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# Post-Programme Surveillance Report

## Cyprus, Autumn 2018

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

# Post-Programme Surveillance Report

## Cyprus, Autumn 2018

EUROPEAN ECONOMY

Institutional Paper 092

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The cut-off date for the data and policy developments included in this report is 22/10/2018 (except for the revised ESTIA scheme adopted on 02/11/2018, which is also covered).

# ABBREVIATIONS

ALMPs: Active labour market policies

AWG: Ageing Working Group

CBC: Central Bank of Cyprus

CCB: Cooperative Central Bank

CET1: Common Equity Tier 1

CIT: Corporate Income Tax

COLA: Cost of Living Allowance

CSE: Cyprus Stock Exchange

CSRs: Country specific recommendations

CyTA: Cyprus Telecommunications Authority

CYSTAT: Statistical Service of Cyprus

DB: Draft Budget

DBP: Draft Budgetary Plan

DSA: Debt Sustainability Analysis

DTA: Deferred Tax Assets

EAC: Electricity Authority of Cyprus

EC: European Commission

ECB: European Central Bank

EDP: Excessive Deficit Procedure

EEZ: Exclusive Economic Zone

EIOPA: European Insurance and Occupational Pensions Authority

ELA: Emergency Liquidity Assistance

EPC: Economic Policy Committee

ESA2010: European System of Accounts 2010

ESF: European Social Fund

ESI: Economic Sentiment Indicator

ESM: European Stability Mechanism

ESMA: European Securities and Markets Authority

EU-SILC: European Union Statistics on Income and Living Conditions

FDP: Field Development Plan

FRBSL: Fiscal Responsibility and Budget System Law

GDP: Gross Domestic Product

GMI: Guaranteed Minimum Income

GVA: Gross value added

HICP: Harmonised Index of Consumer Prices

IAS 39: International Accounting Standard 39

IDR: In-depth review

IFRS 9: International Financial Reporting Standard 9

IMF: International Monetary Fund

LTD: loan-to-deposit (ratio)

LNG: Liquefied Natural Gas

MIP: Macroeconomic Imbalance Procedure

MTO: Medium-term objective

NEET: Not in education, employment or training

NFC: Non-Financial Corporations

NHS: National Health System

NPL: Non-performing loans

OECD: Organisation for Economic Co-operation and Development

PDMO: Public Debt Management Office

PES: Public Employment Services

PIT: Personal Income Tax

PPM: Post-programme monitoring

PPPs: Public-private partnerships

PPS: Post-programme surveillance

PSPP: Public sector purchase programme

SPE: Special purpose entity

RoA: Return on assets

y-o-y: Year-on-year

# EXECUTIVE SUMMARY

**This report presents the findings of the fifth 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 24 to 28 September 2018**. Given that Cyprus has been identified as experiencing excessive macroeconomic imbalances under the Macroeconomic Imbalance Procedure (MIP), this visit also served the purpose of specific monitoring under the MIP. The mission was coordinated with an International Monetary Fund (IMF) Article IV mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System. The next PPS mission will take place in the spring 2019.

**Cyprus continues to enjoy strong growth and favourable labour market developments.** After expanding by 4.2 % in 2017, the economy is expected to grow by 3.9 % in 2018, driven by both domestic and external demand. Growth is set to gradually slow down to 2.9 % in 2020 and become increasingly driven by a domestic demand that is fuelled by strong private consumption and buoyant investment mostly in the construction and shipping sectors. Employment has been rising, and by mid-2018 the unemployment rate had fallen below the euro area average. A diminishing slack in the labour market points to a modest acceleration in wages. Inflation remains subdued.

**Public finances have performed remarkably so far in 2018, but the adverse fiscal impact of the sale of the Cyprus Cooperative Bank (CCB) is not yet fully established**. The Commission autumn forecast projects an increase of the general government surplus to 2.8 % of GDP in 2018, excluding any potential deficit-increasing impact from the banking support measures related to the CCB sale. The strong fiscal position reflects the better-than-expected collection of revenue and the prudent expenditure management in the first 8 months of 2018. However, the public support measures for the sale and orderly winding down of CCB have resulted in a projected increase in the country's public debt to 105 % of GDP in 2018, and the government's exposure to explicit contingent liabilities (namely asset protection schemes) has increased. These support measures are also expected to weigh on the budget balance in 2018, depending on the statistical treatment, which is still to be determined.

**It is essential to safeguard budgetary surpluses to ensure a steady decline in the very high level of public debt.** Although public debt is expected to resume its declining path as of next year, it would remain one of the highest in the euro area. In this context, the projected sizeable headline and primary budgetary surpluses in 2019 and 2020, driven by favourable macroeconomic environment and prevailing tax buoyancy, provide the necessary basis for prioritising debt reduction. A continuation of prudent expenditure management remains essential, particularly in view of the cyclical nature of tax revenues and the uncertainties surrounding the potential fiscal impact of the healthcare reform.

**The sale of the publicly-owned CCB, formerly the second largest bank in the country and burdened by very high non-performing loans (NPLs), to Hellenic Bank (HB) was a major step in stabilising and consolidating the banking sector.** The CCB sale has put the banking sector on a sounder footing and was an important driver behind the return of Cyprus' sovereign credit rating to investment grade for the first time since 2012. With this sale, around one third of the NPLs in the economy (EUR 5.7 billion) were taken out of the banking sector and transferred to the publicly-owned residual entity of the CCB.

**Nevertheless, considerable challenges remain in the financial sector.** Even after the CCB sale, the NPL ratio, estimated at 31 % of total loans for end-2018 (Central Bank of Cyprus definition), is still one of the highest ratios in the EU. Furthermore, the NPLs from the residual entity will continue to weigh on the economy, even though they are out of the banking system, as the private sector remains heavily indebted. Therefore, it is essential to adopt an appropriate governance framework and management structure for the CCB residual entity in order to maximise recoveries and the recuperation of public funds. The government plans to introduce ESTIA, a subsidy scheme for NPLs backed with primary residences. The scheme's eligibility criteria have been tightened compared to its initial design. However, there are still concerns about moral hazard and fairness, in particular concerning potential strategic defaulters. To further mitigate such concerns it is crucial that the foreclosure procedure is promptly initiated upon re-

default under the scheme and towards the remaining defaulted borrowers outside the scheme. The July 2018 legislative package is welcome. The package includes amendments to the insolvency and foreclosure frameworks, changes to the Sale of Loans Law and the adoption of the Securitisation Law. Swift and full implementation will be crucial for the package to be effective. Other challenges include fully integrating the CCB into HB. Also, the banking sector continues to be under pressure because of low-interest income, the potential need for additional provisions to deal with high NPLs, and high operating costs. Outside the banking sector, it is important to progress with the integration of the supervision of pension funds and insurance companies.

