemes agreed as part of the sale of the Cyprus Cooperative Bank.

<sup>10</sup> For a more detailed analysis of the tax revenue increase and its sustainability risks, see section 4.1.3 of the 2019 Country Report for Cyprus.

confidence as reflected by the regained investment grade rating for Cyprus' sovereign debt. The sizeable contingent liabilities also pose an additional risk.

## **5. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT**

Cyprus is subject to the preventive arm of the SGP and should ensure compliance with its MTO. Under the European Semester in July 2018 the Council considered that Cyprus complied with the SGP.

### **5.1. Compliance with the deficit criterion**

According to notified data, the headline balance in Cyprus recorded a deficit of 4.8% of GDP in 2018. The deficit was explained by the one-off government support measures related to the sale and orderly winding down of the Cyprus Cooperative Bank in 2018, which amounted to EUR 1.7 billion (8.3% of GDP). The headline balance is projected to return to a surplus of 3.0% of GDP in 2019 and above 2.5% of GDP in 2020. The excess over the reference value is therefore temporary. The deficit cannot be considered exceptional, as it neither results from an unusual event nor from a severe economic downturn for the purposes of the Treaty and the SGP. It should also be noted that the structural balance improved to 2.0% of GDP in 2018, compared to 1.3% of GDP in the previous year. The structural balance is projected to remain above the medium-term objective in 2019 and 2020. The debt remains above the 60% reference value of the Treaty in 2018 and over the forecast horizon.

Therefore, the deficit criterion of the Treaty is *prima facie* not considered to be complied with in 2018. In this regard, the Commission has published a report in accordance with Article 126(3) of the Treaty on 5 June 2019 assessing whether an excessive deficit exists in Cyprus.<sup>11</sup> The report concluded that further steps leading to a decision on the existence of an excessive deficit should not be taken.

### **5.2. Compliance with the debt criterion**

After it corrected its excessive deficit in 2015, Cyprus was in the transition period for the following three years (until the end of 2018) and should have ensured sufficient progress towards compliance with the debt reduction benchmark. This implies that, during this period, it was required to make sufficient progress as defined by the minimum linear structural adjustment (MLSA) towards compliance with the debt reduction benchmark at the end of the transition period. As from 2019, as its public debt exceeds the 60% of GDP reference of the Treaty, Cyprus has to comply with the debt reduction benchmark.

According to the notified data, Cyprus made sufficient progress towards compliance with the debt reduction benchmark in 2018. In particular, the (recalculated) change in the structural balance in 2018 was higher than the required MLSA by 4.3% of GDP.

Based on the Stability Programme, in 2019, Cyprus is expected to meet the debt reduction benchmark, as its debt to GDP ratio is expected to be below the benchmark, with a gap to the debt benchmark of 9.1% of GDP. This is broadly in line with the Commission 2019 spring forecast, according to which Cyprus is expected to respect the benchmark in 2019, as illustrated by a negative gap to the debt benchmark of 6.5% of GDP.

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<sup>11</sup> COM (2019) 530 final.



For 2020, Cyprus is also expected to respect the debt reduction benchmark in 2020 based on the Stability Programme, with a gap to the benchmark of 8.7% of GDP. The Commission 2019 spring forecast points to a similar result, as shown by a negative gap to the debt benchmark of 4.7% of GDP.

**Table 4. Compliance with the debt criterion**

	2018	2019		2020	
		SP	COM	SP	COM
Gross debt ratio	102.5	95.7	96.4	89.1	89.9
Gap to the debt benchmark <sup>1,2</sup>		-9.1	-6.5	-8.7	-4.7
Structural adjustment <sup>3</sup>	0.7				
<i>To be compared to:</i>					
Required adjustment <sup>4</sup>	-3.7				

Notes:

<sup>1</sup> Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

<sup>2</sup> Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

<sup>3</sup> Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

<sup>4</sup> Defines the remaining annual structural adjustment over the transition period which ensures that - if followed - Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (S/CP) budgetary projections for the previous years are achieved.

