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Post-Programme Surveillance Report

Cyprus, Autumn 2017

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European Commission

Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Autumn 2017

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| The cut-off date for the data and policy developments included in this report is 23/10/2017 |
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ABBREVIATIONS

| | |
|---|--|
| ALMPs: Active labour market policies | EU-SILC: European Union Statistics on Income and Living Conditions |
| AWG: Ageing Working Group | FDP: Field Development Plan |
| CBC: Central Bank of Cyprus | FRBSL: Fiscal Responsibility and Budget System Law |
| CCB: Cooperative Central Bank | GDP: Gross Domestic Product |
| CET1: Common Equity Tier 1 | GMI: Guaranteed Minimum Income |
| CIT: Corporate Income Tax | GVA: Gross value added |
| COLA: Cost of Living Allowance | HICP: Harmonised Index of Consumer Prices |
| CSE: Cyprus Stock Exchange | IAS 39: International Accounting Standard 39 |
| CSRs: Country specific recommendations | IDR: In-depth review |
| CyTA: Cyprus Telecommunications Authority | IFRS 9: International Financial Reporting Standard 9 |
| DB: Draft Budget | IMF: International Monetary Fund |
| DBP: Draft Budgetary Plan | LTD: loan-to-deposit (ratio) |
| DSA: Debt Sustainability Analysis | LNG: Liquefied Natural Gas |
| DTA: Deferred Tax Assets | MIP: Macroeconomic Imbalance Procedure |
| EAC: Electricity Authority of Cyprus | MTO: Medium-term objective |
| EC: European Commission | NEET: Not in education, employment or training |
| ECB: European Central Bank | NFC: Non-Financial Corporations |
| EDP: Excessive Deficit Procedure | NHS: National Health System |
| EEZ: Exclusive Economic Zone | NPL: Non-performing loans |
| EIOPA: European Insurance and Occupational Pensions Authority | OECD: Organisation for Economic Co-operation and Development |
| ELA: Emergency Liquidity Assistance | PDMO: Public Debt Management Office |
| EPC: Economic Policy Committee | PES: Public Employment Services |
| ESA2010: European System of Accounts 2010 | PIT: Personal Income Tax |
| ESF: European Social Fund | PPM: Post-programme monitoring |
| ESI: Economic Sentiment Indicator | |
| ESM: European Stability Mechanism | |

PPPs: Public-private partnerships

PPS: Post-programme surveillance

PSPP: Public sector purchase programme

RoA: Return on assets

RoE: Return on equity

SB: Structural balance

SGP: Stability and Growth Pact

SMEs: Small and medium-sized enterprises

SOEs: State-owned enterprises

SRB: Single Resolution Board

SREP: Supervisory Review and Evaluation Process

SSM: Single Supervisory Mechanism

SWF: Sovereign Wealth Fund

TSOCy: Transmission System Operator of Cyprus

VAT: Value-added tax

VET: Vocational and Educational Training

EXECUTIVE SUMMARY

This report presents the findings of the third post-programme surveillance (PPS) mission of European Commission staff, in liaison with staff from the European Central Bank (ECB), which took place in Cyprus from 25 to 29 September 2017. Given that Cyprus has been identified as experiencing excessive macroeconomic imbalances under the EU Macroeconomic Imbalance Procedure (MIP), this visit also served the purpose of specific monitoring under the MIP. The mission was coordinated with an International Monetary Fund (IMF) Article IV mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System.

The economic recovery in Cyprus has gathered further strength, but sustaining growth over the medium term will require renewed reform momentum, continued fiscal discipline and acceleration in the resolution of non-performing loans (NPLs). Growth should remain strong, albeit somewhat decelerating over the medium term. It has been increasingly driven by domestic demand, while tourism remains buoyant with positive spillovers to other sectors of the economy. Labour market conditions have continued to improve, with employment increasing across sectors. The real estate market has stabilised and the construction sector is rebounding. High private sector debt, which is being reduced only gradually, continues to weigh on growth prospects. In addition, the widening of the current account deficit needs to be closely monitored given the high level of external debt.

Fiscal performance benefited from the favourable macroeconomic environment and from prudent expenditure policies, but important medium-term risks remain. Fiscal performance in the first half of 2017 was stronger than expected, mainly driven by buoyant tax revenues. Expenditure increased at a much slower pace than revenues. On this basis, the general government could record a higher primary fiscal surplus in 2017 than last year. Risks remain for the medium term, such as the uncertain fiscal impact of the recent healthcare reform and the lack of a mechanism to contain increases in the public wage bill beyond 2018. Containing expenditure growth, including in the payroll, remains essential for Cyprus to safeguard fiscal sustainability in line with the requirements of the preventive arm of the Stability and Growth Pact (SGP). If fiscal space materialises, it should be used to accelerate the reduction in the still elevated public debt and to increase public investment in productivity-enhancing projects to improve long-term growth potential.

The very high level of NPLs, albeit decreasing, remains the key vulnerability of the Cypriot economy, rendering it pressing to significantly accelerate the NPL resolution across all banks. The banking sector is showing some positive developments, notably strengthening general confidence which has contributed to the ample availability of liquidity. New lending is picking up, supported by the improving macroeconomic environment. The main issue remains the stock of NPLs, which is declining but remains high and continues to weigh on bank profitability. The recent increases in provisioning for NPLs, while welcome, have exerted further pressure on profitability in a low interest rate environment. NPLs are declining in the banking sector as a whole, but remain among the highest in the EU. NPL restructuring is becoming more challenging, highlighting difficulties in working out retail and SME loans as well as tackling strategic defaults. This also reflects the uneven efforts and success across banks to resolve NPLs in a sustainable manner, which underscores the pressing need to step up NPL resolution in banks that are lagging behind. To facilitate NPL reduction and private sector deleveraging, the authorities should increase their efforts to make insolvency and foreclosure-related legal proceedings more efficient. Swift approval of the securitisation law would help create the secondary market for loans, which could accelerate balance sheet repair. Banks need to accelerate the rationalisation of their operational model in order to shore up their currently weak underlying profitability. Moreover, it will be important to proceed swiftly with the integration of the supervisor of the pension funds and insurance companies.

Maintaining robust growth and safeguarding fiscal sustainability require a renewed commitment by all stakeholders to accelerate the structural reform momentum. The significant reform of the national healthcare system will need to be accompanied by reliable safeguards against possible cost overruns. Given its overarching impact on the functioning of the economy, a swift reform of the judiciary

is needed, including by establishing a commercial court, updating the civil procedure code and adopting legislation on improving claim enforcement. Moreover, the completion of the reform of the public administration would enhance the efficiency of the public sector and support fiscal sustainability. The authorities and other stakeholders should also make material progress in other essential areas, including the privatisation of major state-owned enterprises, the reform of the electricity market, the creation of the sovereign wealth fund and the reform of the title deeds issuance and transfer system. A more determined implementation of the action plan for growth would bring significant long term benefits as it would improve the business environment and facilitate investment.

Risks for Cyprus's capacity to service its debt to the European Stability Mechanism (ESM) remain low. Gross public debt-to-GDP stood at 107.1% at the end of 2016 and is expected to decline thereafter. Borrowing conditions for Cyprus have improved, driven also by European and global factors. Medium-term financing needs are moderate, notably due to Cyprus' active debt management, which included an early repayment of about 30% of the outstanding debt to the IMF in July 2017. Continued fiscal discipline, addressing more forcefully the high stock of NPLs and progress with growth-enhancing structural reforms, will also help consolidate and further improve investor confidence.

Although Cyprus's excessive macro-economic imbalances have started to unwind amid positive macroeconomic developments, the reform momentum needs to be strengthened. In February 2017, Cyprus was identified as experiencing excessive macroeconomic imbalances, which require specific monitoring in the context of the MIP. More precisely, Cyprus is characterised by high levels of public, private and external debt, high non-performing loans and high unemployment. These stock imbalances were reduced in 2016 and in the first half of 2017, although the new measures taken in 2017 to further facilitate the reduction of imbalances were limited in scope. Some measures were announced to accelerate private sector deleveraging and the reduction of NPLs, but uncertainties remain as to their scope and implementation horizon. Significant structural reforms remain pending to help reduce public debt, improve competitiveness and raise potential growth. More details are provided in annex 1 to this report.

The next PPS mission will take place in spring 2018.

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1. INTRODUCTION

Cyprus implemented an economic adjustment programme from April 2013 to March 2016.

The three-year programme was approved by the ECOFIN Council and the IMF Board in March 2013. The programme provided financing by the European Stability Mechanism (ESM) and the IMF of about EUR 7.8bn. Its objective was to put Cyprus' public finances back on a sustainable path, ensure financial stability, implement structural reforms to restore competitiveness, and regain international capital market access at sustainable rates.

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the third post-programme surveillance (PPS) mission to Cyprus between 25 and 29 September 2017.

The mission was coordinated with an IMF Article IV mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country having received financial assistance⁽¹⁾. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

The PPS mission included specific monitoring under the macroeconomic imbalance procedure (MIP).

In February 2017, the Commission concluded that Cyprus was experiencing excessive macroeconomic imbalances, as a very high share of non-performing loans burdens the financial sector and high stocks of private, public, and external debt hang on the economy, in the context of high unemployment and weak potential growth. Under the MIP these excessive imbalances warrant specific monitoring of the progress made with reform implementation to address these imbalances⁽²⁾. A review of the policy measures undertaken is provided in Annex 1 of this report.

⁽¹⁾ PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid.

⁽²⁾ See Communication from the Commission to the European Parliament, the Council and the Eurogroup: '<https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf>'

2. MACROECONOMIC OUTLOOK

Growth accelerates in 2017

Cyprus' real GDP growth accelerated in the first half of 2017 and is expected to reach around 3.5% for the year as a whole. In the first half of the year, the economy grew by 3.6% y-o-y, well above expectations. Real GDP growth in the first quarter was revised sharply up compared to the first estimate, to a seasonally-adjusted 3.7% y-o-y. It was followed by a nearly equally strong second quarter, when real GDP expanded by 3.5% y-o-y. Growth was driven by private and, to a lesser extent, public consumption, as well as strong investment. Private consumption benefitted from the pent-up demand, robust employment and buoyant consumer sentiment amid the ongoing recovery.

Strong investment

Investment has picked up, catching up with EU average levels. After years of subdued growth and volatile levels, gross fixed capital formation in the first half of 2017 was solid, at 19% of GDP, just below the EU average. Construction investment was particularly strong in the first half of the year, linked to the expansion of hotels, big tourism-infrastructure projects and the revival of the residential real estate market. Investment in

equipment, with ship registration featuring prominently in this category, also continued.

Worsening trade balance

Net exports decreased in the first half of the year. Net exports came out quite weak as a result of a sharp fall in gross exports (which in the first half of the year contracted by 3.5% compared to the same period of 2016) and stable imports compared to the first half of 2016. The contraction in exports was driven by the exports of goods, which fell by 22% in the first half of 2017 despite gains in competitiveness over recent years, as a result of less active ship deregistration. Exports of services were also disappointing in light of the record season in tourist arrivals, growing by 1.7% y-o-y in the first half of 2017. The latter is expected to be revised up, as data on tourism revenues show a solid improvement of 18% in the first half of the year. Imports in the first half of the year appear quite stable on a yearly basis. However, once correcting for a one-off ship registration in 2016, imports have actually grown strongly in y-o-y terms.

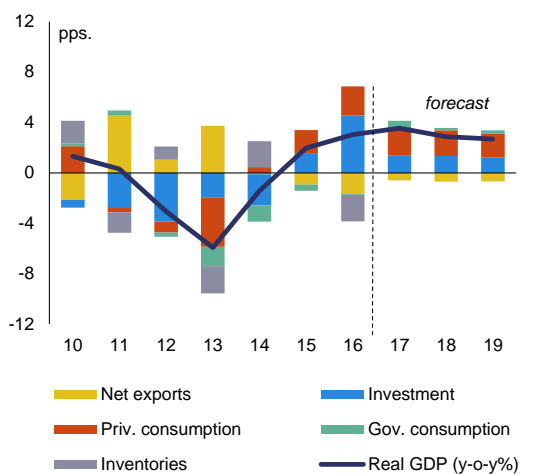
Table 2.1: **Main features of macroeconomic forecast - European Commission Autumn 2017 forecast**

| | 2016 | | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|----------------------|----------|-------|-------|-------|-------|-------|-------|
| | Curr. prices (EUR m) | % of GDP | | | | | | |
| GDP | 18.1 | 100 | -1.4 | 2.0 | 3.0 | 3.5 | 2.9 | 2.7 |
| Private consumption | 12.6 | 69.4 | 0.7 | 2.6 | 3.3 | 3.3 | 2.9 | 2.7 |
| Public consumption | 2.7 | 15.1 | -7.2 | -2.8 | -0.4 | 3.3 | 1.3 | 1.7 |
| Gross fixed capital formation | 3.2 | 17.5 | -17.5 | 13.6 | 35.0 | 7.8 | 7.3 | 6.4 |
| Exports (goods and services) | 11.8 | 65.3 | 4.2 | 6.3 | 3.9 | 2.8 | 2.2 | 2.0 |
| Imports (goods and services) | 12.0 | 66.1 | 4.6 | 8.1 | 6.6 | 3.7 | 3.2 | 2.9 |
| GNI (GDP deflator) | 17.8 | 98.4 | -0.4 | 5.5 | 1.8 | 3.5 | 2.9 | 2.7 |
| Contribution to growth: | Domestic demand | | -3.3 | 2.9 | 6.8 | 4.1 | 3.6 | 3.4 |
| | Inventories | | 2.1 | -0.1 | -2.1 | 0.0 | 0.0 | 0.0 |
| | Net exports | | -0.1 | -0.9 | -1.7 | -0.6 | -0.7 | -0.7 |
| Employment | | | -1.8 | 1.5 | 3.1 | 2.9 | 1.9 | 1.4 |
| Unemployment (1) | | | 16.1 | 15.0 | 13.0 | 11.0 | 10.0 | 9.3 |
| Compensation per employee | | | -3.6 | -1.2 | -0.8 | 1.7 | 1.5 | 1.8 |
| Unit labour costs, whole economy | | | -4.0 | -1.7 | -0.7 | 1.0 | 0.5 | 0.5 |
| Real unit labour costs | | | -2.4 | -0.5 | 0.2 | -0.2 | -0.5 | -1.1 |
| GDP deflator | | | -1.6 | -1.2 | -0.9 | 1.2 | 1.1 | 1.6 |
| Harmonised index of consumer prices | | | -0.3 | -1.5 | -1.2 | 1.0 | 1.1 | 1.4 |
| Terms of trade | | | 7.1 | 3.2 | -0.4 | -0.1 | -0.3 | 0.5 |
| Trade balance (goods and services) (2) | | | -16.0 | -16.7 | -21.3 | -23.7 | -24.6 | -25.2 |
| Current account balance (3) | | | -4.4 | -2.5 | -4.9 | -5.4 | -6.2 | -6.8 |

(1) Eurostat definition, % of labour force (2) % of GDP (3) National accounts term, % of GDP

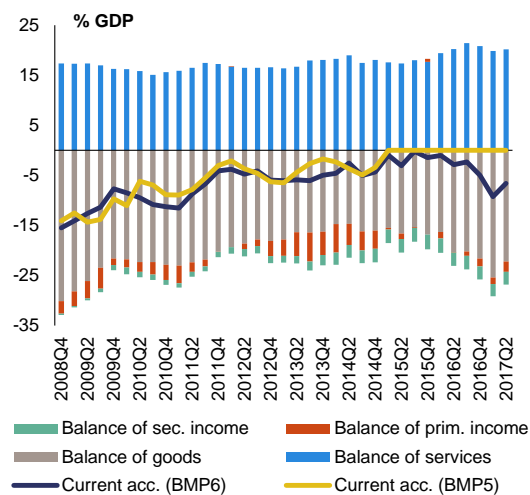
Source: European Commission

Graph 2.1: Real GDP growth and contributions



Source: European Commission

Graph 2.2: Current account developments



Source: Eurostat, ECB

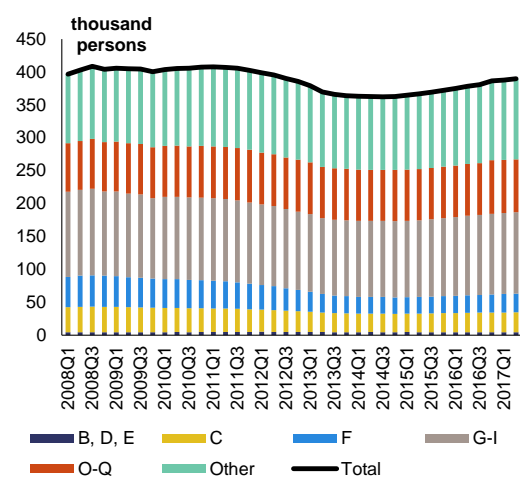
Widening external imbalances

The current account deficit is widening. This trend is driven by worsening net exports and continuously negative primary and secondary income accounts. The current account deficit widened to more than 9% of GDP in the first quarter before narrowing to 6.6% in the second quarter of 2017 (based on 4-quarter rolling sum). The record-high tourism season is likely to boost export of services in the third quarter, reducing the current account deficit. The latter, however, is likely to remain higher than the 4.9% of GDP deficit recorded in 2016. The widening of the current account deficit is partially driven by catch up in investment, which has high import content, and more generally linked to the pent-up consumption during the crisis years. As such, the widening may be of a temporary nature, but the developments warrant close monitoring. The net international investment position remains highly negative. It deteriorated in Q1 2017, but bounced back in the second quarter to an estimated -128.1% of GDP, from -127.8% of GDP at the end of 2016.