**Progress in implementing the structural reform agenda remains essential to continue strong economic performance in the long term.** The swift and comprehensive reform of the judicial system, and in particular the strengthening of the legal enforcement of claims and the establishment of efficient court procedures, is indispensable not only to improve payment discipline and reduce NPLs but also to strengthen the capacity of the banks to lend to the economy. It is also important to improve the business environment and attract productivity-enhancing investment by, among other things, simplifying burdensome procedures to facilitate strategic investments, setting up a competitive electricity market and implementing planned privatisation projects. In parallel, the longstanding public administration and local government reforms need to be completed. Moreover, it is crucial to address the inefficiencies of the current system for issuing and transferring title deeds. It is also important to implement, in a fiscally sustainable way, the much needed healthcare reform.

**The risk of Cyprus not being able to service its debt to the ESM is considered low in the short term.** After initially deteriorating in 2018 because of the CCB sale, borrowing conditions for Cyprus have improved, since the dissipation of uncertainty over the sale and the upgrades of the sovereign credit rating. Standard & Poor’s and Fitch Ratings recently moved Cyprus back to investment grade for the first time since 2012. Thanks to robust economic growth, a large primary surplus, the regained investment grade for sovereign debt and a sizable cash buffer, the risk of Cyprus not being able to service its ESM debt is considered low in the short term. However, due to the CCB sale, the annual financing needs have increased especially in the medium term, albeit remaining manageable (below 7 % of GDP). Thus, continued fiscal discipline, a forceful reduction of NPLs, and progress in implementing growth-enhancing structural reforms will be of critical importance in consolidating and further improving investors’ confidence.

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# 1. INTRODUCTION

**Cyprus implemented an economic adjustment programme from April 2013 to March 2016**. The three-year programme was approved by the 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 fifth post-programme surveillance (PPS) mission to Cyprus between 24 and 28 September 2018** ([1]). The mission was coordinated with an IMF Article IV mission. Staff from the European Stability Mechanism (ESM) participated in the meetings dealing with the ESM early warning system. The aim of post-programme surveillance 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 ([2]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

**The PPS mission, as usual in the autumn, included specific monitoring under the macroeconomic imbalance procedure (MIP)**. In March 2018, the Commission concluded that Cyprus was experiencing excessive imbalances, as a very high share of non-performing loans (NPLs) burdens the financial sector and a high stock of private, public, and external debt hangs on the economy in a context of still relatively high, even though declining, unemployment and weak potential growth. Under the MIP these excessive imbalances warrant specific monitoring of the progress made with reform implementation to address these imbalances ([3]). A review of the policy measures undertaken is provided in Annex 1 of this report.

([1]) 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.

([2]) 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.

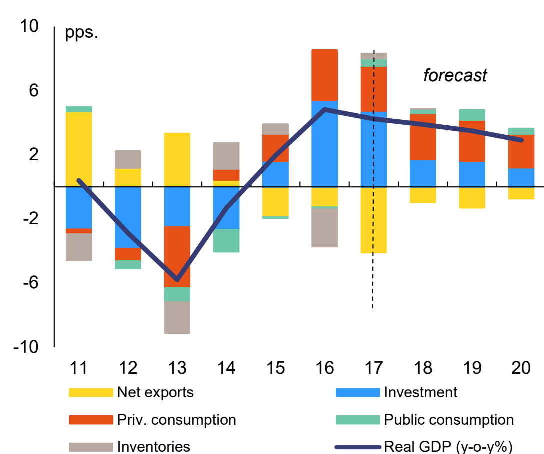
([3]) See Communication from the Commission to the European Parliament, the Council and the Eurogroup: https://ec.europa.eu/info/files/2018-european-semester-communication-country-reports_en

# 2. MACROECONOMIC OUTLOOK

## Macroeconomic situation

**Economic growth in Cyprus remained strong in the first half of 2018.** It was backed by solid private consumption, investment and exports, with real GDP growing by 4 % (see Graph 2.1). The recent revisions to GDP data now paint a more pronounced V-shaped picture of Cyprus' economic recovery since the crisis. For 2016, real GDP has been revised up by 1.4 pps. to 4.8 %; and for 2017 by 0.3 pps. to 4.2 %. Future growth is expected to remain fairly strong and above potential, albeit slowing down from 3.9 % in 2018 to 3.5 % in 2019 and 2.9 % in 2020.

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

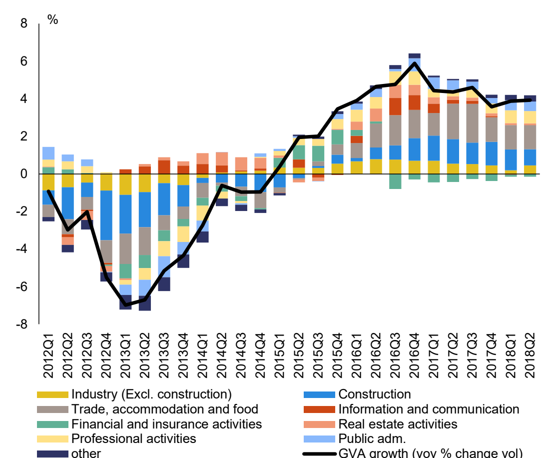



***Source:*** European Commission

**From the supply side, most sectors contributed positively to economic growth in the first half of 2018, with the construction sector being particularly buoyant.** Although it remains well-below its peak levels, construction activity expanded nearly by one fifth compared to the previous year. There are two main streams of investment activity. One is related to tourism, which has been witnessing very strong demand in recent years. Investment in tourism infrastructure (e.g. marinas, casino) and accommodation (building of new hotels and refurbishing of existing ones) is now in progress. The second stream is the residential construction, which is to a very large extent driven by the foreign acquisition of property, fuelled by the 'citizenship-for-investment' scheme. This scheme allows non-EU nationals to obtain Cypriot citizenship if they invest EUR 2 million, of which at least EUR 500 000 has to be invested in a residence that the buyer retains for at least 3 years.

**Those sectors whose performance largely depends on tourism also grew strongly in the first half of the year.** They reported over 5 % growth in real value added terms compared to a year ago. These sectors, which are among the largest sectors in the Cypriot economy, include accommodation and food service activities, transport, and the wholesale and retail trade (see Graph 2.2). The strong inflow of tourists — beating records for the third consecutive year — supported this strong performance.

