European Commission

ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Cyprus, Spring 2019

INSTITUTIONAL PAPER 104 | JUNE 2019

EUROPEAN ECONOMY

Economic and Financial Affairs

European Economy Institutional Papers are important reports analysing the economic situation and economic developments prepared by the European Commission's Directorate-General for Economic and Financial Affairs, which serve to underpin economic policy-making by the European Commission, the Council of the European Union and the European Parliament.

Views expressed in unofficial documents do not necessarily represent the views of the European Commission.

LEGAL NOTICE

Neither the European Commission nor any person acting on behalf of the European Commission is responsible for the use that might be made of the information contained in this publication.

This paper exists in English only and can be downloaded from https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

Luxembourg: Publications Office of the European Union, 2019

PDF ISBN 978-92-79-98851-6 ISSN 2443-8014 doi:10.2765/598330 KC-BC-19-011-EN-N

European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2019

EUROPEAN ECONOMY

Institutional Paper 104

ACKNOWLEDGEMENTS

The report was prepared in the Directorate-General for Economic and Financial Affairs under the direction of Manfred Bergmann, Director, Moisés Orellana, Head of Unit for Cyprus, and Magdalena Morgese-Borys, Deputy Head of Unit for Cyprus.

The report was approved by Carlos Martínez Mongay, acting Deputy Director-General ([1]).

Contributors: Filip Keereman, Emrah Arbak, Cristina Sucila, Angela Droussiotou, Nuria Subirats-Rebull, Milda Valentinaite, Andreea-Alexandra Maerean, Anda Patarau, Pedro Arevalo, Katerina Aristodemou, Christos Koulouteris, Luigi De-Sanctis, Vallyon Emese, Gildas Lame, Ana Lope and Jaime Ruiz Rocamora. Assistance was provided by Susanne Hoffmann.

The Post-Programme Surveillance assessment was prepared in liaison with staff from ECB ([2]).

The report reflects information available up until 24 April 2019.

Comments on the report would be gratefully received and should be sent by mail or e-mail to:

Moisés Orellana
European Commission
Directorate-General for Economic and Financial Affairs
CHAR 12/006
B-1040 Brussels, Belgium
e-mail: moises.orellana@ec.europa.eu

([1]) The executive summary of this report was adopted as Commission Communication C(2019) 4013 on 23 May 2019. The rest of the report reflects the findings of the Staff Working Document SWD(2019) 197 accompanying this communication.
([2]) European Central Bank (ECB) staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

AMC: asset management company

ALMPs: active labour market policies

BoC: Bank of Cyprus

CBC: Central Bank of Cyprus

CCB: Cyprus Cooperative Bank

CET1: common equity tier 1

CyTA: Cyprus Telecommunications Authority

CYSTAT: Statistical Service of Cyprus

DSA: debt sustainability analysis

DTA: deferred tax assets

EC: European Commission

EU: European Union

ECB: European Central Bank

EDP: excessive deficit procedure

EPC: Economic Policy Committee

ESM: European Stability Mechanism

GDP: gross domestic product

GVA: gross value added

HB: Hellenic Bank

HICP: harmonised index of consumer prices

IFRS: International Financial Reporting Standard

IMF: International Monetary Fund

MTO: medium-term objective

NEET: not in education, employment or training

NFC: non-financial corporations

NPL: Non-performing loans

OECD: Organisation for Economic Co-operation and Development

PDMO: Public Debt Management Office

PPM: post-program monitoring

PPS: post-programme surveillance

SPE: special purpose entity

SSM: Single Supervisory Mechanism

y-o-y: year-on-year

EXECUTIVE SUMMARY

This report presents the findings of the sixth 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 18 to 22 March 2019. The mission was coordinated with the International Monetary Fund's (IMF) Post-Program Monitoring (PPM) mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System. The next PPS mission will take place in autumn 2019.

While the Cypriot economy continued to grow strongly in 2018, external headwinds are increasing and significant domestic vulnerabilities remain. Despite the global economic slowdown, Cyprus posted remarkably strong growth for the third year in a row, reaching 3.9% in 2018. Growth was driven by domestic demand and exports of services, particularly tourism, while inflation remained subdued. Domestic demand is expected to continue to perform strongly in 2019, on the back of rapidly declining unemployment and moderately rising wages. Nevertheless, the growth momentum is forecast to subside, mostly reflecting the less favourable external environment. These challenges are further compounded by key vulnerabilities of the Cypriot economy, notably the still very high levels of non-performing loans as well as private, public and external debt in a context of low productivity growth, and high dependency on foreign capital flows.

The underlying fiscal performance continued to be very strong in 2018 on account of buoyant revenues, even though the general government surplus turned into a deficit due to the one-off banking support measures related to the sale of the Cyprus Cooperative Bank (CCB). For 2019 and 2020, the budget balance is expected to resume posting sizeable surpluses. Risks mainly relate to the fiscal impact of the healthcare reform and the outcome of court rulings on past measures to reign in the public sector wage bill. Moreover, a sharper-than-currently-expected slowdown may adversely affect fiscal revenues. Public debt increased significantly in 2018 due to the bank support measures related to the CCB sale, but is expected to steadily decline thereafter. The high public debt underlines the importance of continued prudent expenditure management to firmly anchor the downward path of public debt in line with the requirements of the Stability and Growth Pact.

Last year Cyprus made significant progress in consolidating its banking sector and reducing non-performing loans (NPLs) held by banks, but important challenges remain. In 2018 NPLs held by banks declined markedly mainly on account of two one-off transactions, i.e. the transfer of the non-performing CCB assets to the state-owned asset management company KEDIPES and the sale of a large NPL portfolio by Bank of Cyprus. This strengthened the balance sheets of the two largest banks. Notwithstanding this important progress, NPL resolution remains a top priority as the NPL ratio in the Cypriot banking sector continues to be the second-highest in the euro area. Moreover, these actions do not change the fact that private sector indebtedness, including loans held by both banks and non-banks, remains highly elevated. To continue with NPL resolution and private sector debt deleveraging, it is essential to enhance payment discipline and resolve unviable debt by fully using the amended insolvency and foreclosure frameworks. Rigorously assessing the compliance with the eligibility criteria and swiftly triggering foreclosure procedures in the case of re-defaults will be critical for the performance of the forthcoming ESTIA scheme for NPLs collateralised with primary residences. Another key priority is the establishment of KEDIPES as a successful asset management company in line with the corresponding State aid decision. This includes overcoming the current delays in setting up an effective governance framework, ensuring operational independence from the State, and having an adequate supervisory framework. Overall, the profitability of the banking sector is challenged by low interest margins, high level of liquidity and still elevated volume of NPLs.

The still favourable economic conditions provide a window of opportunity to step up the pace of structural reforms to boost potential growth. A key priority is the effective implementation of the judicial reform, which is essential for the functioning of the economy. This involves the establishment of new specialised courts, in particular a commercial court, clearing the high accumulation of cases, including cases related to NPLs and revising the outdated civil procedure rules. This would also have a beneficial impact on repayment discipline. Moreover, it is important to swiftly address the long-overdue reform of the title deeds issuance and transfer system. It is also essential to improve the efficiency in the public sector, in particular the functioning of the public administration and of local governments. Furthermore, the business environment needs to be improved, including through the elimination of administrative barriers to investment, the opening up of the electricity market, and the completion of privatisation projects. These structural reforms would facilitate investment in Cyprus and help diversify it to sectors other than construction and tourism, currently the key drivers of growth. The implementation of the national healthcare system is expected to improve access to affordable health care services by reducing high out-of-pocket expenditure. At the same time, it will be important to contain related fiscal risks.

Risks for Cyprus' capacity to service its ESM debt remain low in the short term. The borrowing conditions for Cyprus continue to be favourable. Following the 15-year bond issuance in February 2019, the government tapped the international markets again in April 2019, with a 30-year bond and a 5-year bond. Furthermore, the country stands at investment grade with the three major rating agencies. In view of robust economic growth, expected large primary surpluses, a sizeable cash buffer and improved investor confidence, the risk of Cyprus not being able to service its debt remains low in the short term. However, medium-term debt dynamics are sensitive to macroeconomic shocks, vulnerabilities in the financial system, a significant and sustained rise in the interest rates, and changes in fiscal performance. To maintain the repayment capacity, it is essential for Cyprus to ensure fiscal discipline, reduce further the NPLs and progress on structural reforms to support potential growth.

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

1. INTRODUCTION

Cyprus implemented an economic adjustment programme from April 2013 to March 2016. The three-year programme was approved by the Council of EU Economic and Finance Ministers (Ecofin Council) and the Board of the International Monetary Fund (IMF) in March 2013. The programme provided about EUR 7.3 billion in financing from the European Stability Mechanism (ESM) and the IMF. 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, in liaison with staff from the European Central Bank (ECB), carried out the sixth post-programme Surveillance (PPS) mission to Cyprus between 18 and 22 March 2019. The mission was coordinated with IMF's post-program monitoring (PPM) mission. Staff from the ESM also participated in the meetings dealing with the ESM's Early Warning System. The aim of PPS is to broadly monitor the economic, fiscal and financial conditions of a country that has received financial assistance in order to assess its capacity to repay it ([3]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

([3]) PPS is provided for by Article 14 of two-pack Regulation (EU) No 472/2013. The surveillance started after the EU/IMF financial assistance programme expired and will last until at least 75 % of the financial assistance has been repaid.

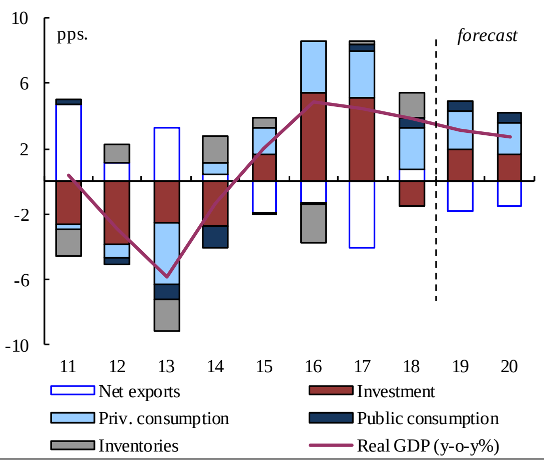
2. MACROECONOMIC OUTLOOK

Macroeconomic situation

Cyprus continues to enjoy a remarkable post-crisis rebound. Real GDP growth in 2018 was 3.9 %, while 2017 data has been again revised up, to 4.5 %, making Cyprus one of the fastest growing economies in the EU for the last 3 years. In 2018, GDP growth was driven by private consumption and exports, while investment declined compared to a year before. This shift from investment to exports is expected to be temporary, as it was mainly caused by ship de-registrations, a feature of the Cypriot economy that distorts the analysis of investment and trade dynamics.

Cyprus' real GDP growth is projected to ease further amid the less favourable external environment and ongoing private sector deleveraging. GDP growth is nevertheless expected to remain well above the euro area average but slow down to 3.1 % in 2019 and to 2.7 % in 2020. Rising domestic demand on the back of falling unemployment remains the key driver of growth.

Graph 2.1: **Real GDP growth and contributions**



Source: European Commission

Investment is expected to remain resilient and to be one of the main drivers for growth, although concentrated in sectors with weak prospects for raising long-term growth. A significant part of investment comes from ongoing tourism-related projects, in response to the increasing demand for accommodation, and as a targeted effort to diversify or upgrade tourism products. Other investment projects relate to residential construction, with half of all transactions in the sector being driven by foreign demand. Local demand should gradually recover thanks to of increasing bank lending. On foreign demand for residential properties, the Citizenship by Investment programme has supported the construction sector, leading to strong house price increases in some regions. Finally, a large share of investment in Cyprus is associated with ship registrations. These are inherently volatile but more likely to increase as a result of efforts to facilitate ship registration. Overall, these three components of investment in Cyprus are mostly funded by foreign, essentially non-EU sources.

Private consumption is set to continue to be solid, supported by a strong labour market performance. Employment has risen by around 4 % each year since 2016, and the unemployment rate fell to 7.1 % in February 2019. Wages are increasing moderately, mostly due to automatic indexation, restauration of wage increments in the public sector and wage renegotiations in some sectors. Altogether, this leads to higher disposable incomes for households and supports private consumption. Moreover, at a time when the labour market is becoming tighter, the employers of several sectors are scheduled to renegotiate wages with the unions. However, private consumption growth may be slowed by sizeable increase in social security contribution rates, contributions to the national health system and expectations that borrowers will step up debt servicing ([4]).

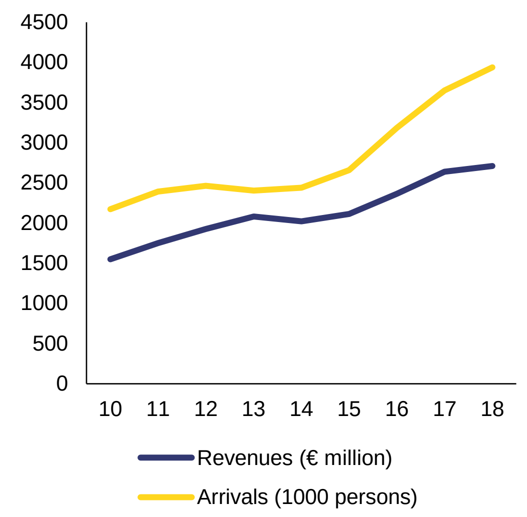
Public consumption is also set to provide ongoing support to growth. The growth contribution of public consumption turned positive in 2017 and is expected to remain supportive to growth over the period covered by the forecast. In particular, public wage increases are set to continue in the coming years, driven by automatic indexation, wage increments and the unfreezing of promotions. Furthermore, two recent decisions by the Administrative Court ruling that public sector payroll and pension cuts since the crisis were unconstitutional might further increase public wages (see Section 4.2 on fiscal outlook).