Source:

*Commission 2019 spring forecast (COM); Stability Programme (SP), Commission calculations.*

### 5.3. Compliance with the MTO

Based on outturn data, the general government balance reached a deficit of 4.8% of GDP in 2018. Cyprus' structural balance reached a surplus of 2.0% of GDP in 2018, above the medium-term objective of a balanced budgetary position in structural terms.

According to the information provided in the Stability Programme, Cyprus is expected to remain above its medium-term objective in 2019 and 2020, with the recalculated structural surplus projected at 1.5% of GDP in 2019 and 1.0% of GDP in 2020.

This is confirmed based on the Commission 2019 spring forecast, which projects somewhat similar structural surpluses of 1.1% of GDP in 2019 and 0.7% of GDP in 2020.<sup>12</sup>

Beyond 2020, the Stability Programme indicates that the structural balance is set to remain above the MTO over the programme period.

<sup>12</sup> For an explanation of the differences between the Stability Programme and the Commission 2019 spring forecast projections, see section 4.1 and 4.2.

**Table 5: Compliance with the requirements under the preventive arm**

(% of GDP)	2018	2019	2020			
<b>Background budgetary indicators<sup>1</sup></b>						
Medium-term budgetary objective (MTO)	0.0	0.0	0.0			
Structural balance <sup>2</sup> (COM)	2.0	1.1	0.7			
<b>Setting the required adjustment to the MTO</b>						
Structural balance based on freezing (COM)	1.7	1.1	-			
Position vis-à-vis the MTO <sup>3</sup>	At or above the MTO	At or above the MTO	At or above the MTO			
Required adjustment <sup>4</sup>	0.0	0.0	0.0			
Required adjustment corrected <sup>5</sup>	-1.3	-1.7	-1.1			
Corresponding expenditure benchmark <sup>6</sup>	4.7	7.4	5.4			
<b>Compliance with the required adjustment to the MTO</b>						
	COM	SP	COM			
	SP	COM	SP			
<b>Structural balance pillar</b>						
Change in structural balance <sup>7</sup>	Compliance					
One-year deviation from the required adjustment <sup>8</sup>						
Two-year average deviation from the required adjustment <sup>8</sup>						
<b>Expenditure benchmark pillar</b>						
Net public expenditure annual growth corrected for one-offs <sup>9</sup>						
One-year deviation adjusted for one-offs <sup>10</sup>						
Two-year deviation adjusted for one-offs <sup>10</sup>						
<b>Finding of the overall assessment</b>						
<b>Legend</b>						
'Compliance' - the recommended structural adjustment or a higher adjustment is being observed.						
'Some deviation' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.						
'Significant deviation' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).						
'Irrelevant for the Significant Deviation Procedure' - a SDP would not be opened only based on the two-year deviation if the MTO has reached (at the time of the freezing or on the base of the last storage) in one of the two years.						
<b>Notes</b>						
<sup>1</sup> The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage point is allowed in order to be evaluated as having reached the MTO.						
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.						
<sup>3</sup> Based on the relevant structural balance at year t-1.						
<sup>4</sup> Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, 2018 edition, p.38.). In case of a SDP, the requirement corresponds to the Council recommendation when available; otherwise it refers to the Commission recommendation to the Council.						
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.						
<sup>6</sup> Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.						
<sup>7</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) is carried out on the basis of Commission 20XX spring forecast.						
<sup>8</sup> The difference of the change in the structural balance and the corrected required adjustment.						
<sup>9</sup> Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)						
<sup>10</sup> Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.						
<b>Source :</b> Stability Programme (SP); Commission 2019 spring forecast (COM); Commission calculations.						

## 6. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Cyprus appears to face fiscal sustainability risks in the short run. In particular, there are some indications that both the fiscal and financial-competitiveness sides of the economy pose potential challenges.<sup>13</sup> The high value of the fiscal sub-index is explained by the one-off banking support measures which led to the deterioration of several fiscal variables, such as the primary balance and the net and gross government debt. Nevertheless, in 2019 the general government balance is expected to be in high surplus contributing to a reduction of gross financing needs this year (also considering the high share of concessionary debt), thus mitigating the high sustainability risk.