Graph 2.2: **Gross value added growth and contributions**




***Source:*** European Commission

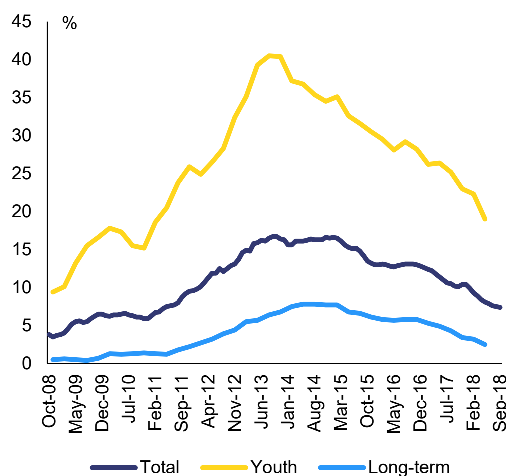
**Professional business services, another pillar of the Cypriot economy, also expanded rapidly**, at close to 7 % year-on-year (y-o-y) in real value added terms in the first half of the year. Professional business services specialise in legal advice, including tax planning, and accountancy. The 'citizenship-for-investment' scheme also helps this sector as many non-EU nationals wishing to acquire Cypriot citizenship tend to use legal services.

**Financial services continued contributing negatively to growth**, though the decline was limited in the first half of the year, below 2 %. This reflects the ongoing resolution of NPLs and the low profitability of the domestic banks (see Section 3 on financial sector issues). However, the investment funds industry, which comprises a small part of the financial sector in Cyprus, is

thriving. In recent years, the number of registered investment funds has risen substantially, despite closures of some funds in 2018, reportedly following the enactment of the stricter European Securities and Markets Authority (ESMA) Regulation.

**The labour market continued to benefit from the enduring economic expansion**. The positive labour market trends that began in 2016 continued, with rapid employment growth bringing the unemployment rate down to 7.5 % by August 2018 (below the euro area average since June). The buoyant economic activity, in particular in the construction and tourism-related sectors, also provided employment opportunities for the most vulnerable groups — the young and the long-term unemployed — reducing their unemployment rates to 19 % and 2.5 %, respectively (see Graph 2.3). Employment expectations in key sectors are positive, signalling a bright outlook in the short term.

Graph 2.3: **Unemployment rates**




***Source:*** Eurostat

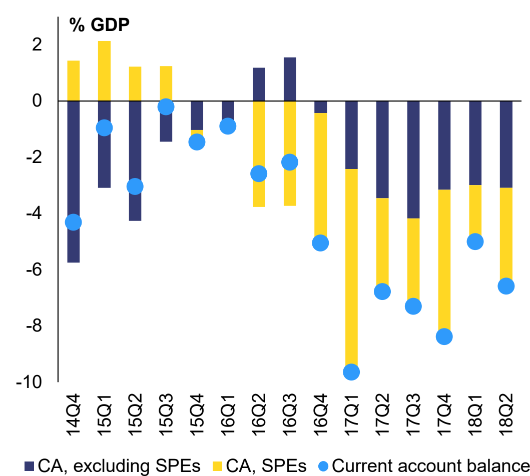
**Wage growth remains moderate, but signs of a modest acceleration are starting to emerge**. Compensation per employee in 2017 increased modestly by 0.7 %, and this rise was exclusively driven by the developments in public administration, education and health. The increase in compensation per employee in these sectors was a combined 3.7 %, while all other sectors in 2017 recorded declines. Increases in public wages stemming from various components (increments, cost of living allowance COLA, (4) restart of promotions that were on hold since the crisis) now look to be very gradually spilling over to private wages. Renegotiated collective agreements suggest that wages could increase by 2 % in 2018-2020. This is also supported by data for the first half of 2018, where compensation per employee in annual terms has increased in tourism-related sectors, construction and manufacturing. In future, diminishing slack in the labour market combined with higher public wages are expected to encourage sharper wage rises in the private sector, though the inflow of foreign workers is likely to moderate this trend.

**The current account deficit widened, although a large part of it is associated with the activities of special purpose entities (5) (SPEs)**. The current account deficit has widened to 8.4 % of GDP for 2017, according to revised data. SPE activities accounted for -5.2 % of GDP (see Graph 2.4). In the first half of 2018, the headline current account deficit contracted on account of the SPE component (de-registration of ships), while the non-SPE part recorded a deficit of slightly more than 3 % of GDP. The combination of robust domestic demand (driving imports) and the positive outlook for SPE activities suggests that the current account deficit is set to widen further, thus increasing the vulnerability to a sudden stop in international capital flows.

(4) A reformed COLA indexation system has been reintroduced since the beginning of 2018, which applies once a year and at half of the level of inflation, which to some extent mitigates the concerns with this measure. For more information see https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-cyprus-en.pdf.

(5) 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

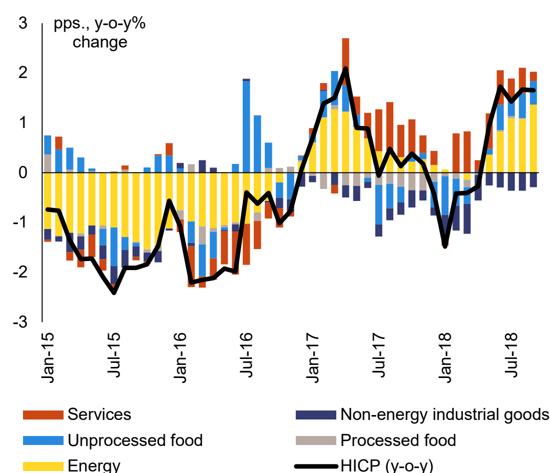
Graph 2.4: **Current account developments, SPEs and non-SPEs**




***Source:*** Central Bank of Cyprus

**Inflation remains subdued**. Headline annual inflation measured by the harmonised index of consumer prices (HICP) up to May 2018 was in negative territory (see Graph 2.5) and is expected to remain low for the year as a whole, at 0.8 %. During the first three quarters of the year, non-energy industrial goods experienced a period of declining prices amid increasing competition, while higher oil prices fed into energy prices with a lag. Going forward, inflation is expected to pick up moderately as a tighter labour market is expected to translate into higher disposable income.

Graph 2.5: **Inflation and contributions**




***Source:*** Eurostat

**The residential real estate market is recovering, with the support of the 'citizenship-for-investment' scheme.** Residential property prices increased for the third year in a row, albeit moderately. Housing sales continued expanding at double-digit growth rates. An increasing number of acquisitions is by foreigners, who accounted for nearly half (48 %) of all property sales in the first 8 months of 2018. Meanwhile, housing demand by Cypriots continues to be constrained by limited bank lending. The mandatory acquisition of personal immovable property in the 'citizenship-for-investment' scheme has been one of the key drivers behind the real estate market recovery. It also contributed to the regional differences in price developments: real estate prices in Limassol, where the foreign, particularly Russian, community is concentrated, rose much more than elsewhere.