([4]) In 2018, a scheme to support defaulting borrowers was designed and foreclosure procedures were reinforced (see Section 3 on Financial sector issues).

Net exports contributed positively to growth in 2018 but are likely to weight on growth in 2019. Last year, for the first time since 2014, net exports were a positive factor for growth. This was linked to a more active ship deregistration affecting the goods' account. Aside from such volatility, the services account – which is the regular positive contributor for growth in Cyprus, and consisting largely, though not exclusively, of tourism services – weakened in 2018 (see Graph 2.2). Over recent years, the number of tourists has strongly increased, leading to full capacity utilisation in peak months and even to accommodation and labour shortages. 2019 is expected to be a more difficult year, partially due to more limited air accessibility as a result of bankruptcies of several airlines servicing Cyprus in 2018, but also due to slowing global demand, increasing competition and high uncertainty related to UK's withdrawal from the EU (UK citizens account for more than a third of all tourists to Cyprus).

Inflation in Cyprus was persistently low and is expected to stay subdued. Inflationary pressures come mainly from energy and unprocessed food categories, while core inflation continues to fluctuate around zero, a somewhat surprising development given that the country is experiencing high growth. Two factors seem to provide some explanation. First, prices of household appliances, clothing, footwear and many other types of non-energy industrial goods are being kept down by the increasing competition among wholesalers, retailers and internet platforms, and by the absence of legislation on when shops can offer sales. Second, although the unemployment rate has fallen notably in recent years, there is still significant slack in the labour market. Furthermore, job creation is the fastest in the low-paid sectors (tourism and construction). Combined with substantial inflows of foreign workers during the peak seasons, this explains why wage growth falls short of expectations ([5]) and does not trickle down to inflation. Inflationary pressures are thus expected to remain subdued.

Graph 2.2: Tourist arrival and tourism revenues



Source: Cystat

The real estate market is recovering steadily. The number of transactions has increased each year since the crisis. Residential property prices are increasing at a moderate pace, below 2 % in 2018 ([6]). There are some regional divergences, with notably more pronounced increases in apartment prices in Limassol, driven by foreign demand. The supply of residential properties is increasing at a fast pace to match the rising demand.

The current account deficit remains very large, although a large part of it is associated with the activities of special purpose entities (SPEs) ([7]). The current account deficit in 2018 was 7 % of GDP (according to Balance of Payments data), slightly lower than a year before (8.4 % of GDP). In Cyprus, the current account is heavily influenced by SPEs (see Graph 2.3). During the first three quarters of 2018, activities of SPEs accounted for roughly half of the current account deficit, while their impact on real economic growth tends to be positive but much smaller in comparison. Aside from these activities, over

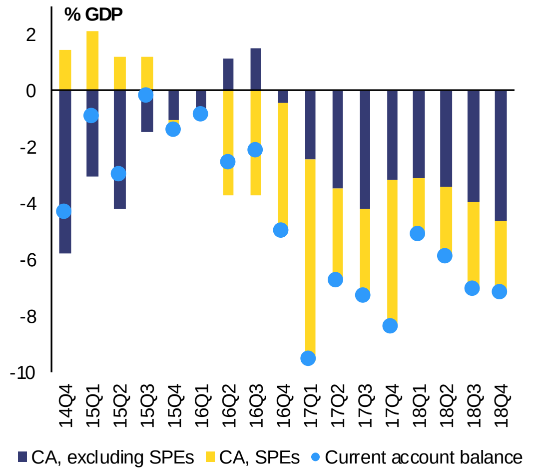
([5]) Based on a benchmark for wage growth consistent with internal labour market conditions. It is calculated as wage growth predicted on the basis of changes in labour productivity, prices and the unemployment rate (see Arpaia and Kiss, 2015)

([6]) According to the preliminary Eurostat data; also supported by the Central Bank of Cyprus data for the three quarters of 2018.

([7]) SPEs are companies registered in Cyprus that are classified as residents of Cyprus but are controlled by a non-resident parent and have no or few employees, little or no production in the host economy and little or no physical presence in the economy. For more information see: https://www.centralbank.cy/images/media/redirectfile/Definition_of_SPEs_EN.pdf

2017-2018 the current account deficit excluding SPEs substantially widened compared to the 2 previous years, reflecting a strong rebound from the crisis and a high import content in consumption and investment.

Graph 2.3: **Current account developments, SPEs and non-SPEs**



Source: Central bank of Cyprus, European Commission

While the Cypriot economy is expected to continue growing strongly, risks are tilted to the downside. As a small, open economy, Cyprus is facing strong headwinds ahead due to the slowdown in global economy. The UK's withdrawal from the EU is another important challenge, as Cyprus has close historic and economic links to the UK. The slowdown in the euro area is likely to add to the weakness in exports. Tourism — one of the major pillars of the economy — has reached saturation point. Labour shortages are starting to emerge in some sectors, signalling the maturing of cycle in Cyprus. Finally, heavy reliance on foreign funding is helping overcome the lack of local lending and partially shields Cyprus from the weaker growth outlook in the rest of the euro area, but it increases the country's vulnerability to external developments.

The main challenge in the longer run is the country's limited growth potential. Cyprus' fast growth over recent years relied heavily on tourism, construction, professional services and shipping. These sectors are unlikely to significantly raise productivity, which weighs on the prospects for long-term growth. There is therefore a pressing need to step up the pace of structural reforms in order to boost potential growth, by helping to diversify investment to other sectors and to improve the business environment (see Section 5 on structural issues). This could also benefit the sectors currently driving growth. For instance, administrative procedures to obtain building permits for large construction projects remain particularly lengthy and cumbersome. Encouragingly, there are some initial signs of diversification of the economy, including investments in education and healthcare. However, progress is also needed in other areas. Cyprus has so far missed the opportunities to explore its natural advantages in solar energy and the creation of a circular economy and has not addressed the long-standing issue of water and waste management. Investments are urgently needed in the environment, energy, digitalisation and innovation ([8]).

([8]) For more details please see 2019 Cyprus Country Report, https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf

3. FINANCIAL SECTOR ISSUES

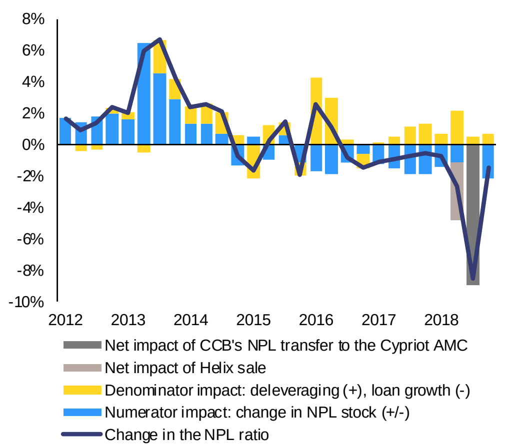
3.1. BANKING SECTOR PERFORMANCE

Asset quality

The stock of NPLs in the banking sector declined significantly in 2018. NPLs halved from EUR 20.6 billion (44 % of all loans) at the start of 2018 to EUR 10.3 billion (30 % of all loans) at the end of the year (see Table 3.1) ([9]). The decline was driven by two one-off operations (see Graph 3.1). In particular, in September 2018 the stock of NPLs of Cyprus Cooperative Bank (CCB), amounting to nearly EUR 5.7 billion, was moved from the bank to the government-owned Asset Management Company (AMC) ([10]). Additionally, Bank of Cyprus (BoC) sold a portfolio of EUR 2.7 billion of NPLs (Helix sale) to funds affiliated with Apollo Global Management ([11]).

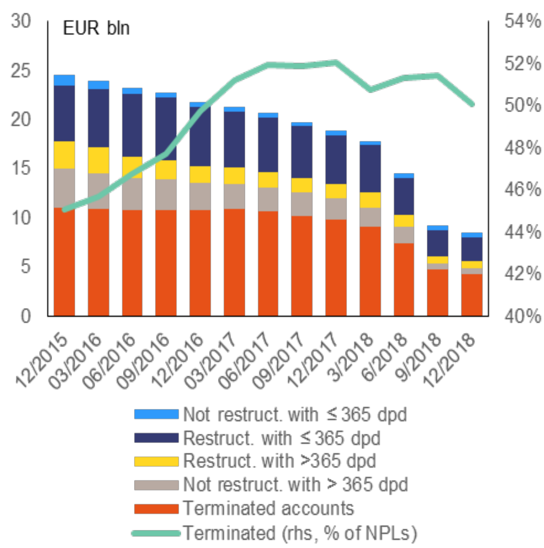
Banks' ability to resolve the remaining NPLs continues to be challenging. The largest volume of NPLs held by the banks at the end of 2018 belonged to households, amounting to EUR 5.2 billion (38 % of gross loans). The NPLs of non-financial corporations amounted to EUR 4.8 billion (33 % of gross loans). Compared to the beginning of 2018, both households and non-financial corporations' stocks of NPLs were roughly reduced by half, driven by the operations outlined above. Nevertheless, they remain high. The overall NPL ratio, of 30 % of total gross loans, continues to be the second-highest in the euro area. Moreover, tackling NPLs for which no or little negotiation options remain (i.e. 'terminated accounts'), which represent nearly half of the current stock (see Graph 3.2), continues to be challenging. While most of these NPLs are backed by real estate collateral, resolving them is still challenging.

Graph 3.1: **Changes in the NPL ratio and breakdown**



Source: Central Bank of Cyprus

Graph 3.2: **Evolution of the NPL stock and its breakdown**



The abbreviation "dpd" stands for days past due, referring to the number of days payments are late for a loan. The figures cover only loans with fixed maturities, which represent over 90% of all loans, excluding revolving loan facilities such as overdrafts. The large reductions in June and September 2018 reflect the developments discussed at the beginning of this section.
Source: Central Bank of Cyprus

([9]) The NPL ratio (i.e. NPL stock to total gross loans ratio) in this report is based on data and scope definition provided by the Central Bank of Cyprus (CBC). In particular, exposures of banks to central banks and credit institutions, and the overseas operations (branches and subsidiaries located abroad) of the banks are not taken into account. Therefore, the NPL figures differ from the ratios in the 2019 Cyprus Country Report, which are based on the ECB definition.

([10]) An additional portfolio of fully-provisioned NPLs (i.e. zero book value), that was kept off the balance sheet of CCB, was also transferred to the asset management company. The portfolio had a gross value of EUR 1.3 billion.

([11]) BoC signed the sale agreement with Apollo Global Management in August 2018. The Single Supervisory Mechanism (SSM) approved the risk transfer in March 2019. However, the announced transaction was already reflected in June 2018 NPL data reported by the CBC (see Graph 3.1).

Table 3.1: **Soundness indicators for the banking sector in Cyprus**

	2012	2013	2014	2015	2016	2017	2018			
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	June	Sept	Dec
NPLs*, all loans (EUR billions)	15.6	26.0	27.3	26.7	23.8	20.6	19.9	16.6	11.0	10.3
NPLs*, all loans (% of total)	22.6	41.5	47.8	45.8	47.2	43.7	43.0	40.3	31.8	30.3
NPLs*, loans to NFCs (% of total)	..	..	58.0	56.0	56.4	50.3	48.4	39.4	36.3	33.3
Restructured non-performing (% of total)	..	12.5	23.3	25.9	25.7	22.8	22.3	16.4	15.4	14.5
Restructured performing (% of total)	..	12.2	5.3	7.5	9.4	8.6	7.9	8.6	8.3	6.7
NPLs*, loans to households (% of total)	..	43.3	52.7	56.2	55.9	53.9	53.6	52.5	38.0	37.7
Restructured non-performing (% of total)	..	6.7	13.9	18.0	20.0	19.7	19.8	19.4	16.8	17.2
Restructured performing (% of total)	..	10.4	8.9	6.7	7.7	8.3	8.0	7.6	8.5	7.0
Coverage rate (Impairments / NPLs)*	47.9	37.7	32.9	37.8	41.7	46.8	48.6	48.3	51.9	50.9
Cost-to-income ratio	55.6	53.4	40.4	44.1	52.5	53.6	63.9	74.3	60.0	n.a.
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	2.2	2.3	1.8	n.a.
Common Equity Tier 1 ratio	..	..	14.2	15.6	15.9	14.9	14.1	14.2	14.1	n.a.
Return on assets (annualized)	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.9	0.3	0.5	n.a.

*In this report the term "NPLs" is used as a shorthand term. In fact, it refers to non-performing exposures (NPEs), following the EU definition, as defined laid down in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278) and as applied by the CBC. The local definition of NPLs definition was used until the end of 2014, from then onwards the EU NPLs definition was used.
The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis. Figures exclude exposures to central banks and credit institutions.
Source: Central Bank of Cyprus

The coverage ratio improved. The average coverage ratio for the banking sector was 51 % in December 2018, up from 47 % at the end of 2017. The transfer of CCB's more risky assets out of the banking system explains most of this development. The aggregate coverage ratio continues to exceed the EU average of 45 %.

Going forward, the stock of NPLs in the banking sector is expected to continue declining. The two largest banks envisage large NPL portfolios sales, aiming to reach single digit levels within the next 5 years. Further NPL reductions may come from ESTIA, the State-support scheme for NPLs backed with primary residences. However, the success of this scheme depends to a large extent on banks and on KEDIPES, the Cypriot AMC, triggering the foreclosure procedures immediately in case of re-defaults. Banks are also considering off-balance sheet securitisations and the repossession of collateral through the use of out-of-court restructuring and also via foreclosures.