The labour market performs strongly

Job creation accelerated, with employment recording robust gains in the first half of the year. In the first quarter employment increased by 3.3% y-o-y, followed by a 3% y-o-y increase in the second. Compared to 2016, all sectors (except agriculture) increased their number of employees. The construction sector expanded most in relative terms, adding 7.4% of personnel y-o-y in the first half of 2017. In absolute numbers, the highest increases in employees early this year were recorded in the wholesale and retail trade, public administration and defence, construction, professional, scientific and technical activities and accommodation and food services.

Graph 2.3: Employment by sector



B, D, E - Industry, C - Manufacturing, F - Construction, G-I - Trade, transport, accommodation and food, O-Q - Public administration, defence

Source: Eurostat

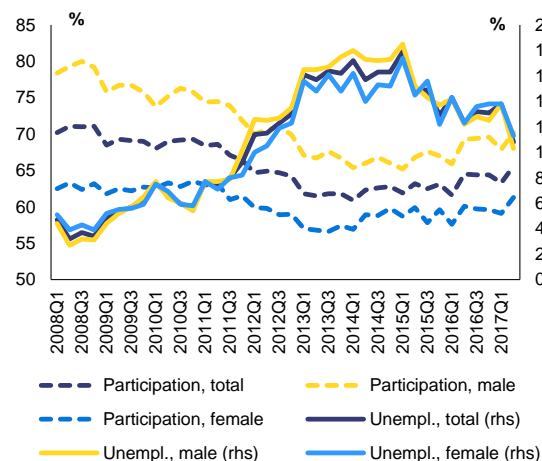
Unemployment decreased faster than expected.

The unemployment rate fell from 13.2% at the end of 2016 to 10.3% of the labour force in September 2017. Youth and long-term unemployment, while still very high, also declined to respectively 26.4% and 4.9% in Q2 2017 as construction as well as food and accommodation sectors offered many low-skilled jobs. The public administration, education sector, and other services also hired many young people early this year. Long-term unemployment, however, still accounts for almost half of the total unemployment.

Participation in the labour force is gradually increasing.

The recent fall in unemployment is even more remarkable in the context of increasing labour participation. Discouraged workers continue to come back to the labour market. This trend, however, was more prominent among the male population over recent years, while the female participation rate continues to be much lower than the rate for males. Overall participation still remains below pre-crisis levels.

Graph 2.4: Participation rate



Source: Eurostat

Wage growth is expected to be contained in the near future but to accelerate in the medium term.

The collective agreements with labour unions on public wage indexation for 2017 and 2018 have clauses that limit the rise of the total public wage bill to the nominal GDP growth. The agreement reached on public wages has an important signalling effect, as it tends to influence the outcome of private sector wage negotiations. However, upward revisions in the growth outlook for 2017 and higher expectations for 2018 may contribute to increasing wage pressures in the coming years. Early this year, as employment grew fast in the lower-paid or entry-level job categories, compensation per employee fell in all sectors, except industry and manufacturing. However, compensation per employee started increasing in the second quarter, recording a 1.1% y-o-y rise. Unit labour costs in the first half of the year followed a similar pattern, turning positive in the second quarter after a negative reading in the first, with marked differences across sectors.

Inflation remains modest

Inflation accelerated somewhat in the first half of 2017, driven nearly exclusively by energy prices and unprocessed food. Headline HICP reached 1.3% in Q2 2017. With the effect of past increases in oil prices fading away, inflation is expected to moderate in the second half of the year, leading to headline inflation of around 1% for the year as a whole. Going forward, in 2018-2019 consumer

prices are expected to increase moderately alongside solid economic growth.

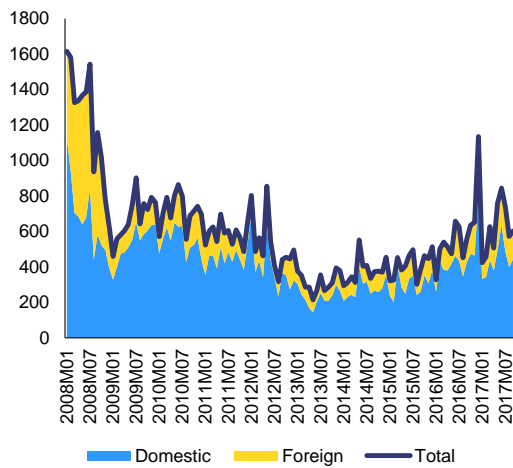
The real estate market recovers

The residential real estate market has passed the lowest point and is in recovery. The Eurostat house price index shows that house prices have been increasing on a yearly basis since the end of 2016. It recorded an annual 2.4% increase in Q1 2017 followed by a 3.6% increase in Q2 2017. A Residential property price index, compiled by the Central Bank of Cyprus, confirms this positive trend. Housing sale contracts on y-o-y basis are up by double digits in both quarters of 2017, with domestic and foreign demand strongly recovering. A number of government incentives (e.g. the citizenship scheme, the reduction in property transfer fees, the exemption from capital gains tax) have contributed to this recovery. The supply is also expected to increase as suggested by the rapid rise in building permits, particularly in the residential segment, and the sales of cement. The stock of credit for house purchases, however, continued shrinking in the first half of 2017, despite mortgage credit becoming gradually cheaper.

contribute negatively. For 2018, real GDP growth is forecast at 2.9% and for 2019 at 2.7%.

The risks to the growth outlook are broadly balanced. Downside risks mainly pertain to the still very high share of non-performing loans, the implication of low potential growth for the medium-term growth outlook, the macroeconomic prospects of the UK, one of the key trading partners of Cyprus, and possible delays in construction of tourism-linked projects. Among upside risks, buoyant confidence leading to stronger domestic demand, higher-than-expected revenues from natural gas exploration and a more pronounced EU economic recovery could spur growth more than expected.

Graph 2.5: Housing sales contracts



Source: Cystat

Solid growth outlook with balanced risks

Growth is expected to remain strong but ease somewhat in 2018 and 2019, driven by domestic demand, while net exports are expected to

3. FINANCIAL SECTOR ISSUES

3.1. BANKING SECTOR PERFORMANCE

Overall situation

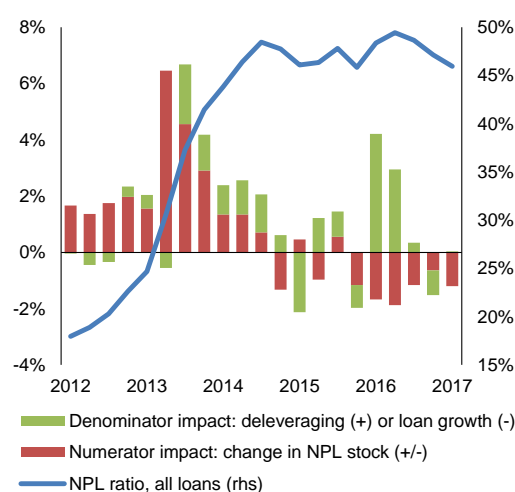
The banking sector remains characterised by a large stock of non-performing loans (NPLs) and low profitability. After having repaid Emergency Liquidity Assistance (ELA) in full in January 2017, banks continued to enjoy ample liquidity buffers, despite a net deposit outflow of about EUR 1 bn in the second quarter of 2017. The latter stemmed notably from some banks' efforts to reduce their deposit base so as to improve their net interest income. In the third quarter of the year, deposits flew back into domestic commercial banks. The locally active banks registered aggregate losses in both 2016 and the first half of 2017 due to low interest rates, balance-sheet deleveraging and especially to the increase in provisions. The banks' Common Equity Tier 1 (CET 1) ratio decreased by about 70 bps to 15% in June 2017. Progress was made with the reduction of NPLs, both in terms of volume and relative to total loans, but their very high level still poses a significant challenge to financial stability.

Asset quality

NPLs have declined but continue to remain very elevated. As of end-June 2017, NPLs stood at 45% of banks' local loans (Table 3.1). The pace of decline in the stock of NPLs has slightly slowed down (Graph 3.1). Meanwhile, the deleveraging in the aggregate banking sector appears to have come to a halt. Should this trend continue, this would lead to a mechanical improvement in the NPL ratio

via a denominator effect.

Graph 3.1: Decomposition of changes in the NPL ratio



Source: Central Bank of Cyprus

The pace of loan restructuring appears to have slowed down according to usual indicators. Part of the restructuring has been in the form of an increased use of debt-to-asset swaps (DTAS), in which a bank writes off or reduces the value of a loan in exchange for taking the ownership of the underlying collateral. However, even after including debt-to-asset swaps, the share of restructured loans in the total stock of NPLs still declined from 43.5% in June 2016 to 41.9% in March 2017, (Graph 3.1). The total stock of restructured loans, including debt-to-asset swaps, declined slightly from a total of EUR 14.4 bn in

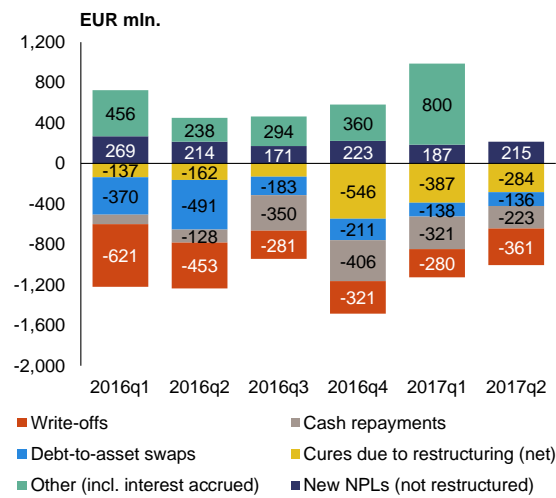
Table 3.1: Soundness indicators for the banking sector in Cyprus

| | 2012 | | 2013 | | 2014 | | 2015 | | | | 2016 | | | | 2017 | |
|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| | Dec | Dec | Dec | Dec | Mar | June | Sep | Dec | Mar | June | Sep | Dec | Mar | June | Mar | June |
| NPLs, all loans (EUR billions) | 15.6 | 26.0 | 27.3 | 27.6 | 27.0 | 27.3 | 26.7 | 25.7 | 24.7 | 24.1 | 23.8 | 23.2 | 22.4 | | | |
| NPLs, all loans (% of total) | 22.6 | 41.5 | 47.8 | 46.1 | 46.3 | 47.8 | 45.8 | 48.4 | 49.4 | 48.6 | 47.2 | 46.0 | 45.0 | | | |
| NPLs, legal entities (% of total) | | 44.4 | | | | | | | | | | | | | | |
| NPLs, loans to NFCs (% of total) | | | 58.0 | 55.8 | 55.7 | 57.0 | 56.0 | 55.1 | 58.3 | 56.9 | 56.4 | 54.4 | 52.5 | | | |
| Restructured non-performing (% of total) | | 12.5 | 23.3 | 22.4 | 24.0 | 25.3 | 25.9 | 26.3 | 27.7 | 26.9 | 25.7 | 23.7 | 22.9 | | | |
| Restructured performing (% of total) | | 12.2 | 5.3 | 5.4 | 7.9 | 7.0 | 7.5 | 7.8 | 9.1 | 9.1 | 9.4 | 9.9 | 10.6 | | | |
| NPLs, loans to households (% of total) | | 43.3 | 52.7 | 53.9 | 54.9 | 56.1 | 56.2 | 56.4 | 56.3 | 56.6 | 55.9 | 55.7 | 55.7 | | | |
| Restructured non-performing (% of total) | | 6.7 | 13.9 | 15.0 | 16.5 | 17.9 | 18.0 | 19.0 | 19.7 | 20.3 | 20.0 | 20.0 | 20.1 | | | |
| Restructured performing (% of total) | | 10.4 | 8.9 | 8.3 | 8.6 | 7.4 | 6.7 | 6.2 | 6.7 | 7.2 | 7.7 | 8.1 | 8.1 | | | |
| Coverage rate | 47.9 | 37.7 | 32.9 | 32.6 | 33.1 | 33.2 | 37.8 | 37.1 | 37.9 | 38.6 | 41.7 | 42.7 | 46.7 | | | |
| Cost-to-income ratio | 55.6 | 53.4 | 40.4 | 41.2 | 35.3 | 43.4 | 44.1 | 54.2 | 52.4 | 52.3 | 52.5 | 51.3 | 48.4 | | | |
| Net interest margin | 2.3 | 2.4 | 2.9 | 3.0 | 2.8 | 2.8 | 2.8 | 2.8 | 2.7 | 2.6 | 2.6 | 2.4 | 2.4 | | | |
| Core Tier 1 ratio | 4.5 | 12.1 | 14.2 | 14.3 | 15.1 | 15.3 | 15.6 | 15.4 | 15.7 | 16.0 | 15.9 | 15.8 | 15.0 | | | |
| Return on assets | -3.4 | -4.3 | -0.6 | 0.8 | 0.6 | 0.0 | -0.6 | 0.6 | 0.6 | 0.5 | -0.3 | -0.1 | -1.7 | | | |

Source: Central Bank of Cyprus

December 2016 to EUR 14.2 bn in March 2017. Graph 3.2 shows that cures of restructured loans have increased compared to last year. However, the performance of recently cured loans (i.e. restructured loans that recently migrated out of non-performing status) is not the main driver of the drop in NPLs.

Graph 3.2: Quarterly NPL flows



The figures are only for loans with fixed maturities, excluding revolving loan facilities such as overdrafts. The substantial rise in the "other" category in early 2017 is due to the additional provisioning charges, which increase the recognition of accrued interest on NPLs.

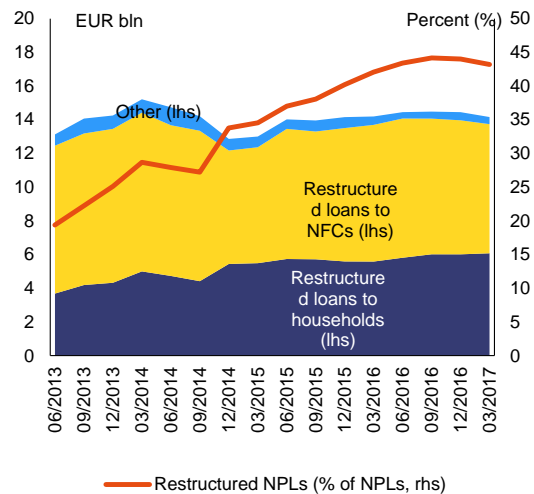
Source: Central Bank of Cyprus

The slow-down in loan restructuring reflects the limited restructuring possibilities applicable for a very sizeable portion of the NPL stock. According to the Central Bank of Cyprus' (CBC) aggregate data, around half of the fixed-term NPL stock is classified as "terminated accounts". Banks consider these cases offer no negotiation possibility, and therefore can only be resolved with collateral realisations (i.e. foreclosures or repossessions) as well as debt write-offs. However, these solutions may take substantial amount of time to legally work through, notably due to inefficient court processes, and are often costly in terms of reputation. In particular, there is political and social pressure on banks not to make use of the foreclosure framework, at least as regards the primary residences, to avoid putting households out of their homes. In addition, the drop in real estate prices over the past few years, which appears to have reached its trough, also means that these solutions could reveal net losses for the

banks, as they may not have fully updated their collateral valuations.

The sustainability of the restructuring solutions continues to be a concern, although more innovative approaches have emerged. Banks continue to resort primarily to temporary payment reductions (extension of maturity, balloon payments, capitalisation of arrears) rather than debt relief (i.e. write-offs, interest rate reduction). Meanwhile, the average default rate has increased from 12.5% at end-2016 to 14.4% in March 2017 for all fixed-term loans restructured prior to 1 January 2016. The share of *re*-restructured loans over all restructured loans also increased to 23.4% in June 2017, up from 21.6% in January 2017. Both indicators exhibit substantial variability across banks and across time, with Bank of Cyprus showing the best results. Hellenic Bank and the Cyprus Cooperative Bank have decided to set-up joint ventures with specialised debt servicers and entrust them with the full management of their NPL portfolios. Although NPLs stay on the banks' balance sheet, this approach intends to lead to a more resolute approach towards debt resolution, benefitting from the expertise and scale advantages of the loan servicers.

Graph 3.3: Evolution of loans restructuring



The figures were adjusted to take into account debt-to-asset swaps, which are included into the relevant categories of loans, i.e. NPLs and restructured loans.