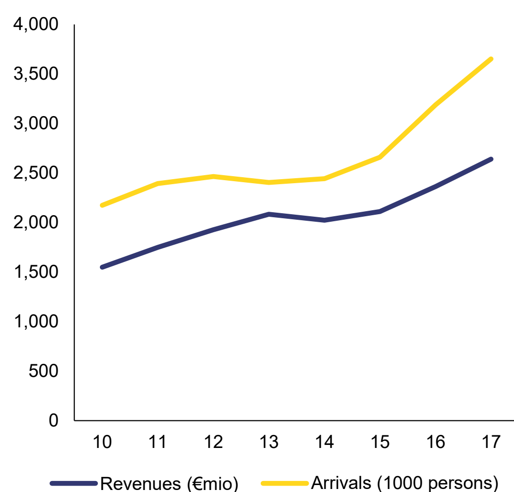
## The economic outlook

**Growth is expected to remain strong and above potential, albeit slowing down** from 3.9 % in 2018 to 2.9 % in 2020. At the same time, it is expected to be increasingly driven by domestic demand. Private consumption is foreseen to remain fairly strong, while unemployment continues to rapidly contract, wages gradually increase and inflation remains low. Investment is set to remain firm (which is also indicated by the upbeat business sentiment), although it is largely concentrated in the construction sector and is expected to have little impact on long-term potential growth. Many large-scale projects are already in the construction phase, and some have recently received building permits. Ship registration, forming part of the equipment investment, is also expected to continue increasing. Moreover, public consumption and investment are projected to increase gradually.

**Exports are expected to be fairly strong in 2018, but to weaken after that.** The strength visible in 2018 is associated with the sizeable ship de-registration that occurred in the first quarter of the year (counted as exports of goods). The underlying gradual weakening stems from the tourism sector, which has been a driving force behind the exports of services in recent years. However, tourism is now confronted with increasing competition from neighbouring countries, particularly Turkey, where safety concerns are abating and the weak lira

reduces costs. Also, those tourists visiting Cyprus (predominantly British and Russian) have lower purchasing power as a result of their currency depreciations (see Graph 2.6). Higher oil prices raise the cost of air transportation to Cyprus and weigh on the growth of revenue from tourism. However, the ongoing diversification of the Cypriot tourism offer — both as regards the quality of accommodation and catering for special interest (conferences, sports, weddings) — is helping to offset somewhat the losses from the negative factors mentioned above. Meanwhile, imports, because of their significant share in the final demand, are projected to outweigh exports, thus leading to an overall negative contribution of net exports to real GDP growth, and to a further widening of the current account deficit.

Graph 2.6: **Tourist arrival and tourism revenues**




***Source:*** Cystat

**The balance of risks to the economic outlook appears tilted to the downside.** On the one hand, investment in the construction sector could be higher than projected. On the other hand, the over-reliance on the construction investment financed through the citizenship-by-investment scheme may become a source of vulnerability, dampening the growth outlook. Moreover, Cyprus is still characterised by high private and public debt and thus remains vulnerable to potential sudden reversals in investor confidence in a context of increasing external headwinds in the financial markets. Finally, increasing protectionism and generally higher levels of uncertainty in the global economy, in particular over developments in the UK and Russian economies (Cyprus' main trading partners), and the decreasing perception of a safety risk in Turkey, Northern Africa and the Middle East (competing tourism destinations) may weigh on Cyprus's economic outlook.

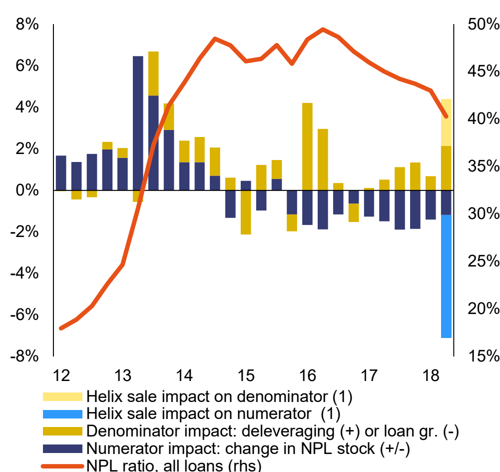
# 3. FINANCIAL SECTOR ISSUES

## 3.1. BANKING SECTOR PERFORMANCE

### Asset quality

**In the first half of 2018, NPLs continued to decline.** Both the NPLs stock and ratio have declined ([6]). The stock of NPLs in local operations of banks declined to 40 % of all loans as of June 2018 from 45 % a year ago (see Table 3.1). The sale of Hellenic Bank's (HB) EUR 140 million NPLs portfolio to Norway's B2Kapital was a positive development — marking the first loan sale in Cyprus — contributing to a downward trend ([7]). However, the downward level shift in NPLs in the second quarter of 2018 is mainly due to the envisaged sale by Bank of Cyprus (BoC) of an NPLs portfolio of EUR 2.7 billion (the so-called Helix Portfolio), which was already agreed with Apollo, the prospective buyer, but not yet approved by the Single Supervisory Mechanism (SSM). This notwithstanding, the transaction is already accounted for in the end June 2018 NPLs data published by the CBC, as reflected in Graph 3.1 ([8]). Excluding the significant BoC sale of NPLs, the decline in the stock of NPLs is comparable with reductions in recent quarters, with deleveraging (i.e. a decline in the total stock of loans) preventing steeper reductions in the NPL ratio. In addition to NPLs sales, the main drivers in cleaning up the balance sheets have been lower NPLs inflows, the continued 'curing' of restructured bad loans, and write-offs. However, the high NPLs stock continues to weigh heavily on the profitability and overall soundness of the Cypriot banking sector.

Graph 3.1: **NPL ratio and its breakdown**




(1) In relation to a re-classification effect due to an agreed-but-not-yet-approved portfolio sale (of the so-called "'Helix"' portfolio).
***Source:*** Central Bank of Cyprus

**The stock of NPLs in the banking sector is expected to decline more significantly in the second half of the year.** This reflects the removal of the CCB's sizable NPLs portfolio (EUR 5.7 billion) out of the banking system in September 2018. Taking into account this operation, the NPL ratio is expected to drop to around 31 % of total loans by end 2018, which is a reduction of 13 percentage points compared to the end of 2017 ([9]). Whether these recent positive developments will lead to a durable improvement in the financial sector remains to be confirmed. Furthermore, given that the NPL ratio continues to be among the highest in the EU, it is important that the new legislation adopted in July is fully and swiftly implemented by both borrowers and creditors to ensure further progress in NPLs resolution.