Weak asset quality of the broader financial system and the elevated private sector indebtedness remain main important concerns. The removal of nearly EUR 10 billion of NPLs in 2018, could help banks turn their focus to lending to the real economy while improving their profitability. However, the NPL reduction did not change the fact that both households and non-financial corporations remain over-indebted. A high level of non-performing debt complicates banks' balance sheet repair and increases the likelihood and amplitude of future crises, besides its negative impact on potential economic growth and demand ([12]).

Banking sector profitability

In 2018 the banking sector returned to profitability, but banks' performance is still under pressure. Overall, banks recorded a net profit before tax of EUR 293 million as of December 2018, compared with a loss of EUR 619 million the year before. The decline of almost EUR 824 million y-o-y (59 %) in loan loss provisioning contributed to bringing the banking sector into profitability again. The return on equity before tax was thus positive, reaching 4.4 % in December 2018 (from -10.6 % at the end of 2017). However, the net interest margin continued to decrease, falling to 1.8 % in September 2018 from 2.4 % the year before. Overall, the capacity of

([12]) For more, see evidence presented in IMF (2017), "Household debt and financial stability", in *Global Financial Stability Report*, Chapter 2, pp. 53-89.

banks to generate profits is still challenged by low interest margins, the high level of liquidity and still elevated volume of NPLs.

Profitability could be improved by increasing further banks' efficiency via reducing their operating expenses. The CCB market exit together with the largest banks' efforts to reduce the number of branches and employees since the crisis, indeed improved efficiency. In September 2018, the cost-to-income ratio climbed to 60 % up from 48.7 % a year ago, on the back of a sharp reduction in income relative to costs and an increased burden with debt servicers' fees. With such a high ratio, there is still room to streamline banks' capacity and operations of banks by using more ICT technologies and online products, by downsizing units through the outsourcing of bad asset management, and by diversifying the range of services offered.

Capitalisation and liquidity

The banking sector aggregate capital position declined. The common equity tier 1 (CET1) ratio decreased to 14.1 % in September 2018 from 15 % a year before, but is still above the EU average of 13 %. The overall capital ratio also decreased by 60 basis points to 15.7 % over the same period. Capital buffers were reduced due to lower retained earnings in 2017 (driven by significant provisioning charges) and due the implementation of IFRS 9 in 2018. Maintaining adequate capital buffers will be challenging, especially in the context of ongoing balance sheet deleveraging and weak profitability.

There were a few new developments regarding macro-prudential measures. On 17 December 2018 the CBC, following consultation with the Cyprus Securities and Exchange Commission (CySEC), designated five investment firms as 'other systemically important institutions' (O-SIIs) ([13]). The additional O-SII capital buffer requirements applicable from 1 April 2019 are 1.5 % for Renaissance Securities (Cyprus) Ltd and 1 % for SIB (Cyprus) Ltd, BrokerCreditService (Cyprus) Ltd, Alfa Capital Holdings (Cyprus) Ltd and Etoro (Europe) Ltd. At the same time, CBC revised the buffers applicable to O-SIIs. As regards the relevant capital buffers to be phased in over 2019-2022, the buffer for Hellenic Bank increased from 1 % to 1.5 %, while the rest remained unchanged (0.5 % for Alpha Bank, 1 % for Eurobank, 1.5 % for Russian Commercial Bank and 2 % for BoC). The countercyclical capital buffer requirement is kept at 0 % ([14]). The temporary macro-prudential rules on liquidity requirements, which were introduced in January 2018, are met with ease by all local banks due to excess liquidity ([15]).

Meeting the minimum requirement for own funds and eligible liabilities (MREL) may be challenging. Due to their heavy reliance on deposit funding, Cypriot banks will need to raise additional non-deposit funding to meet their MREL. This creates additional pressure on banks that already face profitability and asset quality challenges. Nevertheless, the Single Resolution Board has not yet set binding MREL targets for any of the Cypriot banks.

Deposits declined slightly in 2018. A large and quite dramatic reduction in deposits occurred in 2013, following the restructuring of the banking system which involved a bail-in of depositors. Since then, the overall volume of non-resident deposits has continued to decline, notably due to the fall of deposits denominated in foreign currencies, while the deposits denominated in euro have been increasing (see Graph 3.3). One of the reasons for this decline was the stepping up of the anti-money laundering efforts. Unlike non-resident deposits, resident deposits are approaching pre-2013 levels. In 2018 deposits in the banking system declined by 3.54 % y-o-y, led by the decrease in the non-resident deposits ([16]).

([13]) Under Directive 2013/36/EU, O-SIIs are institutions that, due to their systemic importance, are more likely to create risks to financial stability and hence may be required to hold an additional capital buffer.

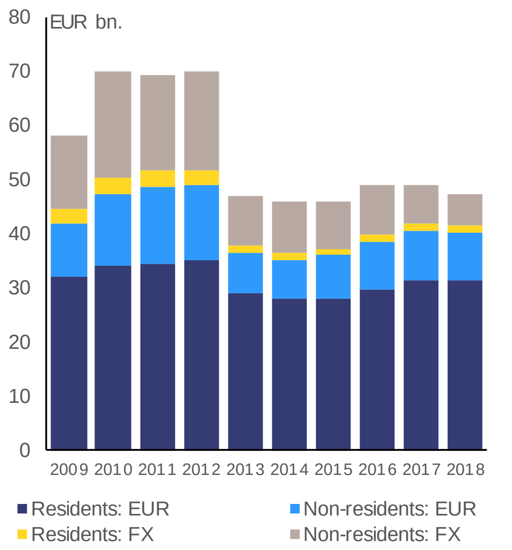
([14]) The CBC also introduced borrower-based measures in 2013, which were streamlined in March 2016, with total debt servicing and the loan-to-value ratio capped.

([15]) On 30 January 2018, the CBC published its macro-prudential decision on additional liquidity requirements, after finalising consultations with EU institutions under CRR Article 458 and SSM Regulation Article 5. The most important impact of the new rules will be the higher outflow rates applicable to covered deposits, going from 10 % in H1 2018 to 7.5 % in H2 2018 and to normal 5 % after 2019.

([16]) The government deposit at the CCB, initially worth of EUR 2.5 billion and then later on of EUR 3.5 billion, was introduced in the overall deposits statistics in April 2018, but then taken out in September, when the CCB legacy was

Liquidity buffers in the overall sector are high, with a liquidity coverage ratio well above 200 %. Moreover, since the improvement of the sovereign credit rating to investment grade in September 2018, banks are able to use Cypriot government securities as collateral for the monetary operations of the ECB.

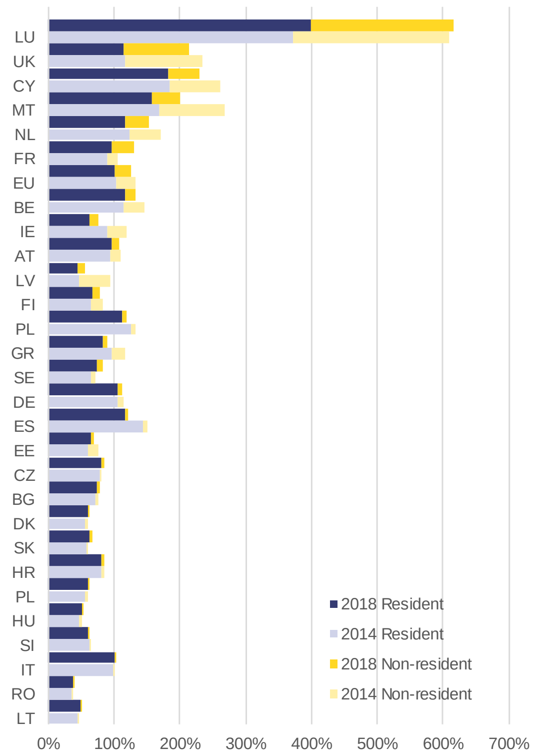
Graph 3.3: **Customer deposits in the Cypriot banking system**



Source: Central Bank of Cyprus

The banks' business model remains based on the ample availability of deposits. The amount of deposits in the Cypriot banking system remains high, the third highest in the EU after Luxembourg and the United Kingdom, when compared to the overall size of the economy (see Graph 3.4). This reflects both high non-resident and resident deposits. It leads to excess liquidity for which it is difficult to find a profitable use in a domestic environment still characterised by a highly indebted private sector — possibly increasing pressure to ease the credit standards. Another consequence is that banks keep significant deposits at the central bank at a negative interest rate.

Graph 3.4: **Customer deposits as % of GDP in EU, residents and non-residents, 2014 and 2018**



Sources: ECB, Bank of England, National Bank of Denmark, Bank of Latvia

Lending

Deleveraging of the banks' balance sheets has picked up. Total consolidated assets of the banking sector decreased by 12 % (EUR 7.8 billion) year-on-year as of September 2018. This reduction was largely due to the CCB exiting the banking system, as well as the Helix portfolio sale by Bank of Cyprus. New lending to the private sector in 2018 decreased slightly compared to the year before, mainly in the corporate sector. Meanwhile, new mortgages increased over the same period.

Interest rates on both deposits and loans declined further. By November 2018, the decline in interest rates accelerated to 67 basis points in annual terms for deposits with less than 1 year maturity for households, and to 92 basis points for firms. These are positive developments in terms of addressing excess liquidity in the banking system. Lending rates also dropped in the same period, by 46 basis points for mortgage lending and 12 basis

transformed into the AMC. Thus, it did not impact on the 3.54 % y-o-y decline in deposits at the end of 2018.

points for corporate loans. As deposit interest rates decreased somewhat more than lending rates, all in all, these developments eased somewhat the pressure on net interest margins for banks, which overall remain tight. Narrow interest margins put pressure on banks' interest income and thus lead to weak profitability.

Restructuring of the banking sector

Bank of Cyprus, the largest domestic bank, has significantly reduced its NPL stock. The bank closed 2018 with a net loss, which was driven by the Helix portfolio sale. However, the sale contributed greatly to the EUR 4 billion NPL reduction. At the end of 2018, the bank's NPLs stood at EUR 4.8 billion, resulting in a NPL ratio of 36 %. The notable improvement in the bank's credit portfolio reduced its average risk-weight, which offset these losses. The March 2019 law providing for the conversion of deferred tax assets (DTAs), transferred from Laiki in 2013 following its resolution, to deferred tax credits (DTCs) will improve the bank's capital buffers further in accounting terms.

Bank of Cyprus's limited profitability, still relatively high level of NPLs and large direct real estate exposures are key concerns. Like its Cypriot peers, the bank has a significant amount of liquidity, which is difficult to be profitably invested. To improve its asset quality, the bank aims to reduce its NPL ratio significantly through the extensive use of ESTIA and additional asset disposals. The bank may also increase its already large real estate portfolio through debt-to-asset restructuring and increasingly via failed foreclosure auctions, which lead to the on-boarding of the unsold collateral.

Hellenic Bank (HB)'s business model and risk profile changed significantly following the acquisition of CCB's 'good' assets. Incorporating CCB's performing assets into the bank's balance sheet, made HB the second largest bank in Cyprus, with its market share in household loans increasing from 6 % to 30 %. The transfer of the performing loans reduced the bank's NPL ratio from 53.3 % in June 2018 to 30.9 % in the following quarter. Profits have also enjoyed a one-off improvement, thanks to a negative goodwill recognition of around EUR 300 million at end-2018. The negative goodwill related to the price paid for the acquisition of the good part of CCB, being below the book value. The bank finalised the capital raise required by the SSM, through a EUR 100 million rights issue and a EUR 50 million private placement with American investment management firm PIMCO. Taking into account all the recent changes, the bank's CET1 ratio remained quite high at 17.8 % as of September 2018.

HB's rapid growth introduces new opportunities, but also creates new risks. The bank stands to make generous profits due to the government bonds and performing loan portfolio transferred from CCB ([17]). The bank aims to reduce its NPL ratio to below 10 % levels within the next few years. However, like BoC, HB has significant excess liquidity and currently has few lending or investment opportunities. Moreover, the bank holds a significant portfolio of sovereign bonds. In addition, the bank faces some cultural challenges in absorbing CCB's activities (e.g. only 20 % of CCB depositors have ATM cards and many still carry physical savings booklets).

RCB Bank (RCB), the third largest bank in terms of total assets, has recently re-orientated its international business. RCB has been under SSM supervision since 2014 as it is considered a significant institution. The bank is partly owned by the Russian VTB Bank (46 %), while the rest of the shares have been recently purchased by the management. Until 2018, the bank had significant collateralised back-to-back exposures to VTB Bank, which were used to fund syndicated loans to Russian corporations. Starting with late 2018 and early 2019, the bank has reduced this line of business. The bank has relatively small domestic exposures, mostly in Limassol, funding Russian expatriates. The bank aims to expand on the domestic market, explore new markets with a focus on large companies and private banking, and reduce VTB Bank's stake.

The liquidations of FBME and Laiki are ongoing. A new application was filed in court, aiming to treat FBME as a branch, which would

([17]) Part of the performing loans portfolio transferred from CCB is covered by the Asset Protection Schemes (APS). The APS also cover the entire NPL portfolio taken from CCB. For more details on the APSs, see Commission Decision of 28.8.2018 in State aid case SA.35334 (2018N-3) – Cyprus – Liquidation aid for the orderly market exit of Cyprus Cooperative Bank Ltd (OJ C 406, 9.11.2018, p.1).

then allow for an easier liquidation. All payments to depositors (EUR 83 million) have been finalised since April 2018 and the amount will be recovered as soon as the liquidation ends. As regards Laiki, an agreement was reached in October 2018 to sell the Greek subsidiary and the procedure should be finalised by end May 2019. Following that, the bank will undergo a final liquidation.