Source: Central Bank of Cyprus

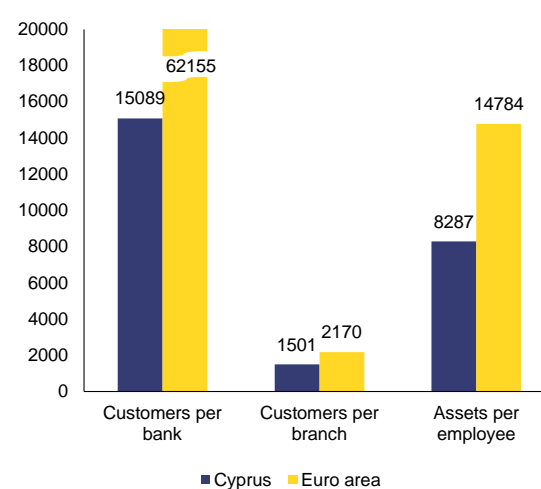
The performance of banks in meeting the loan restructuring targets set by the CBC continues to be uneven and appears to have deteriorated in the first quarter of 2017. An arrears management framework and a code of conduct for the banks were established in 2015 and targets were set to incentivise banks to accelerate the resolution of NPLs (see Table 3.2). Specific targets were set for (i) proposing sustainable restructurings; (ii) concluding sustainable restructurings; (iii) the share of restructured loans that are less than 8 days in arrears; and (iv) the cure rates for early arrears. As of March 2017, banks over-performed the target (i), i.e. proposing sustainable restructuring solutions to their clients. At the same time, the amount of concluded restructuring solutions was significantly behind target, which reflects the overall slowing down in the debt restructuring activity or an increase in restructurings and debt-for-asset swaps. In any case, the results show a deterioration compared to the previous quarter. Banks also under-performed historically with regards to targets (iii) and in particular (iv), related to the new terms of the loan conditions being met and to the curing of early arrears. Overall, these results highlight that banks have consistently made progress in meeting easier targets (namely proposing restructuring solutions), but are facing difficulties in getting lasting results.

Profitability

Profitability remained negative in the first half of 2017. The aggregate loss was reduced from about EUR 380m in 2015 to EUR 141m in 2016. Provisioning decreased by more than EUR 500 m in 2016 but net interest income dropped by EUR 325 m, keeping overall results negative. The results for the first half of 2017 point to a further deterioration in the profitability of banks relative to the same period of 2016, as the net interest margin declined from 2.76% in the first half of

2016 to 2.46% in the first half of 2017. In addition, the large increase in loan loss provisions announced by banks, notably by Bank of Cyprus, tipped the financial results into negative territory in the first half of 2017. Overall, the banks' capacity to generate profits remains under pressure in a context of low interest margins and the workout of the extremely high volume of NPLs.

Graph 3.4: Capacity indicators for Cypriot banks



Source: Central Bank of Cyprus, European Central Bank

Increased provisioning reduces profits directly but also indirectly by limiting banks' ability to register income on NPLs. Interest revenue was overestimated in recent years as some banks register accrued interest income on non-provisioned NPLs. Therefore, under-provisioning allows banks to register profits without the corresponding cash inflow, and to prop up their net interest margin, which is under pressure from the low interest rates environment. It also cosmetically lowers the cost-to-income ratio, an indicator typically used to measure efficiency in the banking sector. Supervisory pressure, notably through the

Table 3.2: Loan restructuring targets and actual performance

| Indicators | 2015 | | | | | 2016 | | | | | | | | 2017 | | | | | |
|---|-------------|-------------|------------|------------|------------|------------|------------|-------------|-------------|------------|------------|------------|------------|------------|------------|-------------|-------------|------------|------------|
| | June actual | June target | Sep actual | Sep target | Dec actual | Mar target | Mar actual | June target | June actual | Sep target | Sep actual | Dec target | Dec actual | Mar target | Mar actual | June target | June actual | Sep target | Sep actual |
| (1) Proposed solutions (%) (non-cumulative) | 6.1 | 9.4 | 6.3 | 12.5 | 13.3 | 11.6 | 14.9 | 14.8 | 25.4 | 14.6 | 18.7 | 15.0 | 21.8 | 14.6 | 16.7 | 14.7 | 14.4 | | |
| (2) Concluded solutions (%) (non-cumulative) | 4.7 | 7.5 | 6.6 | 11.6 | 13.0 | 11.1 | 11.9 | 15.2 | 16.2 | 15.0 | 10.2 | 15.2 | 11.3 | 15.1 | 7.2 | 15.1 | 14.4 | | |
| (3) Terms-being-met (%) (cumulative since Jan 2014) | 65.8 | 66.5 | 69.8 | 72.9 | 69.9 | 71.7 | 69.0 | 72.4 | 72.4 | 72.4 | 72.7 | 72.2 | 71.9 | 72.2 | 68.7 | 71.9 | 71.9 | | |
| (4) Early-arrears cured (%) (non-cumulative) | 28.1 | 27.8 | 31.2 | 40.0 | 38.6 | 40.0 | 35.5 | 43.2 | 35.8 | 43.9 | 41.4 | 44.1 | 42.9 | 44.5 | 33.3 | 43.8 | 43.8 | | |

Source: Central Bank of Cyprus

Single Supervisory Mechanism (SSM) Supervisory Review and Evaluation Processes (SREP), led to an increase in the provisioning coverage of NPLs from about 33% at end 2014 to 38% at end 2015, 42% at end-2016 and to 46.7% as of June 2017. Provisioning is now comparable with the EU averages and should reflect more accurately the real value of the real estate collateral. The improved average coverage ratio also masks some stark 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 provisioning coverage ratios, also considering that about half of the stock of NPLs consists of terminated accounts, for which the valuation of collateral might not fully reflect market prices.

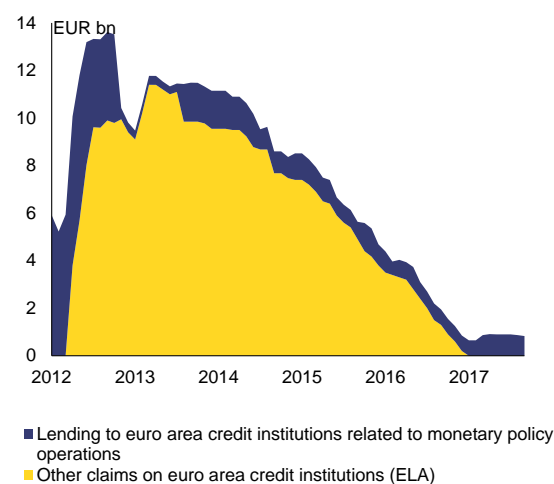
Banks should improve their profitability by reducing operating expenses. The largest Cypriot banks made progress in reducing their number of branches and employees, but still remain oversized according to several indicators. Due to the on-going deleveraging process, the amount of customers and assets per branch or employee in Cyprus is significantly lower than the Euro Area average (Graph 3.4). This suggests that there is still room to rationalise the functioning of Cypriot banks, for instance by increasing the digitalisation of operations and the supply of online banking products and by down-sizing loss-making units. Banks could also diversify the range of services they offer in order to attract new business.

Capitalisation and liquidity

The Common Equity Tier 1 (CET1) capital ratio of all banks declined to 15% in June 2017 from 15.7% a year before, and remains vulnerable to further loss recognition. The overall solvency ratio decreased from 17.5% in March 2017 to 16.4% in June 2017. The CET1 ratio is still higher than the EU average of around 13%, but this reflects the large uncertainty associated with the high ratio of impaired loans. While it is notable that the capital ratios did not decline in 2015 and 2016 despite negative financial results, NPL workout has started to take a toll on the banks' capital buffers. Banks which are more advanced in terms of balance-sheet clean-up have seen their CET decline well below average. If banks continue to increase their provisioning levels and to recognise losses, maintaining current

capitalisation is likely to prove challenging. Therefore some of the largest banks are planning to issue additional capital in order to strengthen their capital buffers as a prerequisite to achieve their NPLs reduction targets.

Graph 3.5: Borrowing from the Eurosystem



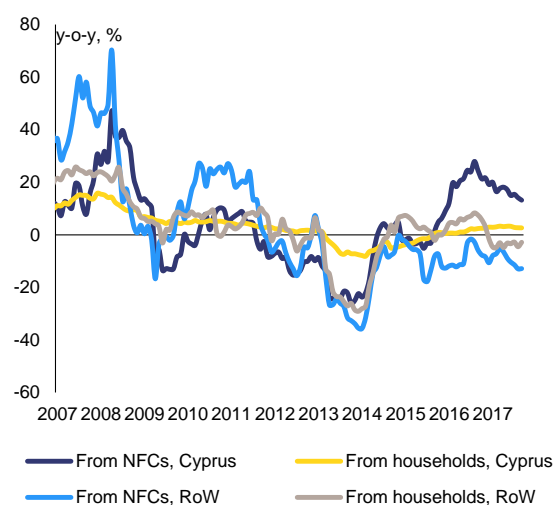
Source: Central Bank of Cyprus

Banks' reliance on central bank funding stabilised at EUR 0.8 bn. On a yearly basis, total reliance on central bank funding was reduced by EUR 1.1 bn (Graph 3.5). The Emergency Liquidity Assistance (ELA) funding in particular has been fully repaid in January 2017, from a peak of EUR 11.4 bn in March 2013. Deposits from residents continued to increase, especially among the corporates (Graph 3.6). The Central Bank of Cyprus has asked for a one-year postponement of the implementation of new Capital Requirements Regulation (CRR) liquidity requirements. This request aims at facilitating the phase-out of the stricter current national liquidity requirements.

New lending is gradually recovering, supported by growing demand for loans. The gross volume of new loans to domestic residents has increased in the first half of 2017 to EUR 1.4bn, albeit from a very low base of EUR 890 m in H1 2016. The bank lending survey showed that credit standards for loans to both businesses and households remained unchanged for several quarters despite growing demand for loans. At the same time, the terms and conditions for loans improved, as banks reduced their interest margins. 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. In this context, it is essential to preserve prudent lending standards and continue improving loan origination procedures.

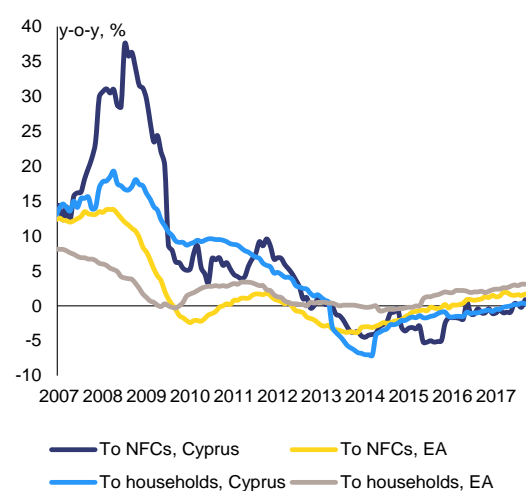
Graph 3.6: Deposits developments



Source: Central Bank of Cyprus

The deleveraging process has bottomed-out. The stock of loans to domestic non-financial corporates and households remained relatively flat on a year-on-year basis, as of August 2017 (Graph 3.7), despite the pick-up in new lending. This partly reflects the growing use of debt-to-asset swaps and debt write-offs by banks in order to restructure their non-performing exposures, which reduce the stock of credit. At the same time, the accrual of unpaid interest on NPLs might understate the downsizing of loan exposures, since capitalised interest payments appear in the statistics as an increase in loans outstanding. Thus, the evolution of the credit stock is indicative of the balance sheet clean-up, while masking a pick-up in new lending.

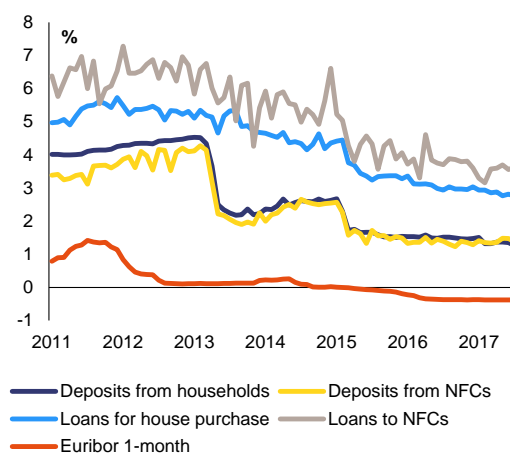
Graph 3.7: Lending growth developments



Source: Central Bank of Cyprus, European Central Bank

The decline of interest rates is bottoming out, both on deposits and loans. In 2015 the CBC narrowed the maximum spread between Libor and the deposit interest rates that banks can offer from 300 to 200 basis points. This action resulted in a sharp decline of both deposit and lending rates, and in particular of the latter, which put additional pressure on the banks' net interest income. As of July 2017, interest rates stabilised for deposits but continued to decline for loans (Graph 3.8).

Graph 3.8: Interest rates developments



Source: Central Bank of Cyprus

3.2. BROADER FINANCIAL SECTOR DEVELOPMENTS

Regulatory and supervisory developments

In recent years, the authorities have ensured a good degree of compliance with the EU supervisory framework and regulatory reform.

Most recently, the regulation on loan impairment and provisioning effectively put in place the IAS-39 provisioning standards while paving the way for the upcoming IFRS-9 rules where forward-looking losses can also be addressed.⁽³⁾ Banks with sizeable legacy issues and those that rely heavily on loan restructuring are likely to face higher additional provisioning charges. In turn, the relatively strong underlying economic conditions are likely to serve as an offsetting factor. In 2017, the SSM and the Central Bank of Cyprus have required additional provisioning buffers to be built, partly in preparation for the gradual introduction of the IFRS-9.

The CBC designated six credit institutions and four investment firms as O-SII⁽⁴⁾s. The imposed capital buffers (to be phased-in over 2019-2022) range from 0.5% (Alpha Bank and Eurobank), to 1% (Hellenic and the Cyprus Cooperative Bank), 1.5% (Russian Commercial Bank) and 2% (Bank of Cyprus). The CBC introduced a counter-cyclical capital buffer in 2016, but has left it at 0% since then.

As regards new legal initiatives, the draft securitisation law is awaiting approval by the Government before a public consultation. One amendment has been incorporated to give borrowers more flexibility when setting-off assets and liabilities in the event of bank liquidation. Moreover, the draft law, much like the foreclosure and loan sales framework, requires the originator to engage with the borrower prior to the inclusion of his or her loan into the securitisation pool.

⁽³⁾ The International Financial Reporting Standard (IFRS) 9 will be the new accounting standard for financial instruments, replacing the current IAS39 from January 1, 2018. It will have a significant impact on banks especially in impairment methodology, as the focus on expected credit losses will require banks to recognize their losses earlier.

⁽⁴⁾ Other Systemically Important Institutions

Measures should be taken to allow the emergence of a secondary market for NPLs.

Despite the introduction of a new legislative framework in 2015, the secondary market for NPLs has not emerged. This is due to various reasons, notably burdensome administrative requirements placed on potential loan buyers, the lack of established independent debt servicers, and difficulties in enforcing contracts and justice decisions. While the increased use of loan servicers may ultimately incentivise loan sales, the use of the foreclosure framework remains very limited, therefore deterring potential buyers. The total market value of properties for which a notification of an intention to sell has been served was EUR 622 m between June 2016 and June 2017. This represents roughly 6% of the NPLs deemed as "terminated accounts". The market value of properties sold through auctions within the same period was much lower, totalling only to EUR 6.4 m.

Following the EIOPA study, work has continued on the integration of the pension fund and insurance supervisors.

The first draft of the legal framework for an independent body was submitted to the Ministry of Finance. The authorities are giving particular attention to ensuring that transfer of staff fully protects current rights and career prospects. With respect to provident pension funds, a working group was set up to study how to reform the currently very fragmented system where each economic sector had its own arrangements concerning contributions and investment policy. The authorities intend to create a universal Pillar 2 System for both the public and private sectors, with harmonised contribution rates and where accumulated funds are managed privately.

Restructuring the banking sector ⁽⁵⁾

Bank of Cyprus (BoC) has materially improved its key performance indicators.

The bank reduced its stock of NPLs by EUR 1.2 bn, or around 11%, in the first half of 2017, adding to the consistent progress made over the past two years. Most of the reduction was possible due to the

⁽⁵⁾ Bank of Cyprus was subject to a restructuring plan during the economic adjustment programme, whereas the CCB agreed to implement a restructuring plan as a condition for receiving State aid in 2014 and 2015.

Table 3.3: Key performance indicators for Bank of Cyprus and the Cyprus Cooperative Bank

| Category | Key performance indicators | Bank of Cyprus | | | Cooperative Group | | |
|---------------|--------------------------------------|------------------|------------------|----------------------|-------------------|-----------|---------------------|
| | | Dec 2016 | June 2017 | Medium-term targets | Dec 2016 | June 2017 | Medium-term targets |
| Asset quality | Non-performing loans (% of loans) | 55% ¹ | 50% ¹ | < 30% ¹ | 60% | 60% | |
| | 90 days past due loans (% of loans) | 41% | 39% | < 20% | 47% | 48% | |
| | Non-performing loans coverage | 41% | 48% | > 50% | 45% | 47% | |
| | Provisioning charge (% of loans) | 1.7% | 4.2% | < 1.0% | 3.0% | 1.0% | < 2.0% |
| Funding | Net loans to deposit ratio | 95% | 90% | 90 - 110% | 70% | 70% | < 85.0% |
| Capital | Common equity tier 1 | 14.5% | 12.3% | > 13.0% ² | 15.4% | 15.5% | > 15.0% |
| | Net interest margin | 3.5% | 3.4% | ~ 3.0% | 2.1% | 1.9% | > 2.0 % |
| | Fees & commissions (% of net income) | 17% | 19% | > 20% | | | |
| Efficiency | Cost-to-income ratio | 41% | 46% | 40-45% | 50% | 49% | < 50% |
| | Number of branches | | | | 246 | 243 | 200 |
| | Number of employees | | | | 2,677 | 2,668 | 2,700 |

Source: Bank of Cyprus and the Management Unit of the Ministry of Finance for the Cyprus Cooperative Bank

curing of restructured loans, whose sustainability continues to be a concern. Meanwhile, the volume of consensual foreclosures involving debt-to-asset swaps has declined. The bank has increased sales of foreclosed assets in the first half of 2017, surpassing the total sales for 2016, but the overall amount remains low. Together with the slow-down in deleveraging, the recent reduction in NPL stock brought the NPL ratio down from 55% at end-2016 to 50% as of June 2017. The bank's capital ratio has declined substantially, mostly due to additional provisioning of EUR 650 m in the first half of 2017. Following the SSM SREP guidance to reflect better the actual time to recovery and average haircuts on recovered assets, the additional provisioning brought the bank's NPL coverage ratio to 48%. This additional provisioning has also contributed to the reduction in the bank's net loans to deposit ratio, down from 95% in end-2016 to 90% in June 2017.