([6]) The NPL ratio (i.e. NPLs stock to total gross loans ratio) referred to in this report is based on the Central Bank of Cyprus' data and scope definitions. Therefore, it differs from the ratios referred to in the 2018 Cyprus country report, which is based on ECB data. In particular, exposures of banks to central banks
and credit institutions and the overseas operations (branches and subsidiaries located abroad) of the Cyprus-based banking groups are not taken into account in the CBC aggregate NPL ratio.

([7]) The NPLs portfolio sale was agreed in January 2018 and took place in June 2018.

([8]) BoC signed the sale agreement with Apollo Global Management, in August 2018. The completion of the transaction remains subject to regulatory approval, most notably on the Significant Risk Transfer (SRT) recognition by the SSM. The CBC data assumes that the transaction will be approved and implemented as planned, implying that — should BoC fail to achieve the SRT of this portfolio — the published NPLs figures would need to be revised upwards.

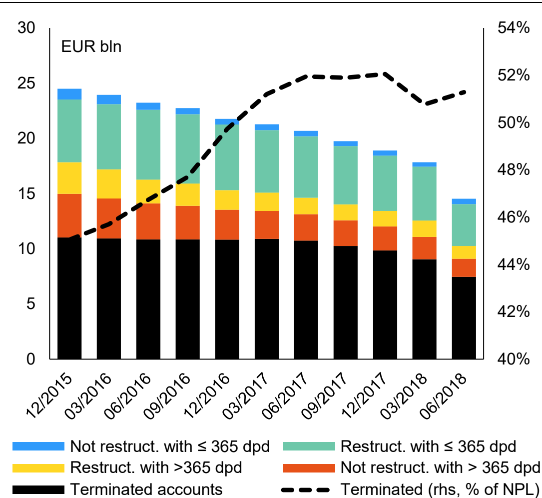
([9]) This calculation assumes the completion of the sale by the BoC of EUR 2.7 billion worth of NPLs, all other things being equal.

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

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | | | | 2018 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dec | Dec | Dec | Dec | Dec | Mar | June | Sep | Dec | Mar | June |
| **NPLs*, all loans** (EUR billions) | 15.6 | 26.0 | 27.3 | 26.7 | 23.8 | 23.2 | 22.4 | 21.5 | 20.6 | 19.9 | 16.6 |
| **NPLs*, all loans** (% of total) | 22.6 | 41.5 | 47.8 | 45.8 | 47.2 | 46.0 | 45.0 | 44.2 | 43.7 | 43.0 | 40.3 |
| **NPLs*, loans to NFCs** (% of total) | .. | .. | 58.0 | 56.0 | 56.4 | 54.4 | 52.5 | 51.0 | 50.3 | 48.4 | 39.4 |
| Restructered non-performing (% of total) | .. | 12.5 | 23.3 | 25.9 | 25.7 | 23.7 | 22.9 | 22.5 | 22.8 | 22.3 | 16.4 |
| Restructured performing (% of total) | .. | 12.2 | 5.3 | 7.5 | 9.4 | 9.9 | 10.6 | 9.9 | 8.6 | 7.9 | 8.6 |
| **NPLs*, loans to households** (% of total) | .. | 43.3 | 52.7 | 56.2 | 55.9 | 55.7 | 55.7 | 54.6 | 53.9 | 53.6 | 52.5 |
| Restructered non-performing (% of total) | .. | 6.7 | 13.9 | 18.0 | 20.0 | 20.0 | 20.1 | 19.9 | 19.7 | 19.8 | 19.4 |
| Restructered performing (% of total) | .. | 10.4 | 8.9 | 6.7 | 7.7 | 8.1 | 8.1 | 8.2 | 8.3 | 8.0 | 7.6 |
| **Coverage rate** (Impairments / NPLs)* | 47.9 | 37.7 | 32.9 | 37.8 | 41.7 | 42.7 | 46.7 | 46.9 | 46.8 | 48.6 | 48.3 |
| **Cost-to-income ratio** | 55.6 | 53.4 | 40.4 | 44.1 | 52.5 | 51.3 | 48.4 | 48.7 | 53.6 | 63.9 | 74.3 |
| **Net interest margin** | 2.3 | 2.4 | 2.9 | 2.8 | 2.6 | 2.4 | 2.4 | 2.4 | 2.3 | 2.2 | n.a. |
| **Common Equity Tier 1 ratio** | .. | .. | 14.2 | 15.6 | 15.9 | 15.8 | 14.9 | 15.0 | 14.9 | 14.1 | 14.2 |
| **Return on assets (annualized)** | -3.4 | -4.3 | -0.6 | -0.6 | -0.3 | -0.1 | -1.9 | -1.3 | -1.1 | 0.9 | 0.3 |

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

Graph 3.2: **Evolution of NPL portfolio**




The figures are only for loans with fixed maturities, corresponding to over 90 % of all loans, excluding revolving loan facilities such as overdrafts.
* The large reduction in June 2018 takes into account the re-classification of a significant portfolio of loans (the so-called "'Helix"' portfolio), which is subject to supervisory approval.
***Source:*** Central Bank of Cyprus

**Legal recourse to collateral is currently the only remaining workout option for a substantial part of NPLs.** The total stock of restructured loans, including both performing and non-performing, declined to EUR 9.4 billion in June 2018, from EUR 12.8 billion a year earlier. In relative terms, total restructured loans as a share of total loans fell from 25.7 % to 22.7 % over the same period. However, the share of restructured NPLs, including debt-to-asset swaps, remained flat at 41.7 % in June 2018, virtually unchanged from a year ago. Further progress in restructuring is difficult, since 51.3 % of the fixed-term NPLs stock is classified as 'terminated accounts', where a non-consensual foreclosure through a legal recourse is seen as the only remaining option (see Graph 3.2) ([10]) ([11]). As a positive development, the Helix portfolio is largely comprised of terminated loans. It remains to be seen, however, if terminated loans continue to be targeted by purchasing firms in the future and whether these investment companies achieve better recovery outcomes.

**Owing to supervisory pressure, notably through the SSM's supervisory review and evaluation processes (SREP), banks have increased provisioning levels**. This pushed the average coverage ratio for the sector to 48.3 % at the end of June 2018, up from 46.8 % a year before. Currently, the coverage level of Cypriot banks is greater than the EU average of 44 %, reflecting high uncertainty over the quality of assets. Most of

([10]) According to the Cypriot loan classification rules, a loan is moved into the terminated category when no negotiation possibilities exist.
([11]) Fixed-term NPLs represent approximately 90 % of all loans.

the additional provisioning charges were taken on board during 2017, while provisioning costs fell in early 2018. Nevertheless, further provisioning is expected as banks continue to clean up their balance sheets and due to the phased-in introduction of the IFRS-9 accounting standards.