Correspondent banking

Correspondent banking is under pressure globally, particularly in smaller Member States like Cyprus. Correspondent banking services are needed for clearing foreign currency transactions. Notably, the smooth settlement of US dollar payments is important as many international transactions, like oil imports and shipping business, are denominated in dollars. For these services, one relies on big international banks, mainly from the US. The pressure on correspondent banking stems from increased regulation and thin profit margins, which may prompt headquarters to retreat from small peripheral countries. Such a withdrawal decision may also be triggered by the country-specific risk and the perception of complying with Anti-Money Laundering rules. To mitigate these risks, Cyprus took a number of initiatives in 2018, such as the transposition of the 4th Anti-Money Laundering Directive and the CBC guidance on the implementation of the new legislation. Work is ongoing for the transposition of the 5th Anti-Money Laundering Directive. These initiatives contributed to the reduction of non-resident deposits to 47% of GDP in 2018 (down from 78% in 2014), although this is still high in international terms (see Graph 3.4).

3.2. FOLLOW-UP ON THE 2018 THREE-PILLAR NPL REDUCTION STRATEGY

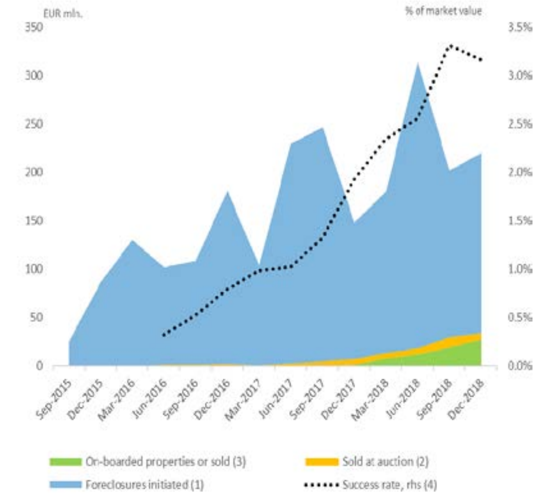
Legal amendments to the foreclosure and insolvency framework

The total market value of foreclosure procedures increased since the approval of the legislative package in July 2018. The number of foreclosure procedures initiated increased, but the share of sold properties remains quite low (see Graph 3.5). Furthermore, over 2018 the cumulative 'success rate', which is the market value of properties successfully sold in an auction as a share of the value of properties for which a foreclosure procedure was initiated, remains low - at around 3 %. Moreover, the success rate has declined in recent quarters. As a result, there is a notable increase in the on-boarding of real estates into the originating banks. Thus, initiating a foreclosure procedure followed by the on-boarding of the asset is becoming another method for banks to bring collateral assets onto their balance sheets ([18]). Regarding e-auctions, the authorities expect to enact two decrees by September 2019, which would establish an electronic auction system, help setup the auctioning platform, and regulate the profession of auctioneers in relation to the conduct of e-auctions. These changes should contribute to increasing sales and recovery rates.

Foreclosure is gradually becoming a credible threat against strategic defaulters. The strengthened foreclosure legislation in place aims to give incentives to defaulting borrowers to resume paying or restructure their debts, or else face foreclosure. Although it is premature, the amendments introduced in July 2018 seem to bear some fruits already given the increased number of initiated foreclosure and the growth in on-boarded collateral after an unsuccessful auction. The authorities are currently working to iron out some of the problems in connection with foreclosures, including the delays that the cumulative methods used to service notices to the borrower are causing to enforcement (delays of approximately 2 additional months). Another issue is the difficulty of accessing private information on the financial position of borrowers including tax liabilities, land registry documents and assets available in the context of restructuring. Lastly, there is a backlog in the issuing of property title deeds, which further complicates legal enforcement as well as restructuring.

([18]) The foreclosure framework used to on-board assets could be problematic if it results in an undue amount of real estate assets on banks' balance sheet.

Graph 3.5: **Foreclosure activity**



(1) Market value of properties for which a notification has been served regarding the intention of a sale within a quarter. (2) Market value of properties successfully sold in an auction within a quarter. (3) Market value of properties sold to third parties or on-boarded (by the originating bank) following an unsuccessful auction within a quarter. (4) Success rate gives the total market value of properties sold in an auction over the total market value of all foreclosures initiated over the past four quarters.
Source: Central Bank of Cyprus

The progress on insolvency is more limited. According to the end of 2018 data, there has been only a slight increase on all proceedings, including examinership and personal repayment plans. There may be some hesitation in going down the insolvency route as borrowers in difficulties might be waiting for the imminent implementation of the ESTIA scheme, and thus explore the system that is most advantageous.

Work is under way on the regulation of the insolvency practitioners' profession and on the enhancement of the efficiency and effectiveness of the Insolvency Service. Technical preparations have been completed but implementation will take longer than expected. The authorities are designing a uniform framework for the three authorities that license insolvency practitioners in Cyprus (the Cyprus Bar Association, the Institute of Chartered Public Accountants of Cyprus and the Insolvency Service of Cyprus). The authorities are also working on a plan to reorganise the procedures and restructure the personnel and departments of the Insolvency Service. Furthermore, to ensure organisational independence, the service is expected to be separated from the Department of Registrar of Companies.

Establishment of KEDIPES, Cyprus Asset Management Company

Progress in setting up KEDIPES has been disappointing so far. The process has been delayed in several key areas, including the official transfer of assets to KEDIPES due to regulatory requirements ([19]). In addition, the selection of the consultant to advise KEDIPES on its workout strategy and operations, which was tendered out in August 2018, has been delayed as well, to March 2019. The adviser selected is the consultancy BDO Ireland, which has significant expertise in Ireland's National Asset Management Agency (NAMA).

The delayed setup of the KEDIPES introduces a number of challenges. Perhaps most notably, NPL restructuring has been stalled due to the delayed transfer of assets to KEDIPES, which also made it difficult to gauge the performance of the NPL portfolio. KEDIPES still has to design a fully-fledged NPL workout strategy. With the help of the adviser, it will also have to assess whether it keeps working with Altamira, its current debt servicer. Significant uncertainty remains on the composition of the board of KEDIPES, while the selection of the five non-executive members is pending final fit and proper assessment by the CBC. KEDIPES is subject to supervision by the CBC under the legislation applicable to all credit-acquiring companies introduced in 2015 and amended in 2018. The CBC is currently finalising a circular on the reporting requirements and building capacity within the existing banking supervision division.

The ESTIA scheme

The launch of the ESTIA scheme has been delayed ([20]). The scheme and the Memorandum of

([19]) The Cypriot Asset Management Company consists of two legal entities, SEDIPES and KEDIPES. SEDIPES (ex-CCB entity) had the status of a cooperative institution, thus the authorities decided to set up a 100% subsidiary (KEDIPES) under the Cypriot Company Law, which was then licensed as a credit acquiring company, whose goal is to manage all CCB's residual assets. However, the transfer of assets from SEDIPES to KEDIPES was delayed as the former actually needed a similar licence for the transfer to take place. SEDIPES' licence as a credit-acquiring company is expected to be revoked following the full transfer of the assets.

([20]) The ESTIA scheme aims to deal with NPLs collateralised by primary residences, which is the most difficult segment to recover value from. Under the scheme the government will pay a subsidy to eligible borrowers, which lowers the

Understanding, which will be signed by the participating institutions and the state, determining the main technical aspects of the subsidy, are before the Attorney General's office for legal vetting. In the following step, they will be submitted to the Council of Ministers for approval. Therefore, the scheme is expected to be launched in mid-2019 at the earliest. Borrowers will have 4 months to file an application. Meanwhile, the Ministry of Labour, which is responsible for assessing compliance with eligibility criteria (following a preliminary assessment by the banks), has contracted a private company to provide an IT solution. Despite outsourcing of the IT solutions, all verifications will be done internally at the Ministry of Labour. There are some implementation concerns over the ability of authorities to verify compliance with some eligibility criteria, most notably the wealth criterion, especially when assets are held outside the country ([21]). The impact of ESTIA on the volume of NPLs will be visible only over time given the difficulties in forecasting the re-default rate.

3.3. BROADER FINANCIAL SECTOR ISSUES

The quality of financial information available on borrowers continues to be limited. The scope and quality of the financial information available for credit risk assessment has been relatively limited but is in the process of being improved. The authorities introduced regulatory amendments in late 2018 to require credit-acquiring firms to also use and report to the credit register.

The integration of the supervisors of the pension funds and insurance companies is progressing slowly. Consultations on the legislation covering the new authority's functioning are ongoing. Authorities currently aim to have the new body operational by early 2020. However, a number of important elements have not yet been determined due to the numerous delays and difficulties arising from the differing status of the staff in the existing bodies. For example, the funding of the body in its early years will be covered by the government. The authorities will engage with the industry to determine the funding structure later on. The authorities expect the new body's resources to be in line with the EU averages.

The new regulatory environment will pose new opportunities and challenges in the pension industry. A key problem is the relatively rudimentary management of the smaller occupational pension funds, which dominate the pension sector. Most pension funds serve a single beneficiary, owing to a number of issues including the inadequacy of Cypriot mandatory pension schemes. The new regulatory framework and the entry into force of the new legislation (IORP II, Solvency II) is expected to trigger a consolidation of these funds.

The way forward after the failure of Olympic Insurance continues to be uncertain. The Cypriot Insurance Companies Control Service, suspended the ailing insurer's license in May 2018, following the insurer's failure to meet its solvency requirements. A liquidation procedure was initiated in early August 2018, but the procedure is currently delayed due to the slow functioning of the Cypriot judiciary in the appointment of a liquidator. With respect to compensation, Cyprus and Bulgaria (where the company had a significant footprint) will deal individually with their domestic claims.

Investment funds are growing rapidly. The total funds under management were EUR 6.1 billion at end of 2018, compared to 3.9 billion in the previous year. Authorities are working to ensure that these funds are subject to adequate regulatory oversight, including most notably the existing anti-money laundering and counter terrorist measures.

debt servicing costs, including interest charges, by one third. For more details on the scheme and on the eligibility criteria, see the Post-Programme Surveillance Report Cyprus, Autumn 2018.

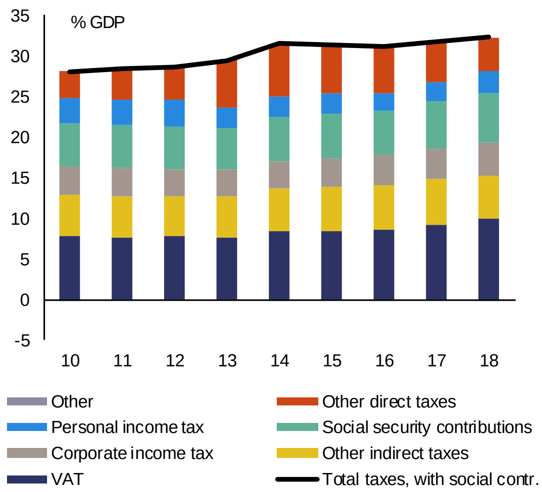
([21]) The scheme raised other concerns, including granting subsidies to borrowers that have significant amount of wealth. The Post-Programme Surveillance Report Cyprus, Autumn 2018 discusses in more details the risks stemming from ESTIA. On this background, it is important for Cyprus to monitor closely the implementation of the scheme.

4. BUDGETARY OUTLOOK AND FISCAL POLICY STANCE

4.1. FISCAL PERFORMANCE

The underlying fiscal performance continued to be very strong in 2018, even though the general government surplus turned into a deficit of 4.8% of GDP due to the one-off banking support measures related to the sale of the CCB. The general government headline deficit turned out at 4.8 % of GDP in 2018, including the impact of the one-offs, i.e. the government's support in the CCB sale ([22]). However, net of one-offs, the headline balance amounted to a surplus of 3.5 % of GDP, compared to a surplus of 1.8% of GDP in the previous year. Thus, the headline balance change from surplus to deficit is entirely due to the EUR 1.7 billion (8.3 % of GDP) one-off impact of the banking support measures in 2018, as estimated by the Statistical Service of Cyprus.

Graph 4.1: **Tax revenue contributions**



Source: Ministry of Finance and European Commission

Budget execution was again marked by a strong revenue performance. Total revenues increased by 7.7 % in 2018, most revenue categories recording an increase (see Graph 4.1). The revenue outturn reflects the strong economic environment and the improving labour market. In particular, tax revenues on production and imports rose by 8 %, mainly thanks to the strong performance in value added tax (VAT) revenues, which increased by 13.5 %. Tax revenues on income and wealth rose by 4.6 %, of which personal income tax and corporate income tax revenues increased significantly. Furthermore, social contributions increased by 7.8 %.

Total current expenditure recorded an increase somewhat similar to last year, while total capital expenditure surged due to the government support measures for the sale of the CCB. Total current expenditure increased by 4.9 % in 2018, compared to 4 % in the previous year. The increase was mainly due to: (i) a rise in intermediate consumption (up 15.4 %, partly due to one-off water-related and pharmaceutical expenditure); (ii) compensation of employees (up 4.3 %, mostly driven by the start of the gradual reversal of wage cuts implemented since the crisis) and (iii) social transfers (up 3.4 %). Total capital expenditure surged in 2018 due to the one-off impact of the banking support measures. The Statistical Service of Cyprus estimated the fiscal impact of these measures at EUR 1.7 billion ([23]). This estimation was confirmed by Eurostat in the context of the April 2019 excessive deficit procedure notification.

Public debt increased significantly in 2018 due to the one-off government support for the CCB sale. After declining considerably (by almost 10 percentage points of GDP) to 95.8 % of GDP at the end of 2017, public debt rose to 102.5 % of GDP by end 2018. This increase is mainly due to the issuing of a series of government bonds in April and July 2018 related to the public support measures for the sale and orderly winding down of

([22]) The Commission will assess Cyprus' compliance with the Stability and Growth Pact based on the following: outturn data notified to Eurostat in spring 2019, the Stability Programme for 2019-2022 and the Commission's 2019 spring forecast. In particular, the Commission will analyse Cyprus' temporary headline deficit in excess of the 3 % deficit reference value.