The Cyprus Cooperative Bank (CCB) has been much less successful in tackling NPLs so far. The volume of NPLs has remained almost constant from end-2014 to June 2017. Meanwhile, the NPL ratio has inched up to 60% partly as a result of the bank's deleveraging over the past years. In July and August 2017, the bank has accelerated loan write-offs, which will lower the NPLs ratio but also the provisioning coverage ratio. The arrears management unit of the bank has undertaken a significant volume of restructurings since December 2014, but this has not materialised in a reduction of NPLs due to the poor quality of

restructuring solutions and a high rate of re-defaults. Moreover, the bank capitalises interest on NPLs in its stock, which contributes to increase NPLs mechanically. The bank's new lending activity is picking up only slowly and cannot provide a channel to utilise the bank's large liquidity which is deposited at the Central Bank.

The CCB has made some progress in its operational restructuring efforts. The legal merger implemented in July 2017 consolidated the 18 Cooperative Credit Institutions with the Central Cooperative Bank. From a legal and regulatory standpoint, the Cyprus Cooperative Bank has become a regular bank. In June 2017, the bank revised its NPL strategy, to substantially cut down costs and NPLs over the next five years. This strategy is focused on the regular banking activity and the NPL management. The bank expects to significantly accelerate the reduction in the stock of NPLs by 2022. To achieve this, the bank has entered into a joint venture in June 2017 with the Spanish loan servicer Altamira, which will be entrusted with the management of the NPLs portfolio. At the same time, the bank intends to down-size, reducing both the number of branches and the level of staff, notably through a voluntary retirement scheme. In parallel to the formulation of the new strategy, the Cypriot government has declared its intention to reduce its share of ownership in the CCB by at least 25% by attracting a strategic investor, which would bring fresh capital to the bank and dilute the State's shareholding. The CCB hired an international

investment bank (Citigroup) to assist in the planned capital increase.

The resolution of Laiki is making progress. Over the past six months, two subsidiaries of Laiki were successfully sold (Serbia, Ukraine). The resolution authority also sold half of Laiki's shares in BoC in May 2017 and will sell the remainder when the opportunity arises, as market conditions worsened after BoC took additional provisions. The sale of Laiki's former Romanian subsidiary is pending the approval Romanian authorities. Laiki's Maltese and Greek subsidiaries remain to be sold.

The liquidation of the Cypriot branch of FBME is progressing but may be delayed due to international legal challenges. The Cypriot Deposit Guarantee Scheme (DGS) has started making payments to FBME's eligible depositors, although by April 2017 only a total of 1 300 claims were received out of a potential 6 500. The overall liquidation process has been halted by a Court injunction upon the request of a Tanzanian senior bond holder claiming that the liquidation should take place in Tanzania. Furthermore, a Cypriot court rejected the CBC's request to put the bank under liquidation. Thus, it is likely that the liquidation will take place after the deposit insurance payments.

Legal framework for private debt restructuring

The use of the new corporate and personal insolvency processes remains limited. Updated rules of court for corporate insolvency remain necessary for the insolvency framework to be fully effective. Banks have a major responsibility to make full use of the new tools to help address the very high level of NPLs and offer sustainable restructuring solutions to clients who do not have a sufficient repayment capacity. This implies more efforts to inform insolvent borrowers and other stakeholders of the possibilities offered by the insolvency and pre-insolvency mechanisms. This would also require banks' more active participation to insolvency proceedings within the framework of loan restructuring.

The Insolvency Service of Cyprus started operating in June 2015 but needs more resources. There is an intention to establish the Service as an independent organisation. While the Service has received additional resources to

improve its performance (staff, IT), it needs to be further strengthened in order to properly carry out its tasks. It has made significant efforts to publicise the new insolvency framework yet debtor awareness appears insufficient and thus further steps to improve this situation are urgently needed.

Additional efforts are necessary to identify and remove impediments to the effective application of the insolvency framework. Under the leadership of the Ministry of Energy, Commerce, Industry and Tourism (MECIT), a working group was created with relevant stakeholders (Central Bank, Ministries of Finance and Interior) to review the implementation and performance of the insolvency framework to ensure that it supports its objectives and principles. However, this working group only meets on an occasional basis and does not plan to release recommendations before the end of 2018. A more forceful approach from the authorities appears warranted to ensure that insolvency proceedings fully play their role in reallocating resources across the economy.

Use of the foreclosure framework needs to be significantly increased. Foreclosure auctions under the new legislation started only in June 2016 and have proved rather unsuccessful as the majority did not attract satisfactory bids. Despite a clear pickup in foreclosure notices, in the first half of 2017, only 42 properties were sold. A majority of foreclosure notice and auctions are aimed at plots of lands as these are less sensitive than primary residences. Banks have so far used the foreclosure tool mainly as a way to improve the payment discipline of borrowers via a signalling effect rather than as a primary way to collect outstanding debts. Correcting some of the deficiencies built in the foreclosure legislation would also help banks use this tool. This would notably involve lowering the reserve price for the first auction (currently 80% of the book value), facilitating the foreclosure notice service, or better defining the obligations of guarantors. In addition, the foreclosure law should be amended to ensure that the framework also applies to cases affected by a court ruling based on the previous legislation. Overall, a more forceful use of the foreclosure framework, notably towards residential and commercial properties, would provide greater incentives for strategic defaulters to agree to a loan restructuring.

Initiatives are underway to modernise legal procedures and increase the efficiency of the new frameworks. The Supreme Court adopted new Rules of Court for personal insolvency but the drafting of Rules for corporate insolvency is still pending. Amendments to the Civil Procedure law have been proposed to improve the efficiency of court applications, facilitate the enforcement of court decisions and enhance the financial information available to Courts and enforcement agents. Their adoption would facilitate contract enforcement and have a beneficial impact on the business environment. More broadly, the comprehensive reform of the justice system would contribute to a more efficient application of the insolvency and foreclosure frameworks.

The reform of the system of title deeds transfers is still pending. A substantial number of property buyers, despite having paid the full purchase price, still have not yet received their title deed. The adoption of the legacy cases law (for property sales up to end of 2014) created some momentum. Out of the 14 628 applications received as of end September 2017 linked to legacy cases, 6 683 title deeds were issued which led to almost 3 000 transfers of titles. This progress is notably due to sustained efforts by the Department of Land and Surveys, including website information, training, and an instruction manual sent to all relevant staff. There is some uncertainty as to the constitutionality of the Legacy law, on which the Supreme Court is expected to rule following contradictory court rulings issued by lower courts. Until a final ruling is issued, the authorities will continue to apply the law, although amendments are under consideration to improve the legacy law.

A reliable new system for the transfer of future title deeds is yet to be designed. There is general agreement that a future system should ensure that buyers who pay the full purchase price will get their titles quickly and have no possibility to refuse them (for example to avoid paying overdue taxes). Progress is slow on this issue due to its political sensitivity, although the authorities remain committed to design a reliable legal framework in the coming months.

There is still considerable work to be done to address the backlog of issuance of new title deeds. At the current rate of title deeds issuance, it would take about seven years to address the backlog of unissued title deeds (about 28 000 titles were pending as of September 2017). However, the Ministry of Interior has announced measures towards the streamlining of procedures underlying the issuance of title deeds, notably through technical assistance provided by the European Commission. Measures were taken to assist the issuance and, thus, the transfer of title deeds where relatively minor breeches of planning conditions have occurred. The main bottleneck preventing a faster issuance of title deeds appears to be the municipalities' uneven ability to face their obligations, notably regarding the issuance of certificates of approval, which are required to finalise the issuance of title deeds. The source of the problem might be solved in the long term through the proposed reform of local governments, but more immediate actions by municipalities are warranted. The creation of a working group is notably under consideration to identify cases where minor deviations from the original building permits could be tolerated, thus allowing the issuance of title deeds.

4. BUDGETARY OUTLOOK AND FISCAL POLICY STANCE

4.1. FISCAL PERFORMANCE

Cyprus' fiscal performance in the first eight months of 2017 was significantly stronger than in the previous year. The general government balance reached a surplus of 2.3% of GDP from January to August 2017, up from 0.1% of GDP in the same period of the previous year. The primary surplus increased to 4.2% of GDP from 1.9% of GDP the year before. The better-than-anticipated labour market developments and private consumption contributed to the revenue over-performance (13.1% y-o-y growth), with a surge in indirect and direct tax revenue (i.e. VAT receipts, corporate and income taxes) and social security contributions. Total expenditures also increased, albeit at a much slower pace (3.2% y-o-y growth). This was mainly due to a rise in intermediate consumption (i.e. medical, water and energy supplies), compensation of employees (i.e. hiring of additional personnel for security forces), gross fixed capital formation and social transfers.

For the entire year 2017, the Commission expects the primary balance to increase, underpinned by the favourable macroeconomic environment and one-off revenues. Based on the Commission autumn forecast, the primary balance is projected to reach 3.5% of GDP in 2017. The high revenue collection is expected to offset the impact of expansionary fiscal measures, such as the abolition of the immovable property tax, the termination of the temporary wage levy and the additional hiring of soldiers in 2017. Furthermore, the government's signature of gas exploration licenses for a three-year period is set to positively contribute to the rise in revenue in 2017-2019, with a one-off signature fee amounting approximately to 0.2pps of GDP each of these years. There are however uncertainties related to the execution pattern of intermediate consumption and capital spending towards the end of the year.

4.2. FISCAL OUTLOOK

Looking forward, the fiscal performance is projected to maintain sizeable budgetary surpluses. The Commission autumn forecast projects a general government headline surplus of 1.4% of GDP and a primary surplus of 3.6% of

GDP in 2018. Both headline and primary balances are expected to increase further to 1.9% of GDP and 3.9% of GDP in 2019, respectively, on account of an increase in social security contributions (amounting to 0.4% of GDP).⁽⁶⁾

Growing pressures to raise public expenditure and recently adopted measures give rise to some concerns in the medium term. The reform of the healthcare system might create additional budgetary pressure in the coming years. For instance, during the transitory period of five years, when the financial and operational autonomy of public hospitals is being established, the government will cover possible cost overruns.⁽⁷⁾ Furthermore, the absence of a permanent mechanism containing public-sector wage growth and of a mechanism specifying emoluments for all public sector positions may further loosen the fiscal stance in Cyprus.⁽⁸⁾ The collective agreement that limits public sector wage growth to the nominal GDP growth expires in 2018. Finally, despite its expected limited fiscal impact, the government's decision to compensate members of provident funds for the 2013 bail-in losses⁽⁹⁾ creates a precedent for other groups to make similar claims, therefore creating additional medium and long term fiscal risks.

The government is facing the challenge of balancing pressures for fiscal relaxation with prudent fiscal management. Since the end of the economic adjustment programme, the government

⁽⁶⁾ Pursuant to the pension system reforms of 2008-2012, social contribution rates for employers and employees are set to increase by 1 pps of insurable earnings in 2019.

⁽⁷⁾ The National Health System will be financed by contributions from employers and employees, starting in March 2019. Such contributions will initially cover only outpatient care. One year later the contributions will increase and cover both outpatient and inpatient care. The government has also commissioned a study on the fiscal and economic impact of the reform, which is expected to be delivered by the end of 2017.

⁽⁸⁾ In addition, the Fiscal Council has raised concerns about the need to establish an appropriate mechanism specifying emoluments for each position within the public sector, which would justify the granting of pay rises.

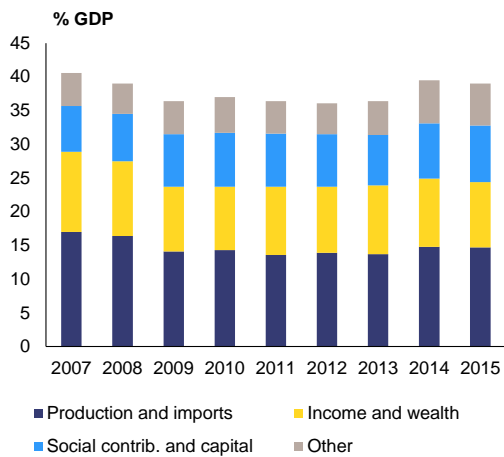
⁽⁹⁾ This measure is aimed to gradually compensate members of provident funds in order to reduce the 2013 bail-in losses from 50% to 25%. The first compensational scheme was implemented in 2013-2014, amounting to EUR 300 million. This is the second compensational scheme, estimated to cost EUR 166 million over 40 years, as beneficiaries will only be refunded once reaching their pension age. The provision for 2018 is EUR 7.5 million.

has continued fiscal consolidation. Pressures for fiscal relaxation pose challenges for fiscal policy makers, notably given the need for growth-enhancing public investment to improve long-term growth potential. Indeed, public investment in Cyprus is below the EU average, as it was significantly reduced during the crisis. Future resource allocation could therefore prioritise public investment towards more long-term productivity-enhancing projects, for example investment in R&D, while ensuring sound public finance and continuing the deleveraging trend. Regarding revenue, the tax structure in Cyprus is relatively growth-friendly, given that the most distortionary taxes on labour and capital are among the lowest in the EU. At the same time, a significant share of corporate tax revenue stems from Cyprus' ability to attract companies setting up business, partly due to its favourable tax regime. This revenue is however subject to risks as these companies may easily change tax residence if more attractive conditions are offered elsewhere. The volatile nature of this source of government revenue should be taken into account in order to maintain a prudent fiscal policy.

(MTO) of a balanced position. A new assessment of the planned structural adjustment towards the MTO in 2017 and 2018 will be done on the basis of the Draft Budgetary Plan for 2018 and the Commission 2017 autumn forecast. In the medium term, the authorities' commitment to prudent budget execution should be continued in order to achieve the fiscal targets in line with the SGP. Spending control remains key in the coming years in order to ensure a balanced budget in structural terms.

Public debt is forecast to decline to 93.9% of GDP in 2019. This debt path reflects expected sizeable fiscal primary surpluses, combined with favourable debt dynamics mostly due to strong nominal growth. However, a faster reduction of government debt would make Cyprus less vulnerable to future economic shocks by creating the necessary fiscal space (see Section 6 on Sovereign Financing and Capacity to Repay).

Graph 4.1: Tax revenue contributions



Source: Eurostat

Cyprus' compliance with the Stability and Growth Pact (SGP) will be essential to preserving the credibility of fiscal policy. Based on the Commission 2017 autumn forecast, the structural balance is expected to be in surplus in 2017 and above its Medium Term Objective

5. STRUCTURAL ISSUES

5.1. FISCAL-STRUCTURAL REFORMS

Public financial management and budgetary framework

Some progress has been made concerning the implementation of the fiscal framework and public investment management. The secondary legislation for the Fiscal Responsibility and Budgetary Systems Law (FRBSL) is being implemented. This legislation lays down, inter alia, procedures for budget preparation, requirements for within-year budgetary adjustments, and the responsibilities of commitment control officers. Limited progress was made to improve public investment management, with the current efforts being limited to building administrative capacity in key institutions by providing specific guidance, training programmes and acquiring IT management systems.

State-owned enterprises

The implementation of the privatisation plan is by-and-large at a standstill. The privatisation plan aims to improve economic efficiency, attract investment in Cyprus and reduce public debt. Since the House of Representatives rejected budgetary appropriations earmarked for privatisation projects in the budget for 2017, the government effectively dismantled its privatisation unit and cancelled decrees placing the Cyprus Telecom Authority (CyTA) and the Cyprus Stock Exchange (CSE) under privatisation. Only minor privatisation projects remain active, while the House of Representatives exerts close scrutiny of any progress made on these files. The lack of progress regarding privatisation also exposes the state to contingent liabilities due to the weakening competitiveness of public companies such as CyTA.

In July 2017, the House of Representatives adopted a law abrogating the legal framework for privatisation. This abrogation was referred by the President of the Republic to the Supreme Court as unconstitutional, and therefore remains inapplicable. Such an abrogation would send a negative signal to investors, as the existing privatisation law, which was adopted during the programme, provides for a transparent and

predictable framework for privatisation, including by identifying the objectives that must be pursued by these transactions. Should this law be abolished, privatisation would occur on an ad-hoc basis, with fewer guarantees as to the proper management of the process.

Despite the recent setback, the Government still envisages the corporatisation of the Cyprus Telecommunications Authority (CyTA). The Government withdrew in May 2016 its legislative proposal for the privatisation of CyTA due to strong political opposition. The proposal aimed at fulfilling the necessary prerequisites for launching the privatisation process, namely turning CyTA into a Limited Liability Company, setting the future employment rights of CyTA employees, and identifying key national security requirements. These steps remain necessary for any privatisation of CyTA. The Government still contemplates submitting an updated legislative proposal to corporatize CyTA, notably excluding the sale of a majority share of capital to private investors.

No notable progress was made regarding the privatisation of other assets. The sale of land assets is not likely to go ahead as planned, as the authorities are instead contemplating alternative solutions to extract economic value from unused property assets. The privatisation processes of the National Lottery and of the Troodos residences are progressing slowly. A study was commissioned to establish a long term strategy for the Cyprus Stock Exchange, which might lead to its eventual privatisation.