### Banking sector profitability

**In accounting terms, the banking sector as a whole was profit-making in the first half of 2018 after recording losses the year before.** The sector's aggregate pre-tax profit was EUR 134 million as of June 2018, up from a net loss of EUR 549 million a year ago. The development was mainly driven by declining provisioning costs, which fell by 87.6 % to EUR 130 million in the first half of 2018, compared to EUR 1.05 billion a year ago. This reduction more than offset the decline in total operating profits, mainly driven by a 12.8 % reduction in net interest income. Overall, the capacity of Cypriot banks to generate profits continues to be challenged by dwindling interest margins and the high level of NPLs.

**One way of improving profitability is to increase the efficiency of banks by reducing their operating expenses.** While the largest banks have made good progress in reducing the number of their branches and employees since the crisis, several indicators suggest that they are still oversized. The amount of customers and assets per branch or employee in Cyprus remains significantly lower than the euro area average. This is also impacted by the larger deleveraging that took place in Cyprus. In addition, due to non-staff administrative costs ([12]) the cost-to-income ratio climbed to 74.3 % in June 2018, up from 48.4 % a year ago. There is thus room to rationalise the capacity and operations of Cypriot banks by using more ICT technologies and online products, downsizing units by outsourcing bad asset management, and diversifying the range of services offered to attract new business.

### Capitalisation, liquidity and lending

**Bank capital levels are under pressure**. The average Common Equity Tier 1 (CET1) capital ratio of banks declined to 14.2 % in June 2018, down from 14.9 % a year before, due to recurrent losses. The overall capital ratio also decreased by 80 basis points to 15.5 % over the same period. While the CET1 ratio is still higher than the EU average of around 13 %, Cypriot banks have to maintain a higher capital ratio to absorb shocks associated with weak asset quality. Meanwhile, lower retained earnings due to significant provisioning charges in the previous year and the implementation of IFRS 9 standards reduced capital buffers in the first quarter of 2018. Maintaining adequate capital buffers will be challenging, especially in the context of ongoing balance sheet deleveraging and weak profitability. Some of the largest banks are therefore planning to issue additional Tier 1 or Tier 2 capital in order to strengthen their capital buffers.

**No new macro-prudential measures were introduced in 2018, although a review of measures in place is ongoing following recent developments.** In July 2017, the CBC designated six credit institutions as 'other systemically important institutions' (O-SIIs) ([13]). In September 2018, the relevant (additional) capital buffers to be phased in over 2019-2022 were: 0.5 % for Alpha Bank, 0.5 % for Eurobank, 1.5 % for HB, 1.5 % for RCB 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]).

([12]) This includes the cost of loan servicing contracts that banks have entered into since 2017. The increase in expenditure in 2018 is also affected by one-off expenditures for sale and acquisition deals of 2018.

([13]) Pursuant to 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.

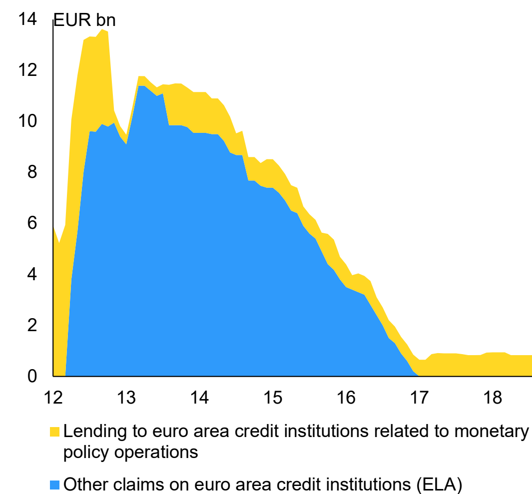
([15]) On 30 January 2018, the CBC published its macro-prudential decision on additional liquidity requirements, after finalising consultations with EU institutions under CRR Article 458 and SSM Regulation Article 5. The most important impact of the new rules will be the higher outflow rates applicable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

**Cypriot lenders may face difficulties meeting their minimum requirement for own funds and eligible liabilities (MREL).** Due to their heavy reliance on deposit funding, Cypriot banks will need to raise additional non-deposit funding to meet their MREL. This may be difficult for banks facing significant profitability and asset quality challenges. For the moment, no binding MREL target has been set for any of the Cypriot banks by the Single Resolution Board.

**Banks' reliance on central bank funding remains insignificant, while deposits provide banks with ample funding.** In August 2018, Cypriot banks' reliance on central bank funding stood at around EUR 0.8 billion (see Graph 3.3). Deposits declined significantly in the first quarter of 2018. In particular, the CCB recorded sizeable deposit outflows linked to doubts about the viability of the bank. While some of these deposits flowed to other Cypriot banks, it also appears that some left the banking system, either through increased banknote demand or as cross-border outflows. Deposits from residents increased by the end of August 2018 year-on-year, especially from non-financial corporations (NFCs), whereas deposits from non-residents declined over the same period (see Graph 3.4). In September, following the CCB sale, the State deposit of EUR 3.5 billion was removed from the banking system. Liquidity buffers in the overall sector remain comfortable. Moreover, since the upgrade 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.

**Deleveraging of the banks' balance sheets has continued.** Total consolidated assets of the banking sector decreased slightly by 2 % year-on-year as of June 2018. This reduction was largely due to the contraction of the gross stock of loans to domestic residents (almost 11 % year-on-year as of June 2018), which itself was driven by the BoC Helix portfolio sale, conditional on supervisory approval.