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

the CCB, which amounted to EUR 3.2 billion (15 % of GDP). The transaction represented a level-shift upwards in Cyprus' public debt. However, the debt-to-GDP ratio in 2018 increased by only 7 percentage points of GDP compared to the previous year, as the strong underlying fiscal performance, the snowball effect (i.e. changes in the debt-to-GDP ratio related to the difference between nominal growth and the interest rate) and the early repayment of debt owed to the CBC from the accumulated cash balances in December 2018 (amounting to EUR 483 million or 2.3 % of GDP) partially compensated for the CCB-related debt increase.

4.2. FISCAL OUTLOOK

Cyprus is projected to return to budgetary surpluses in 2019 and 2020. The Commission's Spring Forecast projects that the general government headline balance will reach a surplus of 3.0 % of GDP and 2.8 % of GDP in 2019 and 2020, respectively ([24]). This is mainly due to the projected continued strong – albeit decelerating – GDP growth, which is driven by domestic demand and the improving labour market. It also reflects a sizeable increase in social security contributions in 2019. In addition, the Commission's forecast takes into account the deficit-increasing impact of several expansionary measures, such as the gradual reversal of public wage cuts implemented since the crisis, the ESTIA scheme and the reduction of the excise duties on fuel. The forecast takes into account the start of contributions to the national health insurance system as of March 2019 and the inclusion in the general government sector of the two entities resulting from the sale of the Cyprus Cooperative Bank.

According to the 2019 Stability Programme submitted by the Cypriot authorities, the headline balance is projected to reach 3.0 % of GDP and 2.6 % of GDP in 2019 and 2020, respectively. The authorities underpin the improving fiscal position going forward with the strong economic performance and improving labour market. Based on the authorities' projections, the structural balance is expected to amount to 1.5 % of GDP in 2019 and 0.8 % of GDP in 2020.

It is uncertain to what extent the strong tax revenue growth performance can be sustained. In particular, the sustainability of the recent tax revenue increases from value added and corporate income taxes is unclear. On the one hand, VAT revenues have significantly risen in recent years, mainly as a result of the current positive economic cycle and the strong construction activity. VAT revenues are expected to increase but at a slower pace on the back of a strong although decelerating macroeconomic outlook. However, this revenue increase might decelerate further in the future due to changes in the economic cycle and a potential slowdown in construction activity. On the other hand, corporate tax revenue is an inherently volatile source of revenue, which might be impacted by possible relocation decisions by (large) companies currently benefiting from Cyprus' tax regime. For a more detailed analysis of the tax revenue increase and its sustainability risks, see Section 4.1.3 of the 2019 Cyprus country report ([25]). To safeguard fiscal sustainability, it is important that Cyprus ensures that temporary or volatile revenues are not used to fund additional permanent spending.

Fiscal risks are mainly tilted to the downside, partly due to mounting pressure to further increase expenditure. Positive cash balances from the resulting CCB entities constitute an upside risk. However, most of the risks are tilted to the downside. There are uncertainties regarding the fiscal implications of court cases on the constitutionality of the public sector wage and benefit cuts during the crisis. In that context, the Administrative Court recently issued two decisions ruling that both public sector payroll and pension cuts implemented since the crisis are unconstitutional. The government announced its intention to appeal the decisions before the Supreme Court, with a request of suspension pending the appeal. Confirmation of these rulings in favour of claimants could significantly impact public finances. The potential fiscal impact of such court decisions is uncertain at this stage and therefore a potential downside risk to public

([24]) The Commission forecast is based on a no-policy change assumption, i.e. it is consistent with previous policy orientations and includes new measures that are sufficiently detailed and have been adopted or credibly announced by the authorities.

([25]) 2019 Cyprus country report, pp 28-31. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf finances, in particular if the ruling is extended to all civil servants.

The potential fiscal impact of the country's healthcare reform also remains uncertain, in particular as the Law on the new organisation of public hospitals stipulates that the State will finance any potential deficit of public healthcare providers in the first 5 years of implementation of the national health insurance system (as of June 2019) ([26]). In addition, the ongoing discussions between the government and the unions about creating a provident fund for public sector employees recruited after October 2011 and on contracts of indefinite duration may weigh on public finances.

Finally, additional risks to the fiscal outlook stem from the potential realisation of explicit contingent liabilities, specifically in relation to state-owned enterprises and the guarantees created for the sale of the CCB. As explained in Section 4.1.2 of the 2019 Cyprus country report, the state's exposure to explicit contingent liabilities increased in 2018, mainly due to the establishment of asset protection schemes agreed as part of the sale of the CCB. A prudent expenditure management remains essential, based on a careful monitoring of expenditure developments, especially in light of possible future risks to the robustness of revenues.

Public debt is projected to steadily decline in 2019 and 2020 on the back of projected strong fiscal performance. According to the Commission's Spring Forecast, Cyprus' public debt is expected to decrease from 102.5 % at the end of 2018 to 96.4 % by end of 2019, and further to below 90 % in 2020 ([27]). The decrease reflects the projected high primary surpluses and favourable debt dynamics mostly due to strong real GDP growth ([28]). According to the 2019 Stability Programme, public debt is projected to decline to 95.7 % of GDP in 2019 and below 90 % of GDP in 2020. Nevertheless, public debt in Cyprus is among the highest in the EU, making the country vulnerable to potential financial or economic shocks ([29]). However, these risks are somewhat mitigated by the fairly contained medium-term financing needs and increased investors' confidence, as reflected by the regained investment grade rating for Cyprus' sovereign debt.

([26]) For more on the fiscal impact of the national health insurance system see the 2019 Cyprus Country Report, pp 27-28. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf

([27]) On 24 April, the government issued 30-year and 5-year bonds aiming to early repay the outstanding Russian loan (of around EUR 1.6 billion). These issuances were not taken into account in the Commission's Spring Forecast, as the information on the issuances was only available after the cut-off date for the forecast.

([28]) See also Section 6 and Annex 1 for an analysis of debt sustainability.

([29]) See the Commission's fiscal sustainability analysis in the 2019 Cyprus country report, pp 25-26. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf

5. STRUCTURAL ISSUES

5.1. FISCAL STRUCTURAL REFORMS

Public financial management and budgetary framework

The fiscal framework is being implemented, which aims to safeguard fiscal transparency and contains risks of fiscal relaxation. Progress continues to be made in the reform of public financial management. In particular, the selection process for the inclusion of public investment projects in the budget, as well as the project implementation and monitoring, are advancing through the standardisation of project appraisals. This is aimed to promote those projects that are considered to be viable and beneficial in the long run. While substantial progress has been made in the initial stages of the pre-selection and appraisal of projects, further progress is needed on the selection of projects on the basis of their economic viability and affordability. The administrative capacity of the key institutions involved in the assessment of investment projects has been further strengthened over recent years through guidelines, templates and training. In addition, a new software management system is being acquired. It has yet to be decided whether or not to set up a unit within the Ministry of Transport in charge of overseeing ongoing and forthcoming public-private partnerships.

Privatisation and state-owned enterprises

Progress on individual privatisation projects remains limited. While the port of Larnaca is expected to be privatised and re-developed in the coming months, the timeline for other privatisation projects is uncertain. Progress on the draft bill for licensing the activities of the national lottery to a private investor and the privatisation of the residences owned by the government in the Troodos Mountain is slow. The draft bill on the corporatisation of the Cyprus Telecommunications Authority (CyTA) has stalled at the House of Representatives since 2017 and, for now, there is no intention of adopting this bill. No notable progress has been made on privatising other assets, such as the Cyprus Stock Exchange. Progress on the individual privatisation projects could attract further foreign investment into Cyprus and reduce the state's exposure to contingent liabilities from public companies.

Despite the withdrawal of the law on the governance of state-owned enterprises (SOEs), some steps are being taken to improve their governance and performance. The draft bill on the governance of SOEs, which had been pending adoption by the House of Representatives since 2015, was recently withdrawn by the government, as it was deemed that the bill had no potential of being voted through the House ([30]). However, some steps are being taken to improve the corporate governance of the SOEs to ensure more effective monitoring of their operation, while minimising fiscal risks. The fiscal framework already in place provides the legal basis for the financial oversight of SOEs, including their annual budgets and strategic plans. In line with the framework, in 2018, the government adopted a circular requesting SOEs to prepare their budgets for 2020 based on the three-year medium-term budgetary framework. Furthermore, the government plans to further strengthen the SOEs' planning and reporting framework as the public financial management reform progresses. This reform aims to bring all organisations into the strategic planning process over the coming years. In particular this reform intends to turn the traditional budget process into an activities-based budget. The government plans to start implementing this reform within 2019, with the three public universities. Finally, the Institute of Directors in Cyprus ([31]) published a code of conduct on the governance of the SOEs based on best practices, including the OECD guidelines.

Revenue administration

Revenue administration reforms are gradually progressing. Measures to step up the fight against tax evasion continue, targeting those taxpayers with the biggest impact on public revenue

([30]) Even though the law concerned SOEs that were not intended for privatisation, it was associated by stakeholders to privatisation and hence garnered significant opposition.

([31]) The Cyprus' Institute of Directors is the Cyprus Branch of the UK Institute of Directors. Its members are directors from the business community, financial institutions and the public sector. http://ecoda.org/fr/members/ecodas-members/member-details/?94=&uid=2549&cHash=c0aa3655d1d80452d9d37b2d17671310

collection as well as boosting voluntary compliance. Some of the chapters of the Tax Procedure Code are expected to be adopted by the end of 2019. The integration of the tax administration system is progressing while the assignment of the tender for the deployment of a new tax IT system has been delayed and is now expected by the end of 2019.

Public administration reform

The horizontal reform of the public administration is still pending. The authorities are revising a set of bills to modernise: (i) the appraisal system of civil servants, (ii) promotion procedures, and (iii) the Public Service Commission to address the comments from the House of Representatives following the rejection of these bills in 2016. The authorities confirmed that the reform is among their top priorities, with the re-submission of the bills to the House of Representatives expected for June 2019. The main revisions under discussion include removing the quota with regard to good performers, the possibility for appraisal of the management by staff, the introduction of an assessment centre to select all levels of management and increasing the weight given to experience, performance and academic background in the criteria used to decide on promotions.

Containing the public sector pay roll remains essential. The horizontal public administration reform also included a draft bill establishing a permanent mechanism to ensure that increases in the public sector payroll are in line with developments in fiscal conditions and nominal GDP growth. The authorities do not envisage this bill to be re-submitted to the House of Representatives. Currently, the spirit of the proposed bill is being implemented in the broader public sector through collective agreements. However, looking forward and given the mounting pressures on increasing public sector wages, also related to the court cases on the constitutionality of the public sector wage and benefit cuts during the crisis (see Section 4.2 on Fiscal outlook), the introduction of a binding and permanent mechanism needs to be reconsidered.

Local government reform

The reform of the local governments is gaining momentum. The reform, which had been stalled in the House of Representatives since 2015, is gathering political support. Currently a revised law ([32]) is under consultation with the stakeholders and the authorities intend to submit it to the House of Representatives before the summer break in 2019. The reform proposes reducing the number of local governments and aims to grant local governments more responsibilities in order to redefine the relationship between the residents in Cyprus and the different layers of government. These new responsibilities would be also met by newly established, proportional revenue raising powers for the local governments, thus making them financially independent and viable. In this way, the subsidy currently provided by the central government is expected to be partially replaced in the long term. Overall, the authorities estimate that the reform will be budgetary neutral. The reform is also expected to provide better local public services and more efficient water and waste management. It could also play a significant role in simplifying the procedures for issuing title deeds and building and spatial permits (see Section 5.2 on Immovable property rights). In addition, the reform intends to establish a common accounting and financial reporting framework for all local governments, which could improve the management of public finances.

5.2. REFORMS RELATED TO THE NON-PERFORMING LOANS WORKOUT

Reform of the justice system

Addressing inefficiencies in the justice system is a key priority. Given the strong link between the judicial process and the functioning of the economy, in particular the effective workout of NPLs, the authorities have given high priority to reforming the justice system. Furthermore, with the sale and wind-down of the Cyprus Cooperative Bank in 2018, the government has committed to gradually — within 18 months after the decision

([32]) The revised law (the Municipal law) is based on recommendations made by an independent expert appointed in November 2018 in an effort to overcome the controversial issues faced during the discussions in the House of Representatives.

on 19 June 2018 — implement measures to significantly improve the handling of NPL cases by the courts. The European Commission, through the Structural Reform Support Service (SRSS), provides technical support to the authorities to help prepare the reform of the justice system.

Notwithstanding the high political priority attached to judicial reform, progress in its implementation has been slow. First, the clearance of the backlog of cases, including cases related to NPLs, is facing delays. While an action plan is being carried out, the recruitment of additional judges and the creation of a focused taskforce for clearing this backlog of cases is expected to be delayed by one year. The delay is due to the preparation of new criteria for recruiting judges, using the recommendations of an independent study supported by the Commission ([33]). The new criteria are expected to be approved by the Supreme Court in the coming months. On a more positive note, six existing judges were assigned to handle financial disputes, including the ones related to NPLs. However, they still need to undergo appropriate training. Also, progress in increasing the specialisation of courts is slow. This includes the establishment of the Administrative Court for International Protection (the corresponding law was adopted in July 2018, but the court is still not operational due to the lack of suitable buildings), a Commercial Court (draft law still pending for adoption) and a Court of Appeal (draft law still under consultation). These new courts are expected to help reduce the backlog of cases and shorten court procedures.