Based on the Commission 2019 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, projected at 96.4% of GDP in 2019, is expected to decrease to 61% in 2029, thus remaining slightly above the 60% of GDP Treaty threshold. The government debt level in 2019 is projected to be the highest over the 2019-2029 horizon. Sensitivity analysis shows similar risks.<sup>14</sup> Overall, this highlights medium risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would nonetheless put debt on a clearly decreasing path by 2029, falling slightly below the 60% of GDP reference value in 2029.

The medium-term fiscal sustainability risk indicator S1<sup>15</sup> is at -0.7 percentage points of GDP, primarily related to the high level of government debt contributing by 2.2 percentage points of GDP. This indicator thus signals low risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -1.3 percentage points of GDP. Based on the debt sustainability analysis and the S1 indicator, overall medium-term fiscal sustainability risks are, therefore, medium. Fully implementing the fiscal plans in the Stability Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at -0.7 percentage points of GDP. In the long term, Cyprus therefore appears to face low fiscal sustainability risks, primarily related to the projected rise in ageing costs contributing by 0.9 percentage points of GDP, mainly driven by pension expenditure. Full implementation of the programme would also put the S2 indicator at -0.7 percentage points of GDP, leading to a similar long-term risk.<sup>16</sup> The debt sustainability analysis discussed above points to medium risks so that, overall, long-term fiscal sustainability risks are assessed as medium for Cyprus.

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<sup>13</sup> This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 6 for a definition of the indicator.

<sup>14</sup> Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

<sup>15</sup> See the note to Table 6 for a definition of the indicator.

<sup>16</sup> The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

**Table 6: Debt sustainability analysis and sustainability indicators**

**Table 5. Fiscal Sustainability Assessment  
Cyprus**

<i>Time horizon</i>		<b>Commission Scenario</b>		<b>Stability / Convergence Programme Scenario</b>		
<b>Short-term</b>		<b>HIGH risk</b>				
<b>S0 indicator</b> <sup>[1]</sup>		0.5				
Fiscal subindex		0.5	HIGH risk			
Financial & competitiveness subindex		0.6	HIGH risk			
<b>Medium-term</b>		<b>MEDIUM risk</b>				
<b>DSA</b> <sup>[2]</sup>		MEDIUM risk				
<b>S1 indicator</b> <sup>[3]</sup>		-0.7	LOW risk	-1.3	LOW risk	
of which	Initial Budgetary Position	-2.8		-2.6		
	Debt Requirement	2.2		1.6		
	Cost of Ageing	-0.1		-0.2		
	of which	Pensions	0.5		0.3	
		Health care	0.1		0.1	
		Long-term care	0.0		0.0	
Other		-0.7		-0.6		
<b>Long-term</b>		<b>MEDIUM risk</b>				
<b>DSA</b> <sup>[2]</sup>		MEDIUM risk				
<b>S2 indicator</b> <sup>[4]</sup>		-0.7	LOW risk	-0.7	LOW risk	
of which	Initial Budgetary Position	-1.6		-1.5		
	Cost of Ageing	0.9		0.8		
	of which	Pensions	1.7		1.5	
		Health care	0.2		0.2	
		Long-term care	0.2		0.2	
		Other	-1.3		-1.1	

Source: Commission services; 2019 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indices, thresholds are respectively at 0.36 and 0.49\*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections\*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively\*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively\*.

\* For more information see Fiscal Sustainability Report 2018.

## 7. FISCAL FRAMEWORK

The national fiscal rules are laid down in the Fiscal Responsibility and Budgetary Framework Law, containing in particular a structural budget balance rule with a corrective adjustment mechanism, and a debt rule. As regards the structural balance rule (prescribing conformity with the country's MTO for each year), Cyprus recorded a structural surplus of 2.2% of GDP in 2018 according to the Stability Programme submitted by the authorities, significantly above its MTO of a balanced structural position. Over the period 2019-2022, based on the Stability Programme's projections taken at face value, the structural balance is planned to remain in surplus averaging around 0.8% of GDP, thus overperforming the MTO.