The law on the State-Owned Enterprises' (SOEs) corporate governance has still not been adopted. The law aims at improving the corporate governance of SOEs to ensure a more effective monitoring of their functioning by moving away from exclusive current budget reporting and monitoring to a broader economic and financial performance framework. The law has been submitted for discussion at the Economic and Financial Parliamentary Committee in early April 2015. Even though the law specifically applies to companies not intended for privatisation, it has been nevertheless associated by the stakeholders as part of the wider privatisation strategy. The delays in the adoption of the SOEs law are ultimately damaging the efficiency of the public sector, as the

governance of SOEs needs to be improved and the SOE-related fiscal risks need to be mitigated.

Revenue administration

The reform of the revenue administration is facing delays. The single tax registration process is completed for direct and indirect taxes, which now share common procedures. However, the integration of the debt collection function is facing delays. The tender procedure for a new IT system is ongoing and is expected to be completed in 2018, but the full deployment of the new system is estimated to take several years. Therefore, the current online system is being upgraded to improve performance in the transition phase (e.g. allowing for online debt payments). The Tax Procedure Code has been drafted and is expected to be adopted in 2018.

Public administration reforms

The horizontal reform of public administration should remain a priority. The Government intends to submit to the House of Representatives revised drafts of the public administration reform bills, which were rejected in December 2016. The draft laws will provide, inter alia, for a more modern appraisal system through written exams and interviews, and aim to improve the promotion system by opening promotion posts to all qualified candidates, and by linking further merit and promotion. A mechanism safeguarding the fiscal sustainability of the wage bill, including both the compensation and the number of public employees, was included in a collective agreement between the Government and labour unions, in force until end-2018. In addition, a law aiming to incentivise staff mobility and enhance staff redeployment rules was adopted in May 2017. This is expected to significantly facilitate resource allocation within the public administration. Nevertheless, the pace of reform in the public administration needs to accelerate in order to lower risk for public finance sustainability over the medium- and long-term.

The reform of line ministries has started following the completion of the reviews. Implementation of specific reform plans has started in the ministries of agriculture and education. The ministries of foreign affairs, defence as well as justice and public order have

started to implement reforms in 2017, on the basis of the functional reviews undertaken during the programme.

The reform of local governments has not made progress. The draft bill on local governments has not been approved by the House of Representatives and the implementation deadlines remain vague. The local government reform affects the delivery of local public services, and could notably improve the issuance of title deeds by streamlining the issuance of building permits and certificates. The reform could also improve public finance management since it foresees the implementation of a common accounting and reporting framework for all local government.

Reform of the welfare system

The electronic management of the Guaranteed Minimum Income Scheme (GMI) is in place. Cyprus has put in place an effective electronic management system comprising a comprehensive database where all applications are recorded and information can be cross-checked from different sources, including population registries, the land registry, car registrations, social security records, and banks. On the basis of all information recorded and the parameters defined in the legislation, the system automatically accepts or rejects applications. Appeals are subsequently considered by the system if supported by relevant information. All payments are also processed automatically through the system, and different reports and certifications can be produced. It is now possible to track different types of benefits paid to a single household. Student grants and housing benefits granted to refugees have not been integrated into the central registry but their registries can be cross-checked against the central one.

The new GMI scheme has been comprehensively rolled out. By September 2017, about 28,000 households benefitted from the GMI, or about 48,000 individuals. Of the latter, about 14,000 were beneficiaries from the previous public assistance system. There were 300 new applications per month on average in 2016 but half of them relate to re-submissions. In specific cases, the social welfare services may also refer GMI beneficiaries for social intervention.

A study of the new GMI scheme's impact on poverty will be produced by the Cyprus authorities based on the 2016 EU Statistics on Income and Living Conditions (SILC) data. The latest preliminary figures on the at-risk of poverty, the poverty gap and the impact of social benefits on poverty reduction for 2016 suggest that there was a large positive effect of the introduction of the GMI scheme on poverty reduction. More efforts are being done to encourage employment for GMI participants who are able to work as registration with the public employment service (PES) is made compulsory for GMI participants and targeted ALMPs have been launched in October 2017 with the aim to active some 2500 GMI recipients.

The cost of GMI is expected to decrease slightly. The fiscal cost of GMI amounted to around EUR 250m in 2016, up from EUR 225m in 2015. Expenditure in 2017 is budgeted at the same level, but actual spending is expected to decrease slightly due to a decrease in beneficiaries.

Changes in the legislation on disability benefits have been delayed but the system for assessment of disabilities is in place. The aims of this reform were to create an umbrella legislation encompassing all kinds of disability benefits, to progressively replace cash payments with benefits in kind (goods and services), and to introduce a unified system for the certification of disabilities, while safe-guarding the budget neutrality of the overall reform. Although there are delays with the first two pillars of the reform, the implementation of the unified system for certification has been implemented with the setting-up of two certification centres in Larnaca and in Limassol. These add to the one already operating in Nicosia. The initial results show low deviations from declarations, indicating that no significant abuse of disability benefits is likely to be uncovered.

Healthcare reform

The legislation on the National Health System (NHS) was adopted in June 2017. This major reform intends to implement universal health care in Cyprus by 2020. This was a longstanding Council country-specific recommendation to Cyprus and a key programme commitment. The NHS will be based on a single-payer system, funded by payroll contributions from the State,

employers and employees. The reform intends to significantly lower out-of-pocket costs for healthcare from over 50% to below 15% of overall health costs. An impact study has been commissioned by the Ministry of Finance to assess the potential impact of the NHS on the economy, notably on labour costs, and to update the estimated budgetary needs of the new system. The study will allow the government to identify and propose necessary amendments to the legislation before the full implementation of the NHS. So far, the timeline for NHS implementation envisages an opening of the NHS for outpatient care from June 2019, while the full-blown NHS would be operational from June 2020. This timeline depends on the successful roll-out of the NHS IT solutions, for which a contract has been signed, and on the outcome of negotiations between the authorities and the representatives of medical professionals. This will notably have an impact on the rate of participation of private sector health professionals to the NHS.

The hospital autonomisation bill has also been adopted. The bill grants financial and operational autonomy to all public hospitals under the supervision of an independent public entity, with small independent management teams present in each hospital. The autonomisation process is expected to be completed by June 2020 and will generate short term costs as a set of incentives has been put in place to secure the support of public sector health professionals. The implementation timeline leaves little room for preparing public hospitals for competition with private hospitals, which poses some risks of patient migration towards the private sector. The study commissioned by the Ministry of Finance to assess the budgetary needs of the NHS will also analyse the financial situation and performance of public hospitals so as to better identify the challenges of hospital autonomisation, including the potential fiscal risks resulting from overspending and accumulation of arrears by hospitals (see Section 4.2).

5.2. STRUCTURAL REFORMS

Labour market

Collective agreements have been renewed or are in place for all sectors of the economy, except

the construction sector. The discussions continue to pass legislation for an automatic extension of certain elements of the construction sector collective agreement. There is an agreement in principle on the merit to legislate certain provisions of collective agreements, including wage floors, working hours, and provident fund contributions. This move is advertised as setting minimum standards for the construction industry. However, since the unionisation rate in this sector has fallen below 50%, the extension of an agreement reached between minority unions might not be representative of the needs of the entire sector. ⁽¹⁰⁾

The assessment of the efficiency of active labour market policies (ALMPs) has started. ALMPs include measures targeting the youth under the National Action Plan for Youth Employment as well as measures targeting other vulnerable groups, such as the long-term unemployed, persons with disabilities, but also GMI recipients. The new ALMPs monitoring and evaluation system is approaching its completion. It is expected to be fully developed and established by the end of 2017. A study assessing two schemes for the job placement of unemployed secondary and tertiary graduates shows that these programs had a notable impact on the employability of the participants, as respectively 53% (secondary graduates) and 56% (tertiary graduates) were still employed 6 months after the completion of the scheme.

The public employment services (PES) are not yet equipped to respond effectively to their enhanced tasks, although some actions (PES peer support, IT platform) are taking place. The staff reinforcement of the PES continues to be delayed. The call to recruit 30 employment counsellors is expected to be announced by mid-October, but the effective recruitment is only planned for the end of this year. Besides their important role in reducing searching and matching frictions in the labour market, the PES are a crucial pillar of the welfare reform, together with social intervention. The reduction of welfare dependence hinges to a large extent on the PES response capacity.

⁽¹⁰⁾ It is also important to highlight that current wage floors in the construction sector are the highest of all sectors in Cyprus with EUR 1 645 - EUR 1 905 a month depending on the skill level.

More efforts were made to reach out to the non-registered unemployed. There have been increased efforts in coordination with the Ministry of Education and Youth organisations to reach out to the non-registered unemployed (young in particular) and to identify those who are not in employment, education, or training (NEETs). Further, a Youth Guarantee peer support project has started in July with the aim of improving the outreach measures and the subsequent support provided.

Efforts to tackle undeclared work are progressing with the enactment of the amended law (June 2017) regarding undeclared and illegal employment. The law sets the framework for multi-task inspections under one roof and also imposes heavy fines. Initial results seem promising, with an increase of declared employment by 3.000 workers since the introduction of the law.

Energy

Gas exploration in Cyprus' Exclusive Economic Zone (EEZ) has resumed and will intensify.

Following the renewal of exploration licenses for blocks 2, 3, 9 and 11 of the EEZ (ENI/KOGAS and Total) until 2018, new exploration licenses were granted in April 2017 for blocks 6, 8 and 10. The exploration licenses have been granted to well-known companies (ExxonMobil, Qatar Petroleum, Eni and Total), leading to signature bonuses of around EUR100m. Exploration drilling resumed in June 2017, confirming that the geological features of Cyprus' EEZ are similar to that of the large gas field in 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 in Cyprus' EEZ. More exploratory drillings are expected in 2017 and 2018 and are expected to bring more clarity on the extent of Cyprus' hydrocarbon reserves.

The Cypriot authorities continue negotiating the conditions for the monetisation of the Aphrodite gas field. The Field Development Plan (FDP) for the monetisation of the Aphrodite gas field is still under negotiation with the Block 12 partners (Noble Energy, British Gas). While no decision has been taken yet regarding a possible public stake in the gas export infrastructure, the

authorities remain committed to undertake a financial and budgetary impact analysis prior to approving the FDP.

A plan for importing liquefied natural gas (LNG) to Cyprus has been adopted. The authorities aim to import LNG before 2020 in order to diversify the energy mix in line with EU2020 objectives and in order to facilitate competition between electricity generators. The authorities intend to publish two separate tenders in 2018. The first tender concerns the building, operation, and ultimately transfer of the infrastructure for LNG import and distribution. The other tender seeks a long term contract to import natural gas. The exact cost of the project, its financial model and its detailed implementation steps and timeline have not yet been communicated by the Ministry of Energy.

Parliamentary discussions continue with regard to setting up a Sovereign Wealth Fund (SWF). The SWF bill, which lays out the governance structure of the SWF, and the draft legislation defining inflow and outflow rules of the fund continue to be discussed by the House of Representatives. The adoption of the legislation is key to ensure a sustainable use of revenue stemming from the exploitation of hydrocarbon reserves and would therefore have important positive implications for Cyprus' public debt sustainability outlook.

The timeline for the ownership unbundling of the Electricity Authority of Cyprus (EAC) depends on the effective implementation of the accounting and functional unbundling. The Government committed in January 2016 to proceed with the ownership unbundling of EAC's network activities (transmission and distribution) from its commercial activities (generation and supply). However, the Cyprus Energy Regulatory Authority (CERA) requested that ownership unbundling should occur only once the accounting and functional unbundling of EAC have been implemented and assessed. CERA intends to proceed with three regulatory reviews of the functional and accounting unbundling of EAC until 2019, before authorising the start of the ownership unbundling.

Some progress has been made towards improving the transparency and efficiency of

the Cypriot energy market. The approval of the new electricity trade and settlement rules (TSR) is proving very slow, but is expected for 2017. The Transmission System Operator's (TSOCy) capacity to play its role as independent market operator from 2019 could be strengthened by the Government's proposal to ensure that the TSOCy is fully independent from EAC. However, the proposal is yet to be approved by the House of Representatives. Since September 2017, and until the new TSR are effective, a transitory arrangement allows independent electricity suppliers to strike bilateral contracts with power producers, notably renewable energy producers, therefore increasing competition in the electricity market.

Justice system reform

The Cyprus justice system displays relatively weak efficiency indicators. According to data collected through the European Justice Scoreboard⁽¹⁾, Cyprus is among the worst performers regarding the time needed to reach a final judicial decision and the backlog of pending decisions. These problems mainly stem from inefficient procedures, low level of IT resources, lack of specialisation, and under-use of alternative dispute resolution mechanisms. The low efficiency of the justice system is an obstacle to the proper implementation of the insolvency and foreclosure frameworks, and more generally deters investments as it hampers the enforcement of contracts. A comprehensive reform is considered of key importance to improve the enforcement of contracts, strengthen the business environment and encourage investment.

Reform initiatives have been launched, while a more comprehensive strategy is pending. A 2016 Supreme Court reform plan proposed the creation of intermediate courts levels, specialised jurisdictions, the streamlining of procedures, hiring of judges, upgrading of facilities and development of IT resources. In parallel, the Government announced its interest in creating a commercial court by early 2018. Since early 2017, technical assistance provided by the Commission is ongoing and is expected to lead to the formulation by mid-2018 of a comprehensive strategy for the reform of

⁽¹⁾ http://ec.europa.eu/justice/effective-justice/scoreboard/index_en.htm

the judicial system. The implementation of this strategy will involve close cooperation between the Supreme Court and the ministries of Finance and Justice.

Action plan for Growth

An institutional framework is being designed to support growth-friendly policies. To better address the priorities of the Action Plan for Growth, the Government envisages the creation of three Deputy Ministries – Deputy Ministry for Growth and Competitiveness, Deputy Ministry for Tourism and Deputy Ministry for Shipping. The House of Representatives adopted the legislation allowing the creation of the deputy Ministry for Shipping in July 2017, and could adopt the bills for the other two deputy ministries by end-2017. The creation of those deputy ministries is expected to drive the mobilisation of public resources towards the consistent implementation of strategic policy priorities.

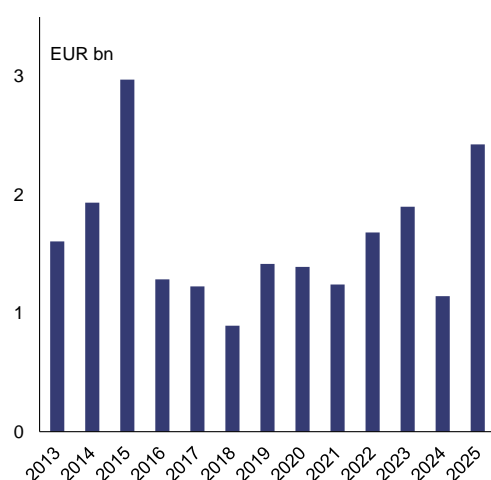
The tourism strategy is being reviewed by authorities. External consultants have delivered a Tourism Strategy, together with the accompanying action plans, to the Cypriot authorities at the end of 2016. The proposed strategy takes a long-term view and envisages making Cyprus a premium, all-year-round destination, receiving 4.6 mn tourists per year by 2030. This strategy is being assessed by the Steering Committee, which will formulate an official proposal, to be submitted to the Council of Ministers for approval by the end of 2017.

Other key elements of the plan are advancing. As part of the Investment Framework, one of the key pillars of the Action Plan for Growth, legislation on the new procedural and legal framework on strategic investments, including the set-up of a fast-track mechanism, has been delayed but is expected to be put in place in 2017. The scope of e-government services is broadening, with a growing number of services being offered through the new government portal ARIADNI. A tender for the purchase of a national e-identification system is expected to be launched by the end of 2017.

6. SOVEREIGN FINANCING AND ABILITY TO REPAY

Cyprus has maintained access to international capital markets at favourable terms. In June 2017, Cyprus issued a seven-year Eurobond of EUR 0.85 bn (4.5% of GDP) with a yield of 2.8%. The main objectives of the transaction were to develop the bond yield curve, manage refinancing risk by smoothening out the debt maturity profile, enhance investor relations and expand the existing investor base. Combined final demand of over EUR 4.2 bn represented the largest order book generated for a Cyprus' benchmark transaction, since the sovereign's return to the international bond markets in June 2014.

Graph 6.1: Medium and long-term debt amortisation



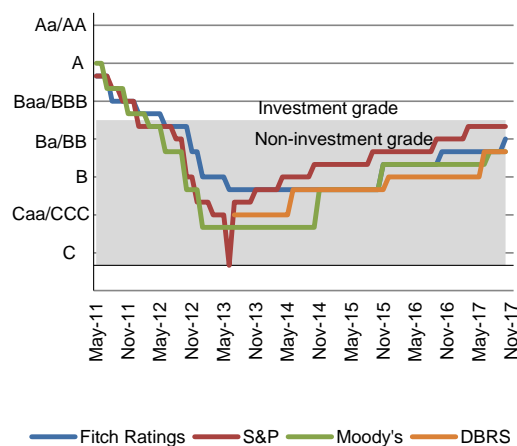
Source: Ministry of Finance - Public debt management office

The recent debt issuance, facilitated by low financing needs in 2017 and favourable market conditions, allowed Cyprus to smoothen the maturity profile of its debt. The international bond issuance was combined with a switch offer for bonds maturing in 2019-2020, at a premium of 9%-16% of par, for a total amount of EUR 514.9 m. Further, an amount of EUR 271 m was used in July 2017 for an early repayment of the more expensive part of the IMF loan, where interest rate was above the market interest rate for Cyprus bonds. The operation brought down the outstanding amount and interest on the IMF loan to EUR 683 m at 1.6%. As a result of active debt management over the last years, there are no more debt amortisation peaks in the medium-term. In 2018-2021, the annual debt principal repayments

now do not exceed EUR 1.4 bn and 7% of the GDP of the respective year (Graph 6.1). Part of the proceeds also allowed Cyprus to increase its cash balance in line with the objective of having at least EUR 1.0 bn of liquid funds by end-2017, as set out in the Medium Term Debt Strategy.