Strengthening the enforcement of judgments should become an essential element of the reform as it would also help improve debt repayment discipline. The long awaited amendment to the Civil Procedure Law to make it easier to execute court decisions related to seizure of movable property has been under legal vetting since March 2016. The amending provisions of the Law include: (i) granting additional powers to the bailiffs (enforcement agents),by allowing them to have access to information held by the government, with the aim of effectively tracing property belonging to the debtor, which could be allocated for seizure, (ii) the establishment of a criminal offence if the debtor moves an asset, which has been marked by the bailiff for seizure, (iii) the shifting of the burden of proof on the debtor in case they claim that have no bank account (obliged to submit relevant certificates); and (iv) the ability of the creditor to have access to information related to the debtor. In addition to the above amending law, more action is deemed necessary in executing court decisions in order to strengthen the debt repayment discipline.

The review of the rules of civil procedures is on track. The revision of the outdated rules of civil procedures is expected to be finalised by the end of 2019 thanks to technical support from the SRSS. The new rules proposed will need to be adopted by the Supreme Court and they are expected to enter into force by mid-2020. These new rules are expected to improve the efficiency of the judicial system as a whole.

The implementation of e-justice — a key pillar of the reform — has been postponed. The current manual and paper-based procedures are causing large delays in the judicial process. The authorities received technical support from the SRSS in the design phase to introduce an electronic system, which should modernise and improve the processing of cases and the overall operation and administration of the courts. The project is facing delays of up to 18 months related to the public procurement procedures. In the meantime, a mini electronic registry has been installed in all civil registries and in the Supreme Court to allow for applications to be more efficiently processed.

The training of judges is on-going and the development of alternative dispute resolution is progressing. The training of judges is advancing, although the establishment of a school for judicial training is still pending. Progress on introducing measures to step up the use of alternative dispute resolution processes in consumer disputes is on the right track. These include legislative measures, the revision of the rules of civil procedure and training of judges and lawyers. The use of alternative dispute resolution is expected to help prevent the accumulation of cases in the future.

([33]) The study "Criteria for the selection and promotion of judges", was finalised in March 2019. It was financed by the 2018 Structural Reform Support Programme.

Immovable property rights

Transfers of title deeds ([34]) **remain a key concern and a credible new system is long overdue.** A significant number of "trapped buyers" ([35]), who have paid the full price for a property, still do not have a title deed. About 6,000 title deeds were transferred out of 9,000 eligible applications, but more effort needs to be made. Concerning the "Trapped Buyers Law" ([36]), there were conflicting rulings at the district court level as to the constitutionality of the Law, thus a final ruling from the Supreme Court is expected. Until then the authorities continue to apply the Law and they expect that the cases that are resolved before the final ruling will not be affected. Some efforts to amend the Law were stopped by the legal service, as the proposed changes were deemed unconstitutional — for past cases, the contract between the bank and the developer of the property precedes. Another effort to amend the Law initiated by the House of Representatives is on-going. However, the issue of constitutionality remains uncertain. Looking forward, the authorities are currently in consultation with the relevant stakeholders to prepare a new system that ensures that the buyers, who have paid the full amount, will receive their title deeds quickly and without a risk of refusal. A framework agreement between the developers and the banks, based on international good practice and due diligence in property transactions are important ingredients for the new system.

Issuance of title deeds has slowed down. A slight fall in the high backlog of unissued titles was recorded — to 24,000 in March 2019, down from 25,000 in September 2018. It is important to note that the initial backlog in 2013 was around 70,000. The remaining backlog concerns the most difficult cases i.e. serious divergence from building and planning permits, which hinders local governments from issuing the necessary certificates. Looking forward, the upcoming local government reform could help simplify the procedures needed to issue the relevant certificates and prevent the accumulation of a backlog. However, in the meantime, more immediate action is warranted for the accumulated past cases.

The simplification of the procedures for issuing building and planning permits is pending. The authorities are in consultation with the private sector (architects and engineers) to increase its involvement in safety and compliance regarding the construction of buildings. This will significantly alleviate the monitoring procedures of the local governments. There is also a proposal to differentiate building plans based on risk factors. The low-risk buildings (i.e. houses) will be able to receive permits quickly. Necessary measures to implement these plans need to be stepped-up. The reform of local governments is also expected to help streamline these procedures (see Section 5.2 on Local government reform).

5.3. OTHER STRUCTURAL REFORMS ([37])

Labour market structural issues

The labour market continued to benefit from strong growth. Employment is increasing, in particular in construction and tourism-related sectors and unemployment fell rapidly to 7.1 % by February 2019. Despite improvements, the situation remains challenging for disadvantaged groups, including young people, whose unemployment rate remains high (20.2 % in 2018), although decreasing. Part-time and temporary employment are also on a decreasing trend, while data on labour market flows point to increasing transitions from inactivity to the labour market. As a result, the number of beneficiaries of the guaranteed minimum income scheme is gradually decreasing. This is also due to the close monitoring of incidences of "voluntary unemployment" — those who do not register with the public employment services or refuse to take a job offer.

([34]) The legal document constituting the evidence of a right to ownership of property.

([35]) The cases where the developers did not repay their mortgages on the specific property, and therefore banks are reluctant to release the mortgage, which is needed for the transfer of the property to the buyer.

([36]) The law refers to sales registered before 2015 and enforces the granting of the title deed to the buyer, who fully paid the price of the property. The unpaid mortgage is shifted to another asset.

([37]) The section covers selected structural issues. For more in-depth analysis and a wider spectrum of structural topics, please consult the 2019 Cyprus country report. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf

Concerns remain in terms of the effectiveness of the active labour market policies (ALMPs) notably on how they tackle skills mismatches and outreach vulnerable groups. For young people not in employment, education or training (NEETs) a high priority project is in place to reach out to those who have completed secondary education, who are not in tertiary education or in employment in order to provide them with individualised guidance. However, the take-up so far has been modest. There are still concerns also with regard to the effectiveness of the public employment services and their capacity in the long term to fulfil their enhanced role. To address skills mismatches, a new initiative is being rolled-out, together with academic institutions, which aims to better align the programmes of tertiary education study to the needs of the labour market.

Healthcare reform

The preparations for implementing the healthcare reform are progressing, while there are uncertainties surrounding its fiscal and economic impact. The national health insurance system as adopted provides universal health coverage and is expected to contribute to a more efficient use of public and private sector resources as well as a reduction in out-of-pocket payments. The implementation phase is steadily progressing, in line with the legal commitments. The new system of primary health care is expected to be operational on 1 June 2019. In parallel, the process of autonomising and upgrading the country's public hospitals is moving forward. However, challenges remain, such as low enrolment of doctors so far, which may hinder the system from functioning properly. Furthermore, the fiscal impact of this reform is unclear. Therefore, this poses downside risk to the fiscal position in the short- to medium-term (see Section 4.2 on Fiscal outlook).

Framework for strategic investments

The legal framework to facilitate strategic investments is pending adoption. A draft bill (Investment Law) was submitted for adoption to the House of Representatives in 2017. The Law aims to significantly reduce the time it takes for a strategic investor to obtain all the necessary permits and licences to invest in Cyprus. The responsibility for implementing the Investment Law was shifted to the Ministry of Interior, as the establishment of the Deputy Ministry for Growth and Competitiveness will likely not materialise. The authorities intend to submit before end-2019 the amended Law to the House of Representatives, but no timeline has been announced for adoption and implementation. The Law is key to improving the business environment and attracting more investment in Cyprus.

Energy

The opening up of the energy market and diversification of the energy mix are progressing, but are facing delays. The deadline for the much needed opening up of the electricity market has again been extended to end-2021, due to delays in the IT system's tendering procedures. In the meantime, the transitional phase continues to apply through bilateral agreements between independent electricity suppliers and power producers, mainly through renewable energy resources. On the positive side, the number of agreements has increased significantly since the since the Commission's last post-programme surveillance mission. Regarding efforts to diversify the energy mix of the island, the authorities have designed incentive schemes for renewable sources of energy. The importing of liquefied natural gas, another aspect of energy diversification, is progressing, albeit with some delays.

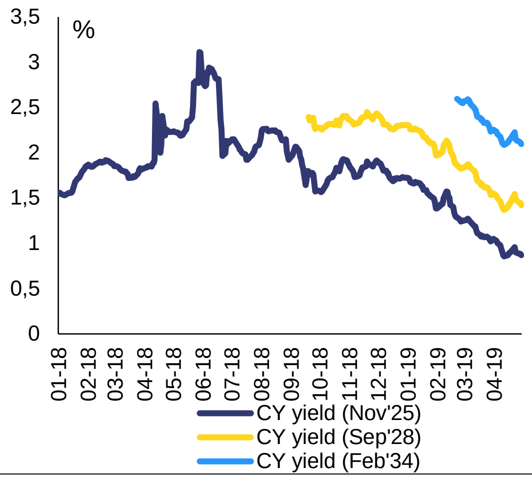
The government's efforts to explore and utilise hydrocarbons are on-going. The authorities expect the explorations in Cyprus' exclusive economic zone to continue as planned. The agreement for the monetisation of the hydrocarbon reserves in Aphrodite field is expected to be concluded in the coming months, but implementation will take several years.

The Law setting up a sovereign wealth fund was recently approved by the House of Representatives. The Law introduces provisions on the establishment and operation of the fund and stipulates general principles governing investment and reserves of the fund, among other things. The final version of the Law no longer contains a provision that the public debt will be serviced by fund revenue.

6. SOVEREIGN FINANCING AND ABILITY TO REPAY

In early 2019, the Cypriot government issued several international bonds, extending further the sovereign yield curve. On 19 February 2019, the government tapped the international markets with a EUR 1 billion bond with a maturity of 15 years, at a yield of 2.76 %. This took place after the 10-year international bond issuance in September 2018, which had a primary yield of 2.4 %. More recently, on 24 April 2019, Cyprus tapped the international markets again with a 30-year bond (worth of EUR 750 million and with a primary yield of 2.84 %) and a 5-year bond (worth of EUR 500 million and with a primary yield of 0.67 %). It is the first time that the country issued bonds with a 30-year maturity, attracting robust demand. Following the issuances, the Cypriot bond yields fell in the secondary market across the yield curve. The 7-year bonds reached yields of around 0.9 % towards the end of April 2019, while the yield of the 10-year bond stood at around 1.4 %, reaching record low levels since 2015 (see Graph 6.1). At the shorter end of Cyprus' yield curve, the yield for three-month Treasury bills on the primary market remained negative.

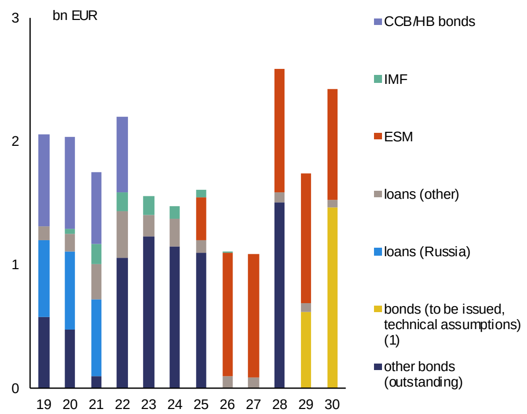
Graph 6.1: **Cyprus sovereign bond yields**



Source: Bloomberg

The State's financing needs are relatively contained ([38]). The 15-year bond issuance, together with the government cash buffer cover Cyprus' regular financing needs until the end of 2019. Excluding T-bills, gross financing needs for 2019 are estimated at around EUR 1.5 billion or 7 % of GDP (consisting of EUR 2.1 billion of debt redemption needs — see Graph 6.2 —, which are partly offset by EUR 0.6 billion of revenue from the projected headline surplus). The debt redemption needs of the year arise mainly from the repayment of a bond held by Hellenic Bank, two repayments of a Russian loan, and a repayment of a domestic bond. At the same time, using the proceeds of the April issuances, the government plans to repay earlier the outstanding Russian loan (of around EUR 1.6 billion) that is due in 2021 ([39]). Over the medium term, total financing needs are expected to be contained (below 7 % of GDP by 2021) on account of the long maturity of the European Stability Mechanism loans and projected government surpluses.

Graph 6.2: **Medium and long-term debt amortisations**



Source: Ministry of Finance – Public Debt Management Office and own calculations

The sovereign long-term credit rating of Cyprus stands at 'investment grade' by Standard & Poor, Fitch and DBRS. Following the CCB sale in September 2018, Standard & Poor was the first rating agency to upgrade the country back to investment grade for the first time since 2012. Fitch and DBRS then followed suit. Currently,

([38]) Financing needs for debt amortisation are a significant part of gross financing needs (GFN), which also include interest payments and revenue/expenditure from primary balance. The IMF risk-based approach categorises countries in the 'lower-scrutiny' category if current or projected GFN do not exceed 15 and 20 % of GDP for emerging markets and advanced economies, respectively (See IMF 2013, Staff Guidance Note For Public Debt Sustainability Analysis in Market-Access Countries).

([39]) The repayment of the outstanding Russian loan would decrease the gross financing needs in particular for 2020 - 2021.

only Moody's ranks Cypriot long-term bonds below investment grade. The outlook is considered stable by all four rating agencies. The return of the sovereign credit rating to investment grade allowed the ECB to restart purchases of Cypriot government bonds under its public sector purchase programme. By the end of December 2018, the purchases amounted to EUR 678 million (book value). The upcoming sovereign rating reviews are scheduled for September 2019 by Standard & Poor's and Moody's, for October 2019 by Fitch and for November 2019 by DBRS.

The risk of Cyprus not being able to service its debt to the ESM remains low in the short term. Cyprus' capacity to repay remains sound in the short term in view of robust economic growth, expected large primary surpluses, a sizeable cash buffer and improved investors' confidence. However, medium-term debt dynamics are sensitive to macroeconomic shocks, vulnerabilities in the financial system, a significant and sustained rise in the interest rates and changes in fiscal performance. To maintain the repayment capacity, it is essential for Cyprus to ensure fiscal discipline, reduce further the NPLs and progress on structural reforms that stimulate growth.