As regards the debt rule (which is line with the Stability and Growth Pact requirement on debt reduction), Cyprus is in the transition period until 2018 and achieved the minimum linear structural adjustment, based on the information provided in the Stability Programme (see Section 5.2. for details). Starting from 2019, the debt reduction benchmark applies.

As a result, based on the information provided in the Stability Programme, the past, planned and forecast fiscal performance in Cyprus appears to comply with the requirements of the applicable national numerical fiscal rules. The current framework did not trigger corrections to the general government headline deficit in 2018, which was above the reference value. As explained above, the 2018 deficit was entirely due to the one-off impact of the government support in the sale and orderly winding down of the Cyprus Cooperative Bank.

The macroeconomic forecasts underlying the Stability Programme had been submitted to the independent Fiscal Council for endorsement. On 15 April 2019, the Council concluded in a letter to the Minister of Finance that the macroeconomic forecast underlying the Stability Programme was deemed to be within acceptable limits, thus endorsing the authorities' macroeconomic forecast.<sup>17</sup> More specifically, as stated in the Stability Programme, the Council concluded that the headline GDP and budget balance figures as forecasted by the Ministry of Finance were considered realistic for the programming period under consideration. The Council's detailed assessment is expected to appear in its 2018 spring report.<sup>18</sup>

The Stability Programme explicitly states that it should be considered as Cyprus national medium-term fiscal plan (NMTFP). Nevertheless, neither the Stability Programme nor the National Reform Programme include indications on the expected economic returns on non-defense public investment projects that have significant budgetary impact.

## 8. SUMMARY

In 2018, Cyprus recorded a headline deficit of 4.8% of GDP, above the 3%-of-GDP reference value. As the deficit criterion of the Treaty is *prima facie* not considered to be complied with in 2018, the Commission published a report in accordance with Article 126(3) of the Treaty on 5 June 2019 assessing whether an excessive deficit exists in Cyprus. The report concluded that further steps leading to a decision on the existence of an excessive deficit should not be taken. The structural budget achieved a surplus of 2.0% of GDP in 2018, above its medium-

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<sup>17</sup>

<http://www.fiscalcouncil.gov.cy/fiscalcouncil/fiscalcouncil.nsf/All/BB2A8591602BD2D2C22583DE002CD218?OpenDocument>

<sup>18</sup> Spring report 2019, Fiscal Council (forthcoming).

term objective. Cyprus made sufficient progress towards compliance with the debt reduction benchmark in 2018.

According to both the information provided in the Stability Programme and the Commission 2019 spring forecast, Cyprus is expected to achieve a headline surplus of 3.0% of GDP in 2019 and above 2.5% of GDP in 2020, remaining above its medium-term objective in both years. Furthermore, according to the Stability Programme and the Commission 2019 spring forecast, Cyprus is expected to respect the debt reduction benchmark in 2019 and 2020.