Yields on Cyprus' debt instruments have continued to decrease. The yield for the 3-month T-bills on the primary market remained in the negative territory since early 2017. In August 2017, the outstanding T-bill stock stood at EUR 300 m, within the target range enshrined in the Medium Term Debt Strategy (1-4% of total debt). Yields on longer term debt have also declined in parallel; 8-year bonds reached a new historical low in October 2017 at 1.8% as a result of improved macroeconomic conditions and better market perception of Cyprus sovereign risk.

Graph 6.2: Sovereign long-term ratings, Cyprus



Source: European Commission

Cyprus' sovereign credit rating has improved but remains below investment grade. In 2017, four rating agencies upgraded Cyprus' sovereign rating. In March 2017, Standard & Poor's (S&P) upgraded its rating by one notch from "BB" to "BB+" with a "stable" outlook. In June 2017, DBRS upgraded Cyprus by two notches from "B" to "BB (low)" and changed the outlook to "stable". In July 2017, Moody's upgraded Cyprus by one notch from "B1" to "Ba3", keeping its outlook at positive. In September 2017, S&P confirmed the

rating of Cyprus at "BB+" and changed the outlook to positive from stable. In October 2017, Fitch upgraded Cyprus by one notch from "BB-" to "BB", keeping its outlook at positive. Cyprus' most favourable rating, by S&P, remains one notch below investment grade (Graph 4.2). Better-than-expected macroeconomic, public debt and fiscal budgetary developments were the main drivers for the recent upgrades. However, vulnerabilities related mainly to the high level of non-performing loans in the financial sector and still high public and private debt could hold back further upgrades.

The sovereign's financing situation remains comfortable. Based on the updated macro and fiscal projections, and supported by long maturity of ESM loans and active debt management, total debt redemptions and fiscal needs are contained in the medium term. Until mid-2019, the financing needs are lower than the estimated cash buffer of EUR 1.6 bn at the end of 2017. In 2018, debt redemptions are estimated at EUR 0.9 bn.

Risks for Cyprus' capacity to service its debt to the European Stability Mechanism thus remain low in the short-term. By 2021, annual debt repayments are not expected to exceed EUR 1.4 bn (7% of GDP of the respective year). This is below investors' demand for Cyprus' latest international bond issuance, which therefore suggests low refinancing risk. However, medium-term debt dynamics are sensitive to macroeconomic shocks, vulnerabilities in the financial system, and changes in fiscal performance.

ANNEX 1

Specific monitoring of macroeconomic imbalances

In February 2017, Cyprus was identified as experiencing excessive macroeconomic imbalances in the context of the MIP⁽¹²⁾. The identified imbalances mainly relate to the large private, government, and external debt. Important vulnerabilities were also identified in the financial sector, which is burdened with a non-performing loans ratio close to 50%.

The Country-Specific Recommendations under the European semester provided guidance for the policy follow-up. These recommendations concern a wide range of policy domains: (CSR1) public finances, judicial system, (CSR2) insolvency and foreclosure frameworks and property rights; (CSR3) non-performing loans and provisioning; (CSR4) business environment and privatization; and (CSR5) labour market. All but the last CSR are considered MIP relevant.

This section provides an overview of the state of play regarding progress with policy implementation to address imbalances as identified under the MIP framework. In order to avoid an overlap of surveillance processes, it does not provide an assessment of fiscal targets.

A1.1.1. Evolution of imbalances

Cyprus' real GDP growth accelerated in the first half of 2017. In the first half of the year, the economy grew by 3.6%, driven by private and, to a lesser extent, public consumption, as well as strong investment. Growth is expected to reach around 3.5% for the year as a whole. Inflation increased in the first half of 2017, as headline HICP reached 1.3% in Q2 2017, driven nearly exclusively by energy prices and unprocessed food.

The negative net international investment position has stabilised but the current account deficit is widening. The current account deficit widened in 2016 to 4.9% of GDP from 2.5% of GDP in 2015, notably due to households' negative savings position (-3.1% of GDP in 2016). The current account widened further to -6.6% of GDP in the second quarter 2017 (based on four quarters rolling sum). The Net International Investment

Position, remains largely negative at -128.1% of GDP in the second quarter 2017, after -127.8% of GDP in 2016 and -145% of GDP in 2015. As of end-2016, about 75% of GDP corresponded to the net international investment position of non-financial ship-owning SPEs.

Private sector debt is slowly decreasing, from 353.5% of GDP in 2015 to 344.6% of GDP in 2016. This reduction has been mostly driven by households, for which debt fell from 126.3% of GDP in 2015 to 120.3% of GDP in 2016. The indebtedness of non-financial corporations (NFCs) has remained mostly stable at 223.3% of GDP in 2016, taking into account that ship-owning SPEs accounted for about a third of the NFCs' debt stock. In 2017, deleveraging is expected to be supported by the pick-up in real GDP growth and inflation.

The property market appears to have slowly started its recovery. The Eurostat house price index shows that house prices have started increasing on yearly basis, by 2.4% y-o-y in Q1 2017 and by 3.6% y-o-y in Q2 2017. In the context of a high share of collateralised debt, this may facilitate loan restructuring through the sale of collateral.

The stock of non-performing loans (NPLs) is declining, but still accounts for about half of total loans. On aggregate, banks are making progress in reducing the stock of non-performing loans, which fell by 9% y-o-y as of end-June 2017 to EUR 22.4bn. However, the progress is uneven among banks. Overall, NPLs still account for close to half the stock of loans (45% at end-June 2017), as total loans are also decreasing.

The general government debt ratio is expected to have peaked in 2015 at 107.5% of GDP and is forecast to decline to around 94% in 2019. By the end of August 2017, public debt declined to 103.7% of GDP. Going forward, the declining debt path reflects expected high primary surpluses and favourable debt dynamics due to strong nominal growth.

The labour market situation is improving. The unemployment rate fell from 13.2% at the end of 2016 to 10.3% of the labour force in September 2017. Youth and long-term unemployment also declined to respectively 26.4% and 4.9% in

⁽¹²⁾ This annex presents developments relevant to the analysis of macroeconomic imbalances and related policy implementation, and therefore might overlap in some respect with the other chapters of the post-programme surveillance report.

Q2 2017. The participation in the labour force is gradually increasing, mostly for male workers.

Potential growth is increasing. After several years of stagnant labour productivity growth and low gross fixed capital formation, both have risen in the first half of 2017.

A1.1.2. Policy measures taken to address macroeconomic imbalances

To reduce private sector debt

To bring debt down to more sustainable levels, the government is expected to remove impediments to the application of the insolvency legislation, but efforts are still at an early stage. The insolvency framework adopted in 2015 was intended to provide an efficient tool for the resolution of unviable debts. However, so far the recourse to insolvency procedures has remained marginal. Debtors generally seem to lack awareness of the benefits of the scheme, while banks appear reluctant to engage in proceedings that appear lengthy compared to bilateral restructuring negotiations. The package of measures envisaged to improve the use of the insolvency framework, as detailed in Cyprus' 2017 National Reform Programme, includes (i) updating the rules of court for corporate insolvency cases, (ii) setting up a working group to assess the functioning of the insolvency framework and elaborate an action plan to improve its efficiency and relevance, and (iii) taking measures to enhance the performance of the Insolvency Service of Cyprus. In March 2017, the authorities set up a working group to review the insolvency legislation and its application, however, the working group meets on an occasional basis and only plans to complete its analysis by end-2018. In parallel, a study has been commissioned to assess the performance of the Insolvency Service of Cyprus and a technical assistance project was launched to improve the regulatory framework for insolvency practitioners.

Measures are also envisaged to incentivise the use of foreclosure as a means to reduce debt stocks and enhance contract enforcement, but only limited progress has taken place since spring 2017. The foreclosure legislation adopted in 2015 allows banks to sell the collateral underlying non-performing loans but its use

remains very limited. The low number of foreclosure auctions is partly due to the inherent limitations of the foreclosure law, which the authorities have so far failed to address. At the same time, banks seem reluctant to use the framework more decisively. So far banks have used the foreclosure procedure more as an incentive for debtors to agree on voluntary restructuring, notably through debt to asset swaps. Cyprus has made no specific commitment to identify and address the shortcomings of the foreclosure framework. On the other hand, the authorities intend to amend the civil procedure law to improve contract enforcement through a better enforcement of court decisions. Since spring 2017, a draft bill was prepared and is under legal vetting.

A clear definition of property rights was identified as key to enable the enforcement of collateral, and some measures have been envisaged to address weaknesses in this area. Active deleveraging notably depends on the possibility for debtors or banks to liquidate real assets and collateral. The deficiencies of the current title deeds issuance and transfer system generate uncertainty regarding property rights, complicating foreclosure procedures and deterring property buyers. In this context, a set of measures were envisaged to improve the system, as detailed in Cyprus' 2017 National Reform Programme, including streamlining the legal framework for the application and issuance of building and planning permits, identifying and addressing the specific issues preventing the issuance of title deeds for existing developments. Up to the spring of 2017, several measures were taken to streamline the issuance of title deeds for new properties and to accelerate the issuance of titles for properties built and sold before 2015. As of September 2017, this allowed the transfer of about 3000 titles, out of about 14600 applications. Since the spring of 2017, a technical assistance project has identified a set of reforms to licensing and permitting procedures which can help to further simplify the issuance of title deeds, but these measures still need to be approved and implemented. However, no new measure was announced to provide for a sustainable and reliable system for the transfer of title deeds.

To reduce non-performing loans

The authorities have taken some measures to help accelerate the reduction of NPLs across the banking sector. The reduction of outstanding NPLs registered so far mainly stems from loan restructuring efforts by banks, the improved economic environment, and the implementation of measures already in place, notably the reforms undertaken by the authorities during the programme. Despite mixed results across banks, arrears management has overall improved and banks appear to provide more sustainable restructuring solutions. During the economic adjustment programme and through their 2017 National Reform Programme, the authorities have notably committed to improve the arrears management framework and to enhance the supervisory reporting and monitoring of NPLs. In July 2017 the Central Bank set up an NPL task force to support the development of a national NPL strategy, although no precise commitment was made as to the concrete implications of this forthcoming strategy.

The authorities are improving the quality of financial information available regarding borrowers. As banks shift from a lending model based on collateral to a model based on borrowers' repayment capacity, it is essential to reduce information asymmetry between borrowers and creditors. As committed in the 2017 National Reform Programme, the authorities intend to improve the credit registry by broadening the set of information collected and made available and expand the set of reporting counterparties, as the relevant national directive is expected to be updated by the end of 2017. The quality of financial information available for credit risk assessment was further improved by integrating the credit registers of the Cyprus Cooperative Bank and of all commercial banks. The creation of a credit scoring system for physical persons has been commissioned, although no precise implementation timeline was communicated.

Measures are still pending to facilitate the development of a secondary market for loans. A functioning and liquid secondary market for loans would help banks to dispose portfolios of loans, including NPLs, thereby downsizing and cleaning up their balance sheet. The key obstacles to the development of such a market include the absence

of third-party servicers, the licensing requirements applicable to the buyers of retail loans, and an inefficient legal framework. Since the economic adjustment programme the authorities committed to facilitate the emergence of a secondary market. A sale of loans legislation was adopted in 2015 and has so far not led to any significant transactions. In addition, the authorities repeated in the 2017 National Reform Programme their commitment to adopt a legislative framework for loan securitisation. However, the latter remains under discussion and is not expected to be adopted before Q2 2018. Nevertheless, Cypriot banks announced the creation of joint ventures with foreign specialised debt servicers to manage their NPL portfolios. This could contribute to accelerating NPL workout and may facilitate the emergence of a secondary market for loans.

To reduce General Government debt

Some measures were adopted to strengthen the long term sustainability of public finance. During the economic adjustment programme the authorities committed to adopt a series of measures to help contain the growth of public expenditure in the long term. This package of measures, also presented in the 2017 National Reform Programme, includes the upgrading of the fiscal framework and the adoption of a mechanism linking the public wage bill growth to economic growth. Since spring 2017 Cyprus has taken various implementation steps related to the Fiscal Responsibility and Budget System law, notably regarding the upgrade of IT systems. Due to the relatively high public wage bill as a share of GDP, a collective agreement was signed in 2016 to contain the growth rate of the compensation of public employees by capping it to recent level of nominal GDP growth. However, this agreement only covers the years 2017 and 2018. No commitment to adopt a permanent legal mechanism has been made by the authorities, although it would provide more reassurance as to the long term wage moderation in the public sector.

Despite some recent progress, several measures to improve the efficiency and productivity of the public administration remain pending. The commitment to a comprehensive reform of the public administration stems from the economic adjustment programme and was repeated in the

2017 National Reform Programme. These measures would contribute to ensuring the long term sustainability of public finance, and thus facilitate the reduction of public debt. Cyprus adopted in May 2017 a law facilitating the professional mobility of public employees, so as to instil more flexibility in reallocating resources across the broader public sector. Nevertheless, key modernisation measures for the public administration aiming at an overhaul of recruitment, assessment and promotion procedures remain pending. Other important draft laws tabled to the House of Representatives remain to be adopted, such as the sovereign wealth fund law, the reform of local governments and the new framework for the governance and monitoring of state-owned entities.

To reduce unemployment

Policy measures were taken to improve public employment services. Cyprus' public employment services (PES) do not appear to have the capacity to play their role effectively, due to a lack of resources and organisational shortcomings. As mentioned in its 2017 National Reform Programme, Cyprus is committed to enhancing and modernising its public employment services by increasing its staff and improving its functioning. Since May 2017, the issuance of job placement vouchers for private sector job placement agencies has alleviated some of the pressure on the PES. In parallel, Cyprus has taken steps to upgrade the job placement IT system. The recruitment of additional staff has been further delayed is now expected to take place at the end of 2017.

Targeted measures were implemented to reduce youth and long term unemployment. As was confirmed by the 2017 National Reform Programme, Cyprus is committed to launching active labour market policies to reduce youth and long term unemployment. New measures were launched in 2017 under the National Action Plan for Youth Employment as well as measures targeting other vulnerable groups, such as the long-term unemployed, persons with disabilities, but also welfare recipients. A monitoring and evaluation system has been commissioned to assess the impact of these policies and is now expected to be in place by the end of 2017.

To increase potential growth

The authorities are taking steps to make the justice system more efficient. The low efficiency of the justice system weighs on the business environment and competitiveness, and hampers the resolution of unviable private debt. The authorities made a commitment to review and modernise the operations of the courts, as detailed in the 2017 National Reform Programme. This commitment notably includes a comprehensive review of the operations of the courts, an update of civil procedure procedures, the creation of a commercial court, the introduction of an e-justice system and the creating of a training academy for judges. Since Q1 2017, the authorities have started the review of the operations of the justice system with the technical assistance of the SRSS. A full set of recommendations is expected by Q2 2018. To streamline judicial proceedings, a law was adopted in July 2017 to improve the filtering of appeals in interlocutory decisions. Efforts to specialise the courts have been continued, with the recruitment of additional judges for the new administrative court in September 2017 and the drafting of a law for the creation of a Commercial Court, which is expected to be submitted to the Council of Ministers by the end of 2017. A study was completed in May 2017 regarding Cyprus' needs in terms of judicial training. The authorities expect to create a school of judicial training by Q2 2018. Finally, a tender was launched in March 2017 to purchase an electronic court administration system so as to digitise the operations of the courts.

The implementation of the Action Plan for Growth continues. Improvements to the business environment are being gradually identified and addressed through the implementation of the Action Plan for Growth. This notably comprises measures to streamline administrative procedures for businesses and allow the electronic filing of accounts for companies. It also includes a set of legislative and administrative reforms to facilitate and incentivise strategic investments, for which draft legislation is expected to be adopted by end-2017. A start-up visa scheme was adopted in 2017 to attract foreign entrepreneurs to Cyprus. An action plan has been set up to promote the growth of exports and develop economic diplomacy. The plan also led to the formulation of a national tourism strategy, which is expected to be adopted

by end-2017. To maximise the impact and properly coordinate this broad set of measures, the creation of deputy ministries for Tourism and Growth is expected to be adopted by the end of 2017 and to be implemented in 2018.

The authorities have made little progress with regard to privatisation. During the economic adjustment programme the authorities committed to the privatisation of a number of state-owned entities in order to stimulate foreign investment, modernise key sectors of the economy, and contain public sector contingent liabilities. The implementation of the privatisation plan faces strong political opposition and has been essentially put on hold. While the successful commercialisation of the port of Limassol is being used as a template for the commercialisation of the port of Larnaca, only minor privatisation projects remain active.