ANNEX 1

European Commission Debt Sustainability Analysis

Based on standard Commission methodology, the Commission's spring 2019 forecast and the debt sustainability analysis (DSA) ([40]) show that government debt is expected to decrease steadily from 102.5 % in 2018 to 96.4 % in 2019, and then continue on a declining path over a 10-year period. Following a significant increase in government debt in 2018 to 102.5 % of GDP due to the one-off government support measures related to the Cyprus Cooperative Bank sale, the government debt-to-GDP ratio is forecast to fall to 96.4 % in 2019 and below 90 % in 2020. Afterwards, in the baseline scenario, government debt is projected to steadily decline to 61.0 % of GDP in 2029 (see Graph A1.1). This debt sustainability analysis uses the Commission's Spring 2019 forecast (for 2019 and 2020) as a starting point to ensure consistency across EU Member States. After 2020, the analysis is based on the following standard assumptions in the Commission's methodology: (i) the structural primary balance, before the cost of ageing, is kept at a surplus of 2.7 % of GDP under the 'no fiscal policy change' assumption; (ii) inflation converges to 2.0 % by 2023 and remains stable after that; (iii) the real long-term interest rate on new and rolled-over debt converges linearly to 3 % (5 % in nominal terms) by the end of the 10-year projection period, in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group; (iv) real GDP grows at the rate projected according to commonly agreed methods with the EPC's Output Gaps Working Group until t+10, and then grows according to the European Commission — Ageing Working Group's projections (average rate of around 1.5 % in 2018-2029); and (v) ageing costs develop according to the 2018 Ageing Report projections ([41]).

The debt trajectory, though declining steadily, is vulnerable to adverse macroeconomic and fiscal shocks and to a sustained increase of interest rates. In the baseline scenario, the debt-to-GDP ratio is expected to decline on average by approximately 3 percentage points (pps) of GDP per year from 2021 onwards. Graph A1.1 illustrates the sensitivity of this projected debt ratio path to three alternative scenarios. The first adverse scenario is a standard macroeconomic shock that assumes a decrease in real GDP growth (by 0.5 percentage point (pp.) compared to the baseline) over the projection period. It also assumes that the lower growth path does not have any repercussions on the government balance. In this scenario, the debt trajectory is on a declining path but at a slower pace compared to the baseline scenario, with government debt reaching 65.5 % of GDP in 2029 as opposed to 61.0 % in the baseline. The second scenario shows that a weaker fiscal performance could significantly undermine the favourable projected trend in the baseline. When assuming a fiscal shock of the structural primary balance that is gradually converging towards its 15-year historical average (a surplus of 1.2 % of GDP), the public debt is deemed to decline at a much slower pace, ending up 11 pps of GDP higher in 2029 compared to the baseline. The last scenario assumes a combination of negative macroeconomic and fiscal shocks together with a sustained increase in interest rates over the entire projection period ([42]). In such a case, government debt is set to decline very modestly until 2026 and then start rising again by 2029. By the end of the projection period it almost reaches 90 % of GDP, as higher interest rates feed through new and rolled-over debt.

The fiscal sustainability analysis continues to point to fiscal risks in the short term, partly reflecting the one-off effects of the banking support measures. However, the projected large primary surplus should enable a significant reduction of government debt in 2019 and thus somewhat mitigate this risk. Table A1.1 presents the Commission's fiscal sustainability framework, which differentiates fiscal risks across the short, medium and long term ([43]). The S0 indicator signals risks of fiscal stress over a

([40]) The DSA toolkit is mainly based on deterministic and stochastic debt projections. Other tools such as contingent liabilities from the banking sector, the government debt profile, gross financing needs or government assets inform the DSA but do not count towards a country's risk classification. For more information on the Commission's fiscal sustainability assessment framework, see European Commission (2019), 'Fiscal Sustainability Report 2018', European Economy Institutional Paper, No. 094.

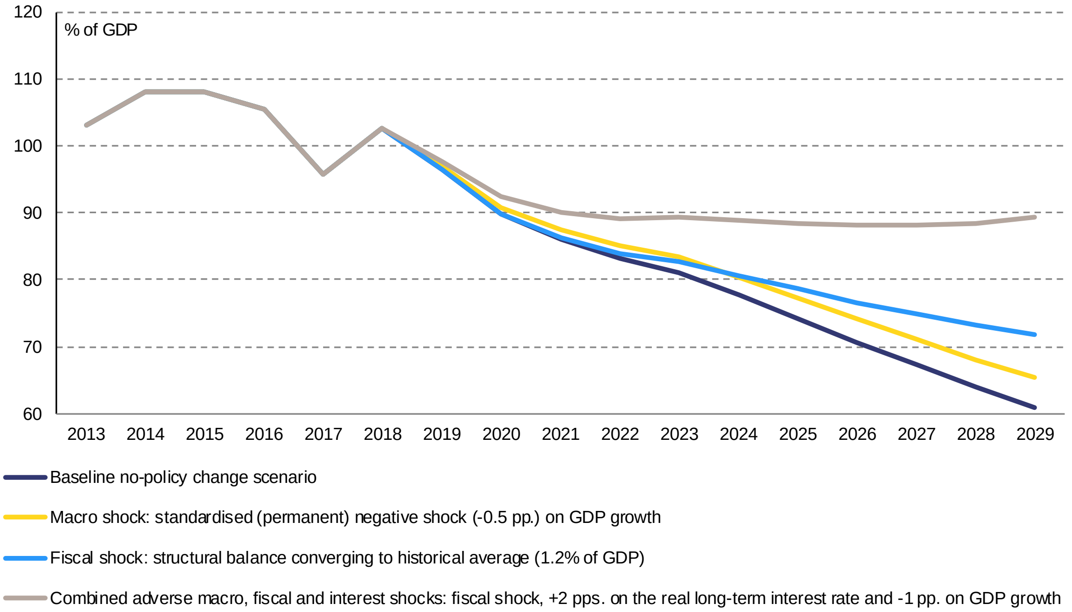
([41]) European Commission and the EPC/Council, 'The 2018 Ageing Report. Economic and budgetary projections for the EU Member States (2016-2070)', European Economy 79/2018.

([42]) In this scenario, the structural primary balance is assumed to linearly decrease in 2021-2024 (and remain constant after that) to reach its historical average (a lower value of 1.2 % of GDP, compared to the 2020 forecast value). In addition, negative feedback effects on interest rates (a sustained shock of +200 basis points) and on real GDP growth rate (a sustained shock of -1 pp. compared to the baseline) are assumed. A sustained shock of +200 basis points (+2 %) on market interest rates can be deemed significant in the current market environment.

([43]) For more details on the Commission's fiscal sustainability methodology, please see the Fiscal Sustainability Report 2018.

one-year period, as indicated by its high value above the critical threshold. In particular, the vulnerabilities come from both the fiscal and financial-competitiveness sides, as pointed by the sub-indices, whereas in the past the fiscal sub-index was below its threshold. The high value of the fiscal S0 sub-index is explained by the one-off banking support measures which led to the deterioration of several fiscal variables such as the primary balance (now in deficit) and the net and gross government debt. Nevertheless, in 2019 the general government balance is expected to be in high surplus contributing to a reduction of gross financing needs this year (also considering the high share of concessionary debt), thus mitigating the high sustainability risk. Finally, financial market perceptions of Cypriot sovereign risk have improved, further mitigating short-term risks.

Graph A1.1: **Debt projections**



Source: European Commission

In the medium and long term, Cyprus faces medium fiscal sustainability risks. The medium-term fiscal risk is assessed based on two main tools: the DSA and the S1 sustainability gap indicator (see Table A1.1). The negative value of S1 indicates that no upfront fiscal adjustment effort is needed to reduce the debt below the reference value of 60 % of GDP by 2033, pointing therefore to a low risk in the medium term. However, the DSA shows that the debt-to-GDP ratio would decline to slightly above the critical 60 % threshold by 2029, pointing to a medium risk. Over the long-term, Cyprus is deemed to be at medium fiscal sustainability risk. The S2 sustainability gap indicator shows low risk, while the DSA indicates medium risk in the long term due to vulnerabilities linked to the high debt burden.

To firmly anchor the debt-to-GDP ratio on a sustainable downward path, it is important for Cyprus to maintain fiscal discipline over the medium to long term. As indicated by the alternative scenarios above, there are large uncertainties surrounding the projected debt-to-GDP path, linked to different potential shocks and the high fiscal surplus assumed to underpin this baseline projection. In view of these risks and given the high level of public debt and increased explicit contingent liabilities in relation to the financial sector, maintaining fiscal discipline and sustaining growth-enhancing structural reforms are essential for ensuring a declining trajectory of the public debt.

Table A1.1: **Sustainability indicators - Commission fiscal risk analysis (in % of GDP)**

Time frame			Current PPS review (spring 2019)		PPS fifth review (autumn 2018)	
Short-term			**HIGH risk**		**HIGH risk**	
S0 indicator [1]			0,5		0,46	
Fiscal subindex			0,5	HIGH risk	0,27	LOW risk
Financial & competitiveness subindex			0,6	HIGH risk	0,57	HIGH risk
Medium-term			**MEDIUM risk**		**MEDIUM risk**	
DSA [2]			MEDIUM risk		MEDIUM risk	
S1 indicator [3]			-0,7	LOW risk	-0,7	LOW risk
of which	Initial Budgetary Position		-2,8		-2,9	
	Debt Requirement		2,2		2,3	
	Cost of Ageing		-0,1		-0,1	
	of which	Pensions	0,5		0,5	
		Health care	0,1		0,1	
		Long-term care	0,0		0,0	
		Other	-0,7		-0,7	
Long-term			**MEDIUM risk**		**MEDIUM risk**	
DSA [2]			MEDIUM risk		MEDIUM risk	
S2 indicator [4]			-0,7	LOW risk	-0,9	LOW risk
of which	Initial Budgetary Position		-1,6		-1,7	
	Cost of Ageing		0,9		0,9	
	of which	Pensions	1,7		1,7	
		Health care	0,2		0,2	
		Long-term care	0,2		0,2	
		Other	-1,3		-1,3	

Note: the 'Commission' no-policy-change scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. Age-related expenditure as given in the 2018 Ageing Report.

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

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

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

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

* For more information see Fiscal Sustainability Report 2018.

Source: European Commission

ANNEX 2

European Commission macroeconomic and fiscal projections (2019 Spring Forecast)

Table A2.1: **Selected economic indicators**

	2014	2015	2016	2017	2018	2019	2020
Real economy			*(percent change)*				
Real GDP	-1.3	2.0	4.8	4.5	3.9	3.1	2.7
Domestic demand incl. inventories	-1.8	3.9	6.1	8.5	3.0	4.8	4.0
Private consumption expenditure	1.0	2.4	4.5	4.1	3.7	3.5	2.8
Government consumption expenditure	-7.5	-0.5	-0.8	3.1	4.3	3.6	4.0
Gross fixed capital formation	-19.0	13.8	41.8	29.0	-7.1	10.2	8.1
Exports of goods and services	4.3	5.2	4.6	6.0	3.3	0.8	0.8
Imports of goods and services	3.6	8.4	6.6	12.2	2.0	3.5	3.0
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	-3.3	3.2	8.4	8.4	1.7	4.9	4.2
Foreign trade	0.4	-1.9	-1.3	-4.1	0.8	-1.8	-1.5
Changes in inventories	1.6	0.6	-2.3	0.2	1.5	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	-1.6	-1.2	-0.6	1.7	1.6	1.1	1.3
HICP	-0.3	-1.5	-1.2	0.7	0.8	0.9	1.1
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	16.1	15.0	13.0	11.1	8.4	6.7	5.9
Employment	-1.8	1.5	4.6	4.3	4.0	2.6	2.0
Compensation per employee	-3.5	-1.3	-1.1	0.7	0.1	2.5	2.8
Labour productivity	0.5	0.5	0.2	0.2	-0.2	0.5	0.7
Unit labour costs	-4.0	-1.7	-1.4	0.6	0.3	2.0	2.0
Public finance			*(percent of GDP)*				
General government balance	-9.0	-1.3	0.3	1.8	-4.8	3.0	2.8
Total revenue	39.8	39.3	38.3	39.1	39.9	41.0	41.8
Total expenditure	48.8	40.6	38.0	37.4	44.7	38.0	39.0
General government primary balance	-5.8	1.9	3.1	4.3	-2.3	5.4	4.9
Gross debt	108.0	108.0	105.5	95.8	102.5	96.4	89.9
Balance of payments			*(percent of GDP)*				
Current external balance	-4.4	-1.4	-5.1	-8.4	-6.5	-8.0	-9.4
Ext. bal. of goods and services	1.8	0.2	-0.6	-3.5	-1.7	-3.3	-4.7
Exports goods and services	62.0	64.5	64.5	64.8	64.3	62.8	61.5
Imports goods and services	60.3	64.3	65.1	68.3	66.0	66.1	66.3
Balance of services	17.7	16.9	20.4	20.7	19.8	19.1	18.4
Balance of goods	-16.0	-16.7	-21.0	-24.2	-21.5	-22.4	-23.1
Balance of primary income	-3.4	1.3	-2.0	-2.7	-2.7	-2.7	-2.7
Balance of secondary income	-2.7	-2.9	-2.4	-2.1	-2.0	-2.0	-2.0
Memorandum item			*(EUR bn)*				
Nominal GDP	17.6	17.7	18.5	19.6	20.7	21.6	22.5