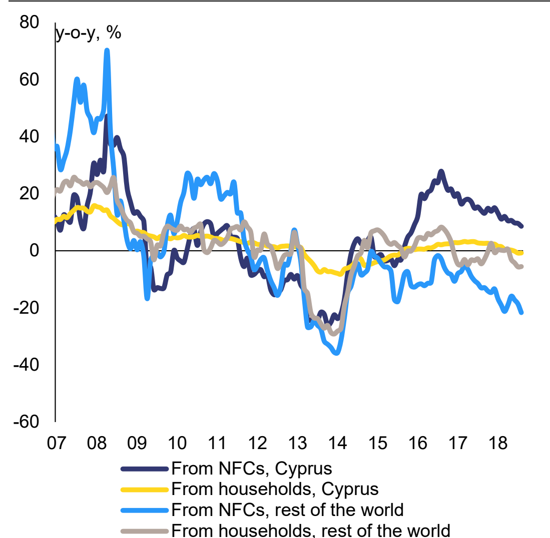
Graph 3.3: **Borrowing from the Eurosystem**




***Source:*** Central Bank of Cyprus

**Interest rates on both deposits and loans declined further but at a faster pace than in earlier years.** Since 2015, when the CBC narrowed the maximum spread between Libor and the deposit interest rates that banks can offer, there has been a sharp decline in deposit rates. The lending rates have also put pressure on banks to lower deposit interest rates. In the first half of 2018, the decline in interest rates accelerated to 33 basis points in annual terms for deposits with less than one year maturity for households and to 49 basis points for NFCs. Lending rates also dropped in the same period, by 36 basis points for mortgage lending and 27 basis points for corporate loans. Put together, these developments squeezed net interest margins further, which fell by around 30 basis points year-on-year to 2.18 % in June 2018. As mentioned above, the narrow interest margins contributed to the decline in banks' net interest income, and ultimately to weak profitability.

Graph 3.4: **Deposits developments**




***Source:*** Central Bank of Cyprus

## Restructuring and resolution of banks

**The acquisition of CCB by HB considerably changed the banking sector landscape in Cyprus.** HB took over almost the entire performing loan portfolio, all government bonds and all customer deposits (see Graph 3.5). Around EUR 2.1 billion (gross book value) of the performing loans transferred to HB are covered by the asset protection schemes (APSs) provided by the CCB and counter-guaranteed by the Cypriot Republic. HB also took over an NPLs portfolio worth approximately EUR 0.7 billion (estimated gross book value), covered by the APSs entirely ([16]). The rest of the NPLs remain in the CCB's residual entity, with a gross book value of EUR 5.7 billion. Since the surrender of the banking licence by the CCB in the beginning of September 2018, the NPLs are no longer part of the banking system ([17]).

**Incorporation of the acquired assets and liabilities into HB is expected to have an overall positive effect on the bank.** On the positive side, there is an immediate reduction in the NPL ratio on account of the improved portfolio mix and improved profitability prospects, driven by enhanced cost efficiency and interest income from the government bonds taken over. In turn, the acquisition involves major organisational and managerial challenges as well as restructuring costs. The final terms of the sale, which are pending, may involve additional assets to be transferred to HB to cover any asset-liability gaps, including most notably CCB's branches. In addition, the SSM has requested HB to raise additional capital of around EUR 150 million to offset new risks in the larger entity. These have been committed to by potential investors and should be met in the upcoming months as a combination of a rights issue and private placements (in the form of ordinary shares).

**Following the acquisition of the CCB, HB will become the second largest Cypriot bank, which may better position the bank to address its main challenges.** Prior to the incorporation of the CCB's assets, the profitability of HB (pre-CCB) was squeezed by a further narrowing of the net interest margin, at 1.8 % in June 2018, down from 2 % in 2017. Fee income was also under pressure, although the latest figures are blurred due to the sale of on-boarded real estate assets. The NPL ratio was very high (at 51.6 %) in June 2018. The bank's CET1 ratio (transitional) was lower at 13.7 % in June 2018, down from 14.1 % at the end of 2017, mostly due to higher risk weights on defaulting assets, but it remained well above supervisory limits. Taking into account the acquisition alone, HB expects its NPL ratio to decline significantly and its NPLs coverage ratio to increase. The bank's profitability is also expected to increase significantly, driven by the high interest income from the government bonds.

**Ensuring an appropriate governance framework and supervision of the residual entity is a key challenge.** The CCB surrendered its banking license on 3 September 2018, when the sale of the CCB to HB was effectively completed. The assets and liabilities of the residual entity were transferred to a fully owned subsidiary of the CCB called the Cooperative Asset Management Company (CAMC), which is a credit-acquiring

([16]) Under the current set-up of the APSs, the Cypriot government would provide compensation for 90 % of the approved credit risk losses while HB would be exposed to 10 %. The duration of the APSs will be 10 to 12 years, depending on the loans. The assets under the APSs amount to approximately EUR 2.8 billion gross book value. For more details on the APSs, see Commission Decision of 28.8.2018 C(2018) 5674 final. For further information on the fiscal impact of the APSs, see Section 4.

([17]) On the financing of the CCB sale by the State, see Section 6.

company established under national law and supervised by the CBC. The CAMC activity is to manage the NPLs under its perimeter (see Graph 3.5) with the view of maximising recovery and repaying the State. The CAMC does not fall within the definition of a 'credit institution' of the Capital Requirements Regulation (CRR), since it cannot accept deposits or grant new loans unless those loans relate to a restructuring. As for other credit-acquiring companies, the CBC has thus limited supervisory powers over the CAMC. However, the role of the CBC as supervisor of credit-acquiring companies can be strengthened.