Conclusion

Since spring 2017, measures were put on track to reduce public debt and stimulate the reduction of NPLs. The authorities completed some fiscal-structural measures to improve the efficiency of the public administration, notably the public sector mobility law. They also initiated a review of the supervisory framework regarding NPLs. To assist its efforts to address macroeconomic imbalances, Cyprus has requested technical support provided by the Structural Reform Support Service (SRSS) to help implement reforms in various areas such as public administration and justice, growth and the business environment, healthcare, education, public financial management and taxation.

There is, however, uncertainty regarding the adoption and implementation of several key reform initiatives. Some important policy measures remain incomplete or are still in at an early stage of their legislative approval. These include the review of the insolvency framework and insolvency service, the adoption of a legislative framework for loan securitisation, improvements to the foreclosure legislation, amendments to the civil procedure law, the adoption of the sovereign wealth fund and the strengthening of public employment services. The implementation of the Action Plan for Growth is expected to make progress by the end of 2017,

with notably the adoption of legislation to create the Tourism and Growth deputy ministries and the adoption of the strategic investment framework.

More needs to be done to address the macroeconomic imbalances identified and outlined within the MIP framework, as a number of reform commitments remain pending. The lack of political majority at the House of Representatives, in the context of a new electoral cycle, has not favoured an acceleration of the reform momentum. To ensure the long term sustainability of public finance, the authorities remain committed to complete the horizontal public administration reform and create the sovereign wealth fund. The adoption of a permanent public sector wage bill mechanism would also contribute to public finance sustainability. Legislation to create a reliable system of issuance and transfer of title deeds remains necessary to help reduce private debt. A resolute implementation of the Action Plan for Growth is warranted to attract investment and raise potential growth. A reform of the operations of the judicial system is under preparation. Combined with a modernisation of the civil procedure law, it could significantly facilitate the enforcement of contracts and property rights, and therefore improve the business environment.

Table A1.1: Overview table of MIP-related reforms

| Reduce private sector debt | | | |
|--|-------------------------|---|--|
| Private indebtedness – Insolvency Frameworks | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected in 2018: amendments to the Civil Procedure Law to facilitate the enforcement of claims.</p> <p>Expected in 2018: Adoption of new Rules of Court for corporate insolvency.</p> <p>Expected in 2019: reform of the Insolvency framework based on the working group's recommendations.</p> | | <p>2016: Adoption of new Rules of Court for personal insolvency.</p> <p>2017: Creation of a working group to review of the new insolvency framework.</p> <p>2017: Independent review of the operations of the insolvency service</p> | <p>CSR 2 (2017): 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> |
| Housing market | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected in 2017: Draft legislation on a new system for the transfer of title deeds.</p> <p>Expected in 2018: Reform of licensing and permitting procedures based on recommendations of external expert</p> | | <p>2016: Administrative simplification measures (planning and building permits) taken to facilitate the issuance of title deeds</p> | <p>CSR 2 (2017): 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> |
| Reduce non-performing loans | | | |
| Financial services | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |

(Continued on the next page)

Table (continued)

| | | | |
|--|--|---|--|
| <p>Expected in 2018: Legislative framework for the securitisation of loans</p> <p>Expected in 2018: Creation of a Credit scoring system for physical persons by the credit register.</p> | | <p>2017: The cooperative banks were integrated to the credit register for commercial banks, providing more comprehensive information on borrowers.</p> <p>2017: Creation of a Central Bank task force on NPLs</p> | <p>CSR 3 (2017): 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.</p> |
| Reduce General Government debt | | | |
| Long term sustainability of public finances | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected in 2018: legislation creating a permanent binding mechanism to contain the growth of the compensation of public sector employees.</p> <p>Expected by end-2017: Adoption of the Sovereign Wealth Fund law</p> | <p>October 2016: The secondary legislation for the Fiscal Responsibility and Budget System law was adopted.</p> | <p>2017: collective agreement containing the growth of the compensation of public sector employees until end-2018.</p> | <p>CSR 1 (2017): 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 and local governments.</p> |
| Public administration | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected in 2018: Legislation modernising the recruitment, assessment and promotion within the public administration.</p> <p>Expected in 2018: Legislation for the reform of local governments.</p> <p>Expected in 2018: Creation of a permanent contact centre for public services and of an online portal for e-services</p> | | <p>2017: Legislation modernising mobility within the public administration.</p> | <p>CSR 1 (2017): 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 and local governments.</p> |

(Continued on the next page)

Table (continued)

| Increase potential growth | | | |
|--|-------------------------|---|---|
| Civil justice | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected in 2018: Creation of a specialised commercial court.</p> <p>Expected in 2018: Legislation amending the Civil Procedure Law to strengthen the legal framework for the enforcement of Court decisions.</p> <p>Expected in 2018: Study regarding judicial mediation and ways to incentivise it.</p> <p>Expected in 2018: Establishment of a training department within the Supreme Court.</p> | | <p>2017: Legislation filtering appeals on interlocutory decisions</p> | <p>CSR 2 (2017): Increase the efficiency of the judicial system by modernising civil procedures, implementing appropriate information systems and increasing the specialisation of courts.</p> |
| State owned enterprises | | | |
| <p>Expected in 2018: legislation overhauling the monitoring and governance of State-owned enterprises.</p> <p>Expected in 2018: proposals for a corporatisation of CyTA.</p> <p>Expected in 2018: Commercialisation of the operations of the port of Larnaca</p> | | <p>2016: Limassol port operations transferred to private consortium.</p> | <p>CSR 4 (2017): 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> |
| Business environment | | | |

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Table (continued)

| | | | |
|---|--|--|--|
| <p>By end-2017: Publication of a national competitiveness report and creation of a National Competitiveness Council</p> <p>By end-2017: Adoption of a National Tourism Strategy and action plan.</p> <p>By end-2017: New procedural and legal framework for strategic investments.</p> <p>Expected in 2018: Creation of deputy ministries for Growth and for Tourism.</p> <p>Expected in 2018: Adoption of the secondary legislation for the reform of the Companies' registrar.</p> | <p>2017: Creation of a deputy ministry for Shipping</p> | <p>2017: Roll-out of e-administration services</p> <p>2017: Measures taken to facilitate strategic investments: publication of the Investor Journey Mapping, Start-up visa scheme.</p> | |
| Reduce unemployment | | | |
| Incentives to work, job creation, labour market participation | | | |
| <i>Announced measures</i> | <i>Adopted measures</i> | <i>Implemented measures</i> | <i>Sources of commitment</i> |
| <p>Expected by end-2017: reinforcement of Public Employment Services staff</p> <p>Expected-2017: ALMPs monitoring and evaluation tool</p> | | <p>2016: Targeted measures to tackle youth and long-term unemployment.</p> <p>2017: Reform of the legislative framework against undeclared work.</p> <p>2017: Upgrade of the employment IT platforms</p> <p>2017: Cooperation with private employment services through employment vouchers</p> | <p>CSR 5 (2017): Speed up reforms aimed at increasing the capacity of public employment services and improving the quality of active labour market policies delivery.</p> |

Source: European Commission

ANNEX 2

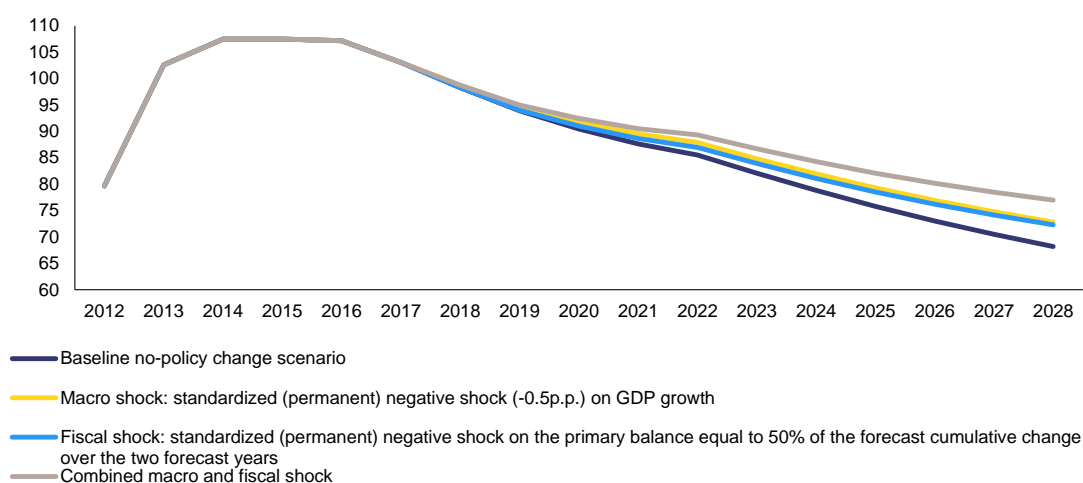
Debt sustainability analysis

Public debt is expected to decline steadily from 107.1% of GDP in 2016 to 68.2% of GDP in 2028.

This debt sustainability analysis (DSA) uses the Commission 2017 Autumn forecast (2017-2019) as a starting point to ensure cross-country consistency. For the outer years, the analysis rests on the following assumptions: (i) the structural primary fiscal balance remains at a surplus of 2.0 % of GDP under the no-fiscal policy change assumption; (ii) inflation converges to 2.0 % by 2022 and remains stable thereafter; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5 % (3% in real terms) by the end of the 10-year projection horizon, in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group (AWG); (iv) real GDP grows at the rate projected by the EPC's Output Gap Working Group until t+10 and thereafter according to the AWG's projections (average rate of around 1.5 %); and (v) ageing costs develop according to the Commission and EPC's 2015 Ageing Report⁽¹³⁾.

The evolution of the debt trajectory continues to be vulnerable to the macroeconomic and fiscal performance. A decrease of real GDP growth by one standard deviation over the horizon would, ceteris paribus, trigger an upward revision of the debt trajectory, by 1.4 pps of GDP in 2020 and 4.6 pps of GDP in 2028, resulting in a lower reduction of the debt ratio compared to the baseline scenario. A combined macroeconomic and fiscal shock would lead to an even more gradual decline, by 2 pps of GDP in 2020 and 8.8 pps of GDP in 2028. Given Cyprus' high level of public debt, continued fiscal discipline and sustained structural reform efforts are therefore necessary to firmly anchor the debt to GDP ratio on a sustainable downward path.

Graph A2.1: Debt projections



Source: European Commission

Given the initial high public debt stock, there are also risks to medium term sustainability. Cyprus is deemed to be at medium sustainability risk in the medium term⁽¹⁴⁾. The DSA points to medium sustainability risk. The S1 indicator is also assessed to point to medium risk, but close to low risk, at 0% of GDP, falling by 0.7 pps of GDP compared to the second PPS review (based on the Commission 2017 Spring forecast). The improvement of the S1 indicator is mostly due to the more favourable forecast regarding the required adjustment given initial budgetary position and debt requirement (see table A2.1). The S2 long-term sustainability indicator is assessed to point to low sustainability risk at -1.8% of GDP,

⁽¹³⁾ European Commission, 'The 2015 Ageing Report. Economic and budgetary projections for the EU 28 Member States (2013-2060)', European Economy 3/2015.

⁽¹⁴⁾ The assessment of medium-term sustainability challenges relies on the joint use of the debt sustainability analysis (DSA, run over a 10-year horizon) and the S1 medium-term sustainability indicator.

marginally deteriorating compared to the Commission 2017 Spring forecast. Cyprus is deemed to be at low risk to fiscal sustainability over the short term, based on the S0 indicator.

Overall, the debt sustainability analysis shows that in the baseline scenario the debt-to-GDP ratio moderately declines in the short and medium-term. However, it would still be at a high level and remain vulnerable to macroeconomic and financial market shocks. A solidly declining trajectory of the debt-to-GDP ratio can be achieved by maintaining fiscal discipline over the medium to long-term horizon. In addition, the debt reduction path crucially hinges on medium and long-term economic growth, which points to the necessity of persevering with the implementation of structural reforms in order to improve competitiveness and boost potential GDP.

Table A2.1: **Sustainability indicators (in % of GDP)**

| Cyprus | | |
|--|---------------------------|---------------------------------|
| | No-policy-change scenario | PPS Second review (Spring 2017) |
| S2* | -1.8 | -1.9 |
| of which : | | |
| Required adjustment given initial budgetary position (IBP) | -1.2 | -1.2 |
| Required adjustment due to cost of ageing (CoA) | -0.5 | -0.7 |
| of which: | | |
| pensions | 0.3 | 0.2 |
| healthcare | 0.2 | 0.2 |
| long-term care | 0.2 | 0.2 |
| others | -1.2 | -1.3 |
| S1** | 0.0 | 0.7 |
| of which: | | |
| Required adjustment given initial budgetary position (IBP) | -2.4 | -2.0 |
| Cost of delaying adjustment | 0.0 | 0.1 |
| Debt requirement (DR) | 2.7 | 3.1 |
| Required adjustment due to cost of ageing (CoA) | -0.2 | -0.4 |
| S0 (risk for fiscal stress)*** | 0.44 | 0.40 |
| Fiscal sub-index | 0.19 | 0.10 |
| Financial-competitiveness sub-index | 0.57 | 0.60 |
| Debt as % of GDP (2016) | | 107.1 |

(*) The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

(**) The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2032, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the autumn 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

(***) The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49.

Source: European Commission

ANNEX 3

European Commission macroeconomic and fiscal projections (2017 Autumn Forecast)

Table A3.1: **Selected economic indicators**

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---------------------------------------|--|-------|-------|-------|-------|-------|-------|
| Real economy | | | | | | | |
| | <i>(percent change)</i> | | | | | | |
| Real GDP | -5.9 | -1.4 | 2.0 | 3.0 | 3.5 | 2.9 | 2.7 |
| Domestic demand incl. inventories | -9.4 | -1.2 | 2.9 | 4.7 | 4.1 | 3.5 | 3.3 |
| Total consumption expenditure | -6.4 | -1.0 | 1.6 | 2.7 | 3.3 | 2.6 | 2.6 |
| Private consumption expenditure | -5.9 | 0.7 | 2.6 | 3.3 | 3.3 | 2.9 | 2.7 |
| Government consumption expenditure | -8.1 | -7.2 | -2.8 | -0.4 | 3.3 | 1.3 | 1.7 |
| Gross fixed capital formation | -12.9 | -17.5 | 13.6 | 35.0 | 7.8 | 7.3 | 6.4 |
| Exports of goods and services | 1.9 | 4.2 | 6.3 | 3.9 | 2.8 | 2.2 | 2.0 |
| Imports of goods and services | -4.9 | 4.6 | 8.1 | 6.6 | 3.7 | 3.2 | 2.9 |
| <i>Contribution to growth</i> | | | | | | | |
| | <i>(percentage points)</i> | | | | | | |
| Domestic demand (excl. inventories) | -7.4 | -3.3 | 2.9 | 6.8 | 4.1 | 3.6 | 3.4 |
| Foreign trade | 3.7 | -0.1 | -0.9 | -1.7 | -0.6 | -0.7 | -0.7 |
| Changes in inventories | -2.2 | 2.1 | -0.1 | -2.1 | 0.0 | 0.0 | 0.0 |
| Inflation | | | | | | | |
| | <i>(percent change)</i> | | | | | | |
| GDP deflator | -1.1 | -1.6 | -1.2 | -0.9 | 1.2 | 1.1 | 1.6 |
| HICP | 0.4 | -0.3 | -1.5 | -1.2 | 1.0 | 1.1 | 1.4 |
| Labour market | | | | | | | |
| | <i>(percent change, unless otherwise stated)</i> | | | | | | |
| Unemployment rate (% of labour force) | 15.9 | 16.1 | 15.0 | 13.0 | 11.0 | 10.0 | 9.3 |
| Employment | -5.9 | -1.8 | 1.5 | 3.1 | 2.9 | 1.9 | 1.4 |
| Compensation per employee | -5.4 | -3.6 | -1.2 | -0.8 | 1.7 | 1.5 | 1.8 |
| Labour productivity | 0.0 | 0.4 | 0.5 | -0.1 | 0.9 | 1.0 | 1.5 |
| Unit labour costs | -5.4 | -4.0 | -1.7 | -0.7 | 1.0 | 0.5 | 0.5 |
| Public finance (1) | | | | | | | |
| | <i>(percent of GDP)</i> | | | | | | |
| General government balance | -5.1 | -8.8 | -1.2 | 0.5 | 1.1 | 1.4 | 1.9 |
| Total revenue | 36.4 | 39.5 | 39.0 | 38.8 | 39.6 | 39.6 | 39.7 |
| Total expenditure | 41.6 | 48.2 | 40.2 | 38.3 | 38.5 | 38.2 | 37.9 |
| General government primary balance | -1.8 | -5.9 | 1.7 | 3.0 | 3.5 | 3.6 | 3.9 |
| Gross debt | 102.6 | 107.5 | 107.5 | 107.1 | 103.0 | 98.3 | 93.9 |
| Balance of payments | | | | | | | |
| | <i>(percent of GDP)</i> | | | | | | |
| Current external balance | -4.9 | -4.4 | -2.5 | -4.9 | -5.4 | -6.2 | -6.8 |
| Ext. bal. of goods and services | 1.8 | 2.0 | 0.8 | -0.8 | -1.3 | -2.1 | -2.7 |
| Exports goods and services | 58.6 | 62.1 | 64.9 | 65.3 | 64.9 | 64.6 | 64.0 |
| Imports goods and services | 56.8 | 60.0 | 64.1 | 66.1 | 66.2 | 66.6 | 66.7 |
| Balance of services | 18.0 | 18.0 | 17.5 | 20.6 | 22.4 | 22.6 | 22.5 |
| Balance of goods | -16.2 | -16.0 | -16.7 | -21.3 | -23.7 | -24.6 | -25.2 |
| Balance of primary income | -4.6 | -3.7 | -0.3 | -1.6 | -1.6 | -1.6 | -1.6 |
| Balance of secondary income | -2.1 | -2.7 | -3.0 | -2.6 | -2.6 | -2.6 | -2.6 |
| Memorandum item | | | | | | | |
| | <i>(EUR bn)</i> | | | | | | |
| Nominal GDP | 18.1 | 17.6 | 17.7 | 18.1 | 19.0 | 19.7 | 20.6 |

(1) Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014.