Source: European Commission

Table A2.2: **Use and supply of goods and services (volume)**

percent change unless otherwise stated	2014	2015	2016	2017	2018	2019	2020
1. Private consumption expenditure	1.0	2.4	4.5	4.1	3.7	3.5	2.8
2. Government consumption expenditure	-7.5	-0.5	-0.8	3.1	4.3	3.6	4.0
3. Gross fixed capital formation	-19.0	13.8	41.8	29.0	-7.1	10.2	8.1
4. Domestic demand excl. inventories	-3.5	3.3	8.5	8.2	1.6	4.8	4.0
5. Changes in inventories (contr. to growth)	1.6	0.6	-2.3	0.2	1.5	0.0	0.0
6. Domestic demand incl. inventories	-1.8	3.9	6.1	8.5	3.0	4.8	4.0
7. Exports of goods and services	4.3	5.2	4.6	6.0	3.3	0.8	0.8
7a. - of which goods	2.1	1.7	-8.9	0.3	23.5	-0.1	0.1
7b. - of which services	5.0	6.4	9.1	7.6	-2.0	1.1	1.0
8. Final demand	0.5	4.4	5.5	7.5	3.1	3.3	2.8
9. Imports of goods and services	3.6	8.4	6.6	12.2	2.0	3.5	3.0
9a. - of which goods	3.9	6.6	11.4	13.7	4.2	4.3	3.5
9b. - of which services	3.3	10.5	1.5	10.5	-0.7	2.5	2.3
10. GDP at market prices	-1.3	2.0	4.8	4.5	3.9	3.1	2.7
(Contribution to change in GDP)							
11. Final domestic demand	-3.3	3.2	8.4	8.4	1.7	4.9	4.2
12. Changes in inventories	1.6	0.6	-2.3	0.2	1.5	0.0	0.0
13. Net exports	0.4	-1.9	-1.3	-4.1	0.8	-1.8	-1.5

Source: European Commission

Table A2.3: **Use and supply of goods and services (value)**

percent change unless otherwise stated	2014	2015	2016	2017	2018	2019	2020
1. Private consumption expenditure	0.2	0.8	3.0	5.0	5.0	4.4	4.0
2. Government consumption expenditure	-11.9	-1.1	-1.2	4.9	5.8	5.4	5.7
3. Gross fixed capital formation	-19.9	12.2	41.7	29.3	-4.6	11.5	9.7
4. Domestic demand excl. inventories	-4.8	1.8	7.4	9.2	3.1	5.9	5.4
5. Changes in inventories	1.6	0.6	-2.3	0.2	1.5	0.0	0.0
6. Domestic demand incl. inventories	-3.3	2.4	5.0	9.3	3.7	5.9	5.4
7. Exports of goods and services	2.7	4.8	4.2	6.7	4.7	1.8	2.0
7a. - of which goods	3.5	2.5	-9.8	0.7	24.2	0.7	1.3
7b. - of which services	2.4	5.6	8.9	8.3	-0.3	2.2	2.2
8. Final demand	-1.0	3.3	4.7	8.3	4.1	4.3	4.1
9. Imports of goods and services	2.2	7.5	5.5	11.4	2.0	4.5	4.3
9a. - of which goods	-0.6	4.1	10.9	13.7	4.6	5.3	4.8
9b. - of which services	5.6	11.4	-0.1	8.7	-1.2	3.4	3.5
10. Gross national income at market prices	-2.1	5.6	0.8	5.5	5.5	4.3	4.0
11. Gross value added at basis prices	-4.3	0.9	3.9	5.4	5.0	4.5	4.2
12. Gross domestic product at market prices	-2.9	0.8	4.2	6.3	5.5	4.3	4.0

Source: European Commission

Table A2.4: **Implicit deflators**

percent change	2014	2015	2016	2017	2018	2019	2020
1. Private consumption expenditure	-0.8	-1.6	-1.4	0.9	1.2	0.9	1.2
2. Government consumption expenditure	-4.8	-0.6	-0.4	1.8	1.4	1.7	1.7
3. Gross fixed capital formation	-1.1	-1.4	-0.1	0.2	2.6	1.2	1.4
4. Domestic demand incl. inventories	-1.5	-1.5	-1.0	0.8	0.7	1.1	1.3
5. Exports of goods and services	-1.5	-0.4	-0.3	0.6	1.4	1.0	1.2
6. Final demand	-1.5	-1.0	-0.7	0.7	0.9	1.0	1.3
7. Imports of goods and services	-1.4	-0.8	-1.0	-0.7	0.0	0.9	1.3
8. Gross domestic product at market prices	-1.6	-1.2	-0.6	1.7	1.6	1.1	1.3
HICP	-0.3	-1.5	-1.2	0.7	0.8	0.9	1.1

Source: European Commission

Table A2.5: **Labour market and costs**

percent change	2014	2015	2016	2017	2018	2019	2020
1. Labour productivity	0.5	0.5	0.2	0.2	-0.2	0.5	0.7
2. Compensation per employee	-3.5	-1.3	-1.1	0.7	0.1	2.5	2.8
3. Unit labour costs	-4.0	-1.7	-1.4	0.6	0.3	2.0	2.0
4. Total population	-1.1	-0.6	0.5	0.9	1.1	0.7	0.6
5. Population of working age (15-64 years)	-2.1	-1.6	-0.1	0.5	0.3	0.3	0.4
6. Employment	-1.8	1.5	4.6	4.3	4.0	2.6	2.0
7. Unemployment rate (1)	16.1	15.0	13.0	11.1	8.4	6.7	5.9

(1) Eurostat definition, % of labour force.
Source: European Commission

Table A2.6: **External balance**

EUR bn unless otherwise stated	2014	2015	2016	2017	2018	2019	2020
1. Exports of goods (fob)	2.8	2.9	2.6	2.6	3.2	3.3	3.3
2. Imports of goods (fob)	5.6	5.8	6.5	7.4	7.7	8.1	8.5
3. Trade balance (goods, fob/fob) (1-2)	-2.8	-3.0	-3.9	-4.8	-4.5	-4.8	-5.2
3.1 p.m. (3) as % of GDP	-16.0	-16.7	-21.0	-24.2	-21.5	-22.4	-23.1
4. Exports of services	8.1	8.6	9.3	10.1	10.1	10.3	10.5
5. Imports of services	5.0	5.6	5.6	6.0	6.0	6.2	6.4
6. Service balance (4-5)	3.1	3.0	3.8	4.1	4.1	4.1	4.1
6.1 p.m. (6) as % of GDP	17.7	16.9	20.4	20.7	19.8	19.1	18.4
7. External balance of goods and services (3+6)	0.3	0.0	-0.1	-0.7	-0.4	-0.7	-1.1
7.1 p.m. (7) as % of GDP	1.8	0.2	-0.6	-3.5	-1.7	-3.3	-4.7
8. Balance of primary and secondary incomes	-1.1	-0.3	-0.8	-1.0	-1.0	-1.0	-1.0
8.1 - of which, balance of primary income	-0.6	0.2	-0.4	-0.5	-0.6	-0.6	-0.6
8.2 - of which, balance of secondary income	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4
8.3 p.m. (8) as % of GDP	-6.1	-1.6	-4.5	-4.8	-4.7	-4.7	-4.7
9. Current external balance (7+8)	-0.8	-0.3	-0.9	-1.6	-1.3	-1.7	-2.1
9.1 p.m. (9) as % of GDP	-4.4	-1.4	-5.1	-8.4	-6.5	-8.0	-9.4
10. Net capital transactions	0.1	0.0	0.0	0.1	-0.1	0.2	0.2
11. Net lending (+)/net borrowing (-) (9+10)	-0.7	-0.2	-0.9	-1.5	-1.4	-1.5	-1.9
11.1 p.m. (11) as % of GDP	-3.7	-1.1	-4.9	-7.8	-6.9	-7.1	-8.6

Source: European Commission

Table A2.7: **Fiscal accounts**

	2014	2015	2016	2017	2018	2019	2020
			levels, EUR m				
Taxes on production and imports	2,600	2,608	2,738	3,056	3,300	3,310	3,442
Taxes on income and wealth	1,812	1,761	1,755	1,835	1,921	1,981	2,053
Social contributions	1,445	1,483	1,545	1,710	1,843	2,369	2,759
Other current resources	1,028	1,024	1,005	998	1,045	1,032	981
Total current revenue	6,884	6,876	7,043	7,599	8,109	8,693	9,235
Capital transfers received	130	101	43	89	169	169	169
Total government revenue	7,014	6,976	7,086	7,688	8,278	8,862	9,404
Compensation of employees	2,341	2,271	2,260	2,354	2,456	2,616	2,799
Intermediate consumption	625	655	625	708	817	872	881
Social transfers	2,469	2,468	2,564	2,620	2,709	3,112	3,480
Interest payments	557	566	510	504	517	517	468
Subsidies	80	72	97	55	60	60	61
Other current expenditure	395	463	397	464	474	491	513
Total current expenditure	6,466	6,495	6,453	6,705	7,034	7,668	8,202
Total capital expenditure	2,125	718	574	639	2,234	546	564
Total government expenditure	8,592	7,213	7,027	7,344	9,268	8,214	8,766
General government balance	-1,577	-236	59	344	-990	648	638
General government primary balance	-1,021	330	569	849	-473	1,165	1,106
			% of GDP				
Taxes on production and imports	14.8	14.7	14.8	15.6	15.9	15.3	15.3
Taxes on income and wealth	10.3	9.9	9.5	9.3	9.3	9.2	9.1
Social contributions	8.2	8.4	8.4	8.7	8.9	11.0	12.3
Other current resources	5.8	5.8	5.4	5.1	5.0	4.8	4.4
Total current revenue	39.1	38.7	38.1	38.7	39.1	40.2	41.1
Capital transfers received	0.7	0.6	0.2	0.5	0.8	0.8	0.8
Total government revenue	39.8	39.3	38.3	39.1	39.9	41.0	41.8
Compensation of employees	13.3	12.8	12.2	12.0	11.8	12.1	12.4
Intermediate consumption	3.6	3.7	3.4	3.6	3.9	4.0	3.9
Social transfers	14.0	13.9	13.9	13.3	13.1	14.4	15.5
Interest payments	3.2	3.2	2.8	2.6	2.5	2.4	2.1
Subsidies	0.5	0.4	0.5	0.3	0.3	0.3	0.3
Other current expenditure	2.2	2.6	2.1	2.4	2.3	2.3	2.3
Total current expenditure	36.7	36.6	34.9	34.1	33.9	35.5	36.5
Total capital expenditure	12.1	4.0	3.1	3.3	10.8	2.5	2.5
Total government expenditure	48.8	40.6	38.0	37.4	44.7	38.0	39.0
General government balance	-9.0	-1.3	0.3	1.8	-4.8	3.0	2.8
General government primary balance	-5.8	1.9	3.1	4.3	-2.3	5.4	4.9
Memorandum item							
Nominal GDP (billion euro)	17.6	17.7	18.5	19.6	20.7	21.6	22.5

Source: European Commission

Table A2.8: **Debt developments**

	2014	2015	2016	2017	2018	2019	2020
Gross debt (% of GDP)	108.0	108.0	105.5	95.8	102.5	96.4	89.9
Real GDP growth (% change)	-1.3	2.0	4.8	4.5	3.9	3.1	2.7
Nominal GDP (EUR bn)	17.6	17.7	18.5	19.6	20.7	21.6	22.5
General government balance (% of GDP)	-9.0	-1.3	0.3	1.8	-4.8	3.0	2.8
Change in gross debt ratio (pps change)	4.9	0.0	-2.5	-9.8	6.8	-6.1	-6.5
	Contribution to the change in stock						
Primary balance	5.8	-1.9	-3.1	-4.3	2.3	-5.4	-4.9
Snow-ball effect	6.3	2.3	-1.6	-3.6	-2.4	-1.8	-1.6
of which							
Interest expenditure	3.2	3.2	2.8	2.6	2.5	2.4	2.1
Real growth effect	1.4	-2.1	-5.0	-4.4	-3.5	-3.0	-2.5
Inflation effect	1.7	1.3	0.6	-1.7	-1.4	-1.1	-1.2
Stock-flow adjustments	-7.2	-0.5	2.2	-1.8	7.0	1.1	0.0

Source: European Commission

EUROPEAN ECONOMY INSTITUTIONAL SERIES

European Economy Institutional series can be accessed and downloaded free of charge from the following address:
https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value[value][year]=All&field_core_tags_tid_i18n=22621.

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/european_economy/index_en.htm
  (the main reports, e.g. Economic Forecasts)
- http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm
  (the Occasional Papers)
- http://ec.europa.eu/economy_finance/publications/qr_euro_area/index_en.htm
  (the Quarterly Reports on the Euro Area)

GETTING IN TOUCH WITH THE EU

In person

All over the European Union there are hundreds of Europe Direct Information Centres. You can find the address of the centre nearest you at: http://europa.eu/contact.

On the phone or by e-mail

Europe Direct is a service that answers your questions about the European Union. You can contact this service:

- by freephone: 00 800 6 7 8 9 10 11 (certain operators may charge for these calls),
- at the following standard number: +32 22999696 or
- by electronic mail via: http://europa.eu/contact.

FINDING INFORMATION ABOUT THE EU

Online

Information about the European Union in all the official languages of the EU is available on the Europa website at: http://europa.eu.

EU Publications

You can download or order free and priced EU publications from EU Bookshop at: http://publications.europa.eu/bookshop. Multiple copies of free publications may be obtained by contacting Europe Direct or your local information centre (see http://europa.eu/contact).

EU law and related documents

For access to legal information from the EU, including all EU law since 1951 in all the official language versions, go to EUR-Lex at: http://eur-lex.europa.eu.

Open data from the EU

The EU Open Data Portal (http://data.europa.eu/euodp/en/data) provides access to datasets from the EU. Data can be downloaded and reused for free, both for commercial and non-commercial purposes.

Publications Office
of the European Union