## 9. ANNEXES

### Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
<b>Core indicators</b>								
GDP growth rate	4.0	2.6	-1.5	4.8	4.5	3.9	3.1	2.7
Output gap <sup>1</sup>	2.5	3.3	-5.6	-1.5	0.8	2.8	3.8	4.3
HICP (annual % change)	2.5	2.3	1.0	-1.2	0.7	0.8	0.9	1.1
Domestic demand (annual % change) <sup>2</sup>	4.8	4.0	-3.0	6.1	8.5	3.0	4.8	4.0
Unemployment rate (% of labour force) <sup>3</sup>	4.3	4.8	13.4	13.0	11.1	8.4	6.7	5.9
Gross fixed capital formation (% of GDP)	20.5	24.7	14.5	17.7	21.5	19.4	20.8	21.9
Gross national saving (% of GDP)	17.1	13.6	10.8	11.6	12.2	12.6	12.4	12.2
<b>General Government (% of GDP)</b>								
Net lending (+) or net borrowing (-)	-3.6	-1.4	-5.3	0.3	1.8	-4.8	3.0	2.8
Gross debt	62.0	54.0	93.1	105.5	95.8	102.5	96.4	89.9
Net financial assets	-30.7	-28.6	-60.5	-75.0	-70.6	n.a	n.a	n.a
Total revenue	34.5	38.4	37.8	38.3	39.1	39.9	41.0	41.8
Total expenditure	38.1	39.8	43.1	38.0	37.4	44.7	38.0	39.0
<i>of which: Interest</i>	3.1	2.5	3.0	2.8	2.6	2.5	2.4	2.1
<b>Corporations (% of GDP)</b>								
Net lending (+) or net borrowing (-)	1.1	-7.9	7.6	2.5	-1.1	8.0	0.8	0.0
Net financial assets; non-financial corporations	-188.1	-167.6	-211.0	-204.8	-193.4	n.a	n.a	n.a
Net financial assets; financial corporations	5.9	4.0	28.0	52.9	38.7	n.a	n.a	n.a
Gross capital formation	7.2	8.8	6.4	8.3	10.7	8.1	12.1	12.7
Gross operating surplus	27.7	21.1	21.3	21.3	20.6	20.8	20.9	20.6
<b>Households and NPISH (% of GDP)</b>								
Net lending (+) or net borrowing (-)	-4.5	-6.6	-5.8	-7.7	-8.5	-9.3	-10.9	-11.4
Net financial assets	129.4	123.7	109.4	108.1	108.3	n.a	n.a	n.a
Gross wages and salaries	34.4	37.6	37.5	36.0	35.6	35.4	35.8	36.1
Net property income	5.6	4.3	1.0	1.2	1.5	0.0	-1.0	-1.2
Current transfers received	17.3	19.1	20.9	19.9	19.5	19.0	20.4	21.6
Gross saving	4.9	5.4	-0.2	-2.1	-2.0	-4.1	-5.0	-5.0
<b>Rest of the world (% of GDP)</b>								
Net lending (+) or net borrowing (-)	-2.9	-10.9	-3.6	-4.9	-7.8	-6.9	-7.1	-8.6
Net financial assets	83.6	68.5	134.0	118.8	117.0	n.a	n.a	n.a
Net exports of goods and services	1.3	-6.6	-0.1	-0.6	-3.5	-1.7	-3.3	-4.7
Net primary income from the rest of the world	-5.4	-4.4	-1.9	-2.0	-2.7	-2.7	-2.7	-2.7
Net capital transactions	0.6	0.3	0.6	0.2	0.5	-0.4	0.9	0.9
Tradable sector	40.0	33.9	33.8	34.9	35.4	35.2	n.a	n.a
Non tradable sector	49.0	53.3	54.6	52.7	51.5	51.3	n.a	n.a
<i>of which: Building and construction sector</i>	8.3	9.3	4.2	3.5	4.2	5.0	n.a	n.a
Real effective exchange rate (index, 2000=100)	90.5	99.0	95.9	86.3	87.2	87.5	86.5	86.5
Terms of trade goods and services (index, 2000=100)	102.1	100.1	99.4	99.9	101.2	102.7	102.7	102.6
Market performance of exports (index, 2000=100)	108.1	94.4	108.8	110.2	113.4	113.1	110.1	107.2

**Notes:**

<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2015 market prices.

<sup>2</sup> The indicator on domestic demand includes stocks.

<sup>3</sup> Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

**Source:**

AMECO data, Commission 2019 spring forecast

### **Mandatory variables not included in the Stability Programme**

The Stability Programme does not include some mandatory variables for the basic assumptions for 2021 and 2022. Not included mandatory variables do not impede the Commission's ability to assess the Stability Programme on the basis of the Programme's assumptions.