Source: European Commission

Table A3.2: Use and supply of goods and services (volume)

| percent change unless otherwise stated | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|-------|-------|------|------|------|------|------|
| 1. Private consumption expenditure | -5.9 | 0.7 | 2.6 | 3.3 | 3.3 | 2.9 | 2.7 |
| 2. Government consumption expenditure | -8.1 | -7.2 | -2.8 | -0.4 | 3.3 | 1.3 | 1.7 |
| 3. Gross fixed capital formation | -12.9 | -17.5 | 13.6 | 35.0 | 7.8 | 7.3 | 6.4 |
| 4. Domestic demand excl. inventories | -7.4 | -3.3 | 3.0 | 7.2 | 4.1 | 3.5 | 3.3 |
| 5. Changes in inventories (contr. to growth) | -2.2 | 2.1 | -0.1 | -2.1 | 0.0 | 0.0 | 0.0 |
| 6. Domestic demand incl. inventories | -9.4 | -1.2 | 2.9 | 4.7 | 4.1 | 3.5 | 3.3 |
| 7. Exports of goods and services | 1.9 | 4.2 | 6.2 | 3.9 | 2.8 | 2.2 | 2.0 |
| 7a. - of which goods | -12.5 | 2.1 | 3.9 | -9.4 | -9.9 | -0.5 | -0.5 |
| 7b. - of which services | 7.8 | 4.9 | 7.0 | 7.9 | 6.5 | 2.9 | 2.5 |
| 8. Final demand | -5.5 | 0.8 | 4.2 | 4.4 | 3.6 | 3.0 | 2.8 |
| 9. Imports of goods and services | -4.9 | 4.6 | 8.1 | 6.6 | 3.7 | 3.2 | 2.9 |
| 9a. - of which goods | -15.3 | 5.1 | 7.8 | 10.6 | 4.7 | 4.1 | 3.5 |
| 9b. - of which services | 11.4 | 3.9 | 8.4 | 1.8 | 2.5 | 2.2 | 2.2 |
| 10. GDP at market prices | -5.9 | -1.4 | 2.0 | 3.0 | 3.5 | 2.9 | 2.7 |
| <i>(Contribution to change in GDP)</i> | | | | | | | |
| 11. Final domestic demand | -7.4 | -3.3 | 2.9 | 6.8 | 4.1 | 3.6 | 3.4 |
| 12. Changes in inventories | -2.2 | 2.1 | -0.1 | -2.1 | 0.0 | 0.0 | 0.0 |
| 13. Net exports | 3.7 | -0.1 | -0.9 | -1.7 | -0.6 | -0.7 | -0.7 |

Source: European Commission

Table A3.3: Use and supply of goods and services (value)

| percent change unless otherwise stated | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|-------|-------|------|-------|------|------|------|
| 1. Private consumption expenditure | -5.9 | 0.2 | 0.8 | 2.0 | 4.4 | 4.1 | 4.4 |
| 2. Government consumption expenditure | -12.4 | -11.6 | -3.4 | -0.7 | 5.4 | 2.6 | 3.5 |
| 3. Gross fixed capital formation | -12.7 | -19.9 | 12.2 | 37.8 | 8.8 | 8.9 | 8.2 |
| 4. Domestic demand excl. inventories | -8.1 | -4.8 | 1.4 | 6.3 | 5.3 | 4.7 | 5.0 |
| 5. Changes in inventories (contr. to growth) | -0.2 | 0.1 | 0.2 | -0.2 | -0.2 | -0.2 | -0.2 |
| 6. Domestic demand incl. inventories | -10.0 | -3.2 | 2.1 | 3.8 | 5.4 | 4.7 | 5.0 |
| 7. Exports of goods and services | 2.1 | 2.7 | 5.3 | 2.8 | 4.2 | 3.4 | 3.5 |
| 7a. - of which goods | -10.7 | 3.5 | 4.7 | -10.2 | -8.8 | 0.6 | 1.4 |
| 7b. - of which services | 7.4 | 2.4 | 5.6 | 7.3 | 7.9 | 4.1 | 4.0 |
| 8. Final demand | -5.8 | -1.0 | 3.3 | 3.4 | 4.9 | 4.2 | 4.4 |
| 9. Imports of goods and services | -3.7 | 2.5 | 7.6 | 5.4 | 5.0 | 4.6 | 4.5 |
| 9a. - of which goods | -13.7 | -0.6 | 5.2 | 10.1 | 6.1 | 5.6 | 4.9 |
| 9b. - of which services | 12.1 | 6.2 | 10.3 | 0.2 | 3.7 | 3.5 | 3.9 |
| 10. Gross national income at market prices | -8.5 | -2.0 | 4.3 | 0.9 | 4.8 | 4.0 | 4.4 |
| 11. Gross value added at basis prices | -6.7 | -4.3 | 0.9 | 1.6 | 5.1 | 4.0 | 4.6 |
| 12. Gross domestic product at market prices | -6.9 | -2.9 | 0.8 | 2.1 | 4.8 | 4.0 | 4.4 |

Source: European Commission

Table A3.4: Implicit deflators

| percent change | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|------|------|------|------|------|------|------|
| 1. Private consumption expenditure | 0.0 | -0.5 | -1.8 | -1.3 | 1.1 | 1.1 | 1.6 |
| 2. Government consumption expenditure | -4.6 | -4.8 | -0.6 | -0.4 | 2.0 | 1.3 | 1.8 |
| 3. Gross fixed capital formation | 0.2 | -2.9 | -1.2 | 2.1 | 0.9 | 1.5 | 1.7 |
| 4. Domestic demand incl. inventories | -0.6 | -1.9 | -0.9 | -0.9 | 1.2 | 1.2 | 1.6 |
| 5. Exports of goods and services | 0.2 | -1.5 | -0.8 | -0.6 | 1.3 | 1.2 | 1.5 |
| 6. Final demand | -0.3 | -1.8 | -0.9 | -0.8 | 1.2 | 1.2 | 1.6 |
| 7. Imports of goods and services | 1.3 | -2.0 | -0.4 | -1.0 | 1.3 | 1.4 | 1.5 |
| 8. Gross domestic product at market prices | -1.1 | -1.6 | -1.2 | -0.9 | 1.2 | 1.1 | 1.6 |
| HICP | 0.4 | -0.3 | -1.5 | -1.2 | 1.0 | 1.1 | 1.4 |

Source: European Commission

Table A3.5: **Labour market and costs**

| <i>Percent change unless otherwise stated</i> | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|------|------|------|------|------|------|------|
| 1. Labour productivity | 0.0 | 0.4 | 0.5 | -0.1 | 0.9 | 1.0 | 1.5 |
| 2. Compensation per employee | -5.4 | -3.6 | -1.2 | -0.8 | 1.7 | 1.5 | 1.8 |
| 3. Unit labour costs | -5.4 | -4.0 | -1.7 | -0.7 | 1.0 | 0.5 | 0.5 |
| 4. Total population | -0.2 | -1.1 | -0.6 | 0.5 | 0.0 | 0.6 | 0.6 |
| 5. Population of working age (15-64 years) | -0.8 | -2.1 | -1.6 | -0.1 | 0.3 | 0.3 | 0.3 |
| 6. Employment | -5.9 | -1.9 | 1.5 | 3.2 | 2.9 | 1.9 | 1.4 |
| 7. Unemployment rate (1) | 15.9 | 16.1 | 15.0 | 13.0 | 11.0 | 10.0 | 9.3 |

Source: European Commission

Table A3.6: **External balance**

| <i>EUR bn unless otherwise stated</i> | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|-------|-------|-------|-------|-------|-------|-------|
| 1. Exports of goods (fob) | 2.7 | 2.8 | 2.9 | 2.6 | 2.4 | 2.4 | 2.5 |
| 2. Imports of goods (fob) | 5.7 | 5.6 | 5.9 | 6.5 | 6.9 | 7.3 | 7.6 |
| 3. Trade balance (goods, fob/fob) (1-2) | -2.9 | -2.8 | -3.0 | -3.9 | -4.5 | -4.9 | -5.2 |
| 3.1 p.m. (3) as % of GDP | -16.2 | -16.0 | -16.7 | -21.3 | -23.7 | -24.6 | -25.2 |
| 4. Exports of services | 7.9 | 8.1 | 8.6 | 9.2 | 9.9 | 10.3 | 10.7 |
| 5. Imports of services | 4.7 | 4.9 | 5.5 | 5.5 | 5.7 | 5.9 | 6.1 |
| 6. Service balance (4-5) | 3.3 | 3.2 | 3.1 | 3.7 | 4.2 | 4.5 | 4.6 |
| 6.1 p.m. 6 as % of GDP | 18.0 | 18.0 | 17.5 | 20.6 | 22.4 | 22.6 | 22.5 |
| 7. External balance of goods and services (3+6) | 0.3 | 0.4 | 0.1 | -0.1 | -0.2 | -0.4 | -0.6 |
| 7.1 p.m. 7 as % of GDP | 1.8 | 2.0 | 0.8 | -0.8 | -1.3 | -2.1 | -2.7 |
| 8. Balance of primary and secondary incomes | -1.2 | -1.1 | -0.6 | -0.7 | -0.8 | -0.8 | -0.8 |
| 8.1 - of which, balance of primary income | -0.8 | -0.6 | -0.1 | -0.3 | -0.3 | -0.3 | -0.3 |
| 8.2 - of which, balance of secondary income | -0.4 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 |
| 8.3 p.m. 8 as % of GDP | -6.7 | -6.4 | -3.3 | -4.1 | -4.1 | -4.1 | -4.1 |
| 9. Current external balance (7+8) | -0.9 | -0.8 | -0.4 | -0.9 | -1.0 | -1.2 | -1.4 |
| 9.1 p.m. 9 as % of GDP | -4.9 | -4.4 | -2.5 | -4.9 | -5.4 | -6.2 | -6.8 |
| 10. Net capital transactions | 0.4 | 0.0 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 |
| 11. Net lending (+)/net borrowing (-) (9+10) | -0.5 | -0.8 | -0.3 | -0.9 | -1.0 | -1.2 | -1.4 |
| 11.1 p.m. 11 as % of GDP | -2.6 | -4.4 | -1.7 | -4.8 | -5.1 | -6.2 | -6.8 |

Source: European Commission

Table A3.7: **Fiscal accounts**

| | 2013 | 2014* | 2015 | 2016 | 2017 | 2018 | 2019 |
|-------------------------------------|---------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | levels, EUR m | | | | | | |
| Taxes on production and imports | 2,475 | 2,593 | 2,601 | 2,733 | 2,948 | 3,068 | 3,202 |
| Taxes on income and wealth | 1,874 | 1,812 | 1,761 | 1,755 | 1,842 | 1,915 | 1,998 |
| Social contributions | 1,362 | 1,445 | 1,483 | 1,545 | 1,663 | 1,721 | 1,850 |
| Other current resources | 738 | 974 | 972 | 953 | 1,004 | 1,052 | 1,077 |
| Total current revenue | 6,449 | 6,823 | 6,817 | 6,986 | 7,457 | 7,755 | 8,127 |
| Capital transfers received | 160 | 130 | 101 | 43 | 58 | 58 | 58 |
| Total government revenue | 6,609 | 6,954 | 6,917 | 7,028 | 7,514 | 7,813 | 8,185 |
| Compensation of employees | 2,594 | 2,337 | 2,267 | 2,256 | 2,363 | 2,434 | 2,522 |
| Intermediate consumption | 735 | 647 | 684 | 646 | 694 | 711 | 742 |
| Social transfers | 2,484 | 2,469 | 2,468 | 2,564 | 2,636 | 2,678 | 2,765 |
| Interest payments (1) | 605 | 496 | 508 | 465 | 458 | 436 | 426 |
| Subsidies | 95 | 80 | 72 | 97 | 98 | 99 | 101 |
| Other current expenditure | 403 | 395 | 463 | 398 | 433 | 456 | 476 |
| Total current expenditure | 6,911 | 6,419 | 6,457 | 6,421 | 6,676 | 6,809 | 7,026 |
| Total capital expenditure (2) (3) | 624 | 2,071 | 665 | 520 | 625 | 719 | 771 |
| Total government expenditure | 7,540 | 8,495 | 7,126 | 6,946 | 7,306 | 7,533 | 7,802 |
| General government balance | -931 | -1,541 | -209 | 82 | 208 | 280 | 383 |
| General government primary balance | -326 | -1,045 | 299 | 547 | 666 | 715 | 809 |
| | % of GDP | | | | | | |
| Taxes on production and imports | 13.6 | 14.7 | 14.7 | 15.1 | 15.5 | 15.5 | 15.5 |
| Taxes on income and wealth | 10.3 | 10.3 | 9.9 | 9.7 | 9.7 | 9.7 | 9.7 |
| Social contributions | 7.5 | 8.2 | 8.4 | 8.5 | 8.8 | 8.7 | 9.0 |
| Other current resources | 4.1 | 5.5 | 5.5 | 5.3 | 5.3 | 5.3 | 5.2 |
| Total current revenue | 35.6 | 38.8 | 38.4 | 38.5 | 39.3 | 39.3 | 39.4 |
| Capital transfers received | 0.9 | 0.7 | 0.6 | 0.2 | 0.3 | 0.3 | 0.3 |
| Total government revenue | 36.4 | 39.5 | 39.0 | 38.8 | 39.6 | 39.6 | 39.7 |
| Compensation of employees | 14.3 | 13.3 | 12.8 | 12.4 | 12.4 | 12.3 | 12.2 |
| Intermediate consumption | 4.1 | 3.7 | 3.9 | 3.6 | 3.7 | 3.6 | 3.6 |
| Social transfers | 13.7 | 14.0 | 13.9 | 14.1 | 13.9 | 13.6 | 13.4 |
| Interest payments (1) | 3.3 | 2.8 | 2.9 | 2.6 | 2.4 | 2.2 | 2.1 |
| Subsidies | 0.5 | 0.5 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 |
| Other current expenditure | 2.2 | 2.2 | 2.6 | 2.2 | 2.3 | 2.3 | 2.3 |
| Total current expenditure | 38.1 | 36.5 | 36.4 | 35.4 | 35.2 | 34.5 | 34.1 |
| Total capital expenditure (2) (3) | 3.4 | 11.8 | 3.7 | 2.9 | 3.3 | 3.6 | 3.7 |
| Total government expenditure | 41.6 | 48.2 | 40.2 | 38.3 | 38.5 | 38.2 | 37.9 |
| General government balance | -5.1 | -8.8 | -1.2 | 0.5 | 1.1 | 1.4 | 1.9 |
| General government primary balance | -1.8 | -5.9 | 1.7 | 3.0 | 3.5 | 3.6 | 3.9 |
| Nominal GDP | 18.1 | 17.6 | 17.7 | 18.1 | 19.0 | 19.7 | 20.6 |

* Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014

(1) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem.

(2) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013.

(3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).

Source: European Commission

Table A3.8: **Debt developments**

| | 2013 | 2014* | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|-------------------------------------|-------|-------|-------|-------|------|------|
| Gross debt (% of GDP) | 102.6 | 107.5 | 107.5 | 107.1 | 103.0 | 98.3 | 93.9 |
| Real GDP growth (% change in PYP) | -4.2 | -2.4 | 0.4 | 1.8 | 2.7 | 4.1 | 3.8 |
| Nominal GDP (EUR bn) | 18.1 | 17.6 | 17.7 | 18.1 | 19.0 | 19.7 | 20.6 |
| General government balance (% of GDP) | -5.1 | -8.8 | -1.2 | 0.5 | 1.1 | 1.4 | 1.9 |
| Change in gross debt ratio (pps change) | 22.9 | 4.9 | 0.0 | -0.4 | -4.1 | -4.8 | -4.4 |
| | Contribution to the change in stock | | | | | | |
| Primary balance | -1.8 | -5.9 | 1.7 | 3.0 | 3.5 | 3.6 | 3.9 |
| Snow-ball effect | 9.3 | 6.0 | 2.0 | 0.3 | -2.5 | -1.7 | -2.0 |
| of which | | | | | | | |
| Interest expenditure | 3.3 | 2.8 | 2.9 | 2.6 | 2.4 | 2.2 | 2.1 |
| Real growth effect | 5.1 | 1.5 | -2.1 | -3.2 | -3.6 | -2.8 | -2.5 |
| Inflation effect | 0.9 | 1.7 | 1.3 | 0.9 | -1.2 | -1.0 | -1.5 |
| Stock-flow adjustments | 11.9 | -7.0 | -0.3 | 2.4 | 1.9 | 0.6 | 1.6 |

* Net of one-off recapitalisation cost of the cooperative banking sector amounting to 8.6% of GDP in 2014.

Source: European Commission

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