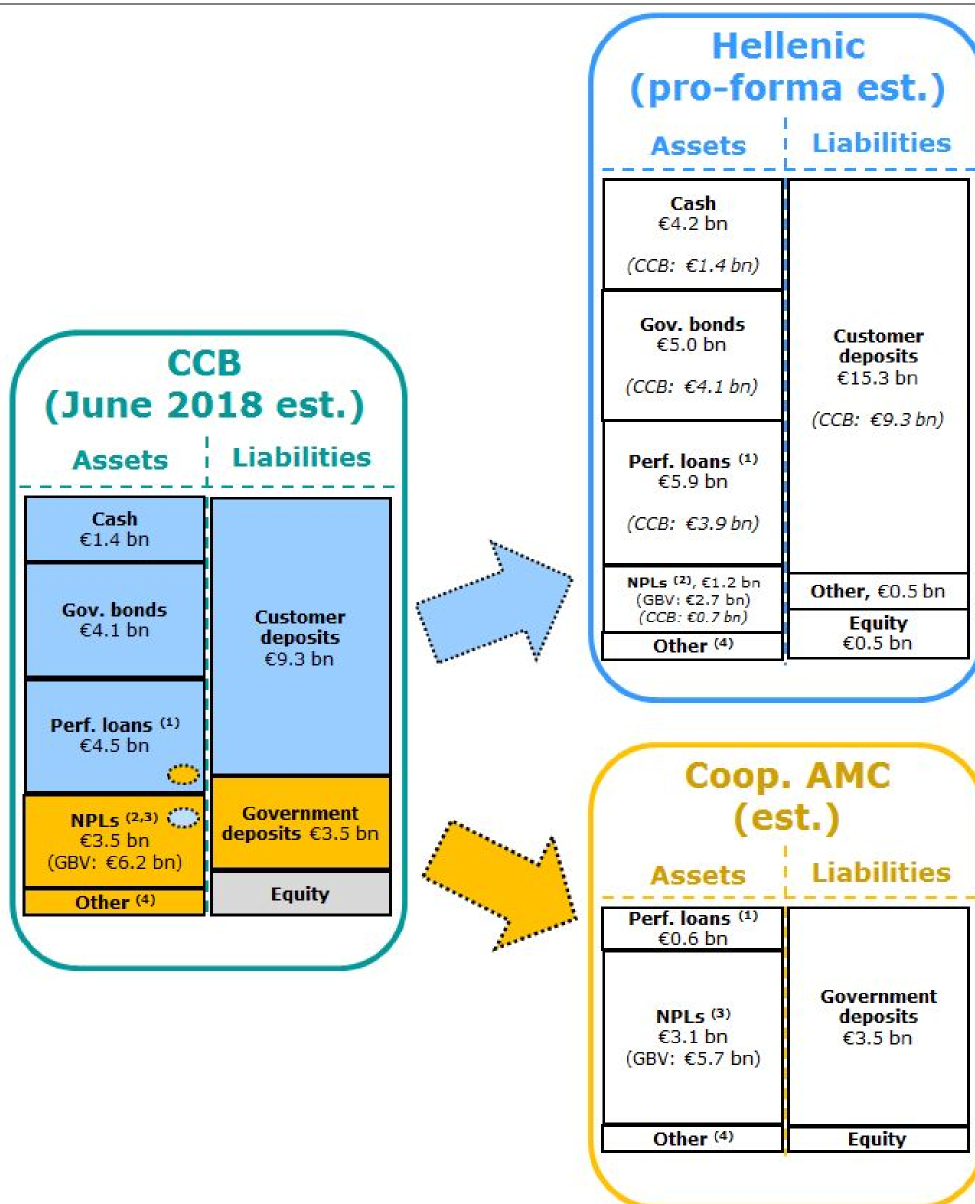
**With a net book value of 20.5 % of GDP, the CAMC is the largest asset management company, relative to the size of the economy, set up in the EU after the crisis (see Graph 3.5).** The organisation of the CAMC and its governance remain to be defined. The government has decided to hire an advisor to prepare a first draft of the governance framework by the end of 2018. At this point, it is not clear whether Altamira, which was CCB's debt servicer since 2017, will continue to service the CAMC. There is also some uncertainty about the future of former CCB staff, including the rights of those who have been transferred to Altamira. As illustrated in Box 3.1, an independent governance and full transparency are essential ingredients for an effective State-owned AMC. Managing successfully the CAMC is also important for addressing private indebtedness, which weighs heavily on households, corporations and overall on the economy.

**BoC, the largest systemic bank in Cyprus, has made notable progress in implementing its restructuring plan.** The bank announced the sale of its UK subsidiary in July 2018 and the sale of EUR 2.7 billion NPLs (Helix portfolio) in August 2018, which is conditional on supervisory approval. Taking both actions into account, and assuming supervisory approval, BoC's NPLs stock dropped by over EUR 4.5 billion between June 2017 and June 2018, reaching 38 %, while the provision coverage ratio remained at 49 %. This adds to the steady progress that the bank has made in reducing its NPLs stock over the past 2 years. The bank's relatively high direct real estate exposures due to the use of debt-to-asset or equity swaps, which represent over 6 % of the bank's total assets, is an ongoing concern. The limited profitability of the bank is another issue. In the first half of 2018, the cost-to-income ratio increased to 51 % up from 46 % a year ago.

**The resolution of Laiki reached its final phase.** The banking licence of Laiki's Russian subsidiary was revoked in 2015, while the Ukrainian, Serbian, and Romanian subsidiaries were sold in 2016 and 2017. After a long delay and various proceedings, a deal was finalised with Malta's National Development and Social Fund in August 2018 to buy Laiki's stake in Malta's Lombard Bank. When the sale of Laiki's Greek subsidiaries is completed, the only remaining asset to liquidate will be Laiki's shares in BoC.

**The liquidation of FBME Bank is underway but may be delayed due to international legal challenges.** The Cypriot Deposit Guarantee Scheme has paid EUR 84 million so far. However, the overall liquidation process has been halted, as a Tanzanian senior bondholder claims that liquidation should take place in Tanzania.

Graph 3.5: **Partial acquisition of the CCB by HB and creation of the Cooperative Asset Management Company (CAMC)**




Notes: All figures are subject to change due to potential valuation fluctuations on various portfolios at the point of transfer.
(1) Around EUR 2.1 billion of performing loans are covered by an asset protection scheme (APS). Moreover, around EUR 0.6 billion of performing loans, including most notably exposures to local authorities, will remain at the residual entity.
(2) Around EUR 0.7 billion (estimated gross book value) of non-performing loans will be transferred to HB, which will also be covered by the APS.
(3) An additional portfolio of off-balance sheet and fully-provisioned NPLs with a gross value of EUR 1.3 billion have also been transferred to the residual entity. These have not been included in the figures on the diagram.
(4) Other assets to be shared between HB and the residual entity include all immovable property of the bank, including branches, and other liquid assets and participations, which were valued at EUR 0.6 billion and EUR 0.2 billion respectively, at the end of 2017. Owing to the potential valuation changes at the point of transfer, some of CCB's non-loan assets may also be transferred to HB.
***Source:*** European Commission

### *Box 3.1:* **A comparison of the CAMC with selected asset management companies**

To give some perspective on the Cypriot asset management company (CAMC), this box provides a comparison with other relevant European asset management companies (AMCs), focusing on key parameters such as size, public ownership, funding, transfer price, asset composition, governance and disposal. During the financial crisis, several countries have used AMCs in order to deal with banks' NPLs. They were established either as a centralised structure by pooling a large share of distressed assets in the financial system, such as NAMA in Ireland or DUTB in Slovenia, or as an entity managing assets from a single bank — as is the case of FMS Wertmanagement (FMS-WM), in Germany, and of the CAMC in Cyprus. The financing of the entities was in the form of State-guaranteed bonds and common equity. While the State only had a 49 % stake in NAMA equity (the rest was privately financed), DUBT and FMS-WM were 100 % owned by the State — similar to the CAMC (see table below). State involvement can signal commitment for solving the problem, but may also raise concerns over political interference. Therefore, ensuring independent governance and full transparency of a State-owned AMC is essential.

In nominal terms, FMS-WM was the biggest. However, relative to the size of the economy, it is the CAMC, which is comparable to NAMA in terms of the value of the transferred assets. The haircuts applied to the gross value of the assets were 69 % in Slovenia and 57 % in Ireland. In Cyprus, the haircut is estimated at 41 %. In the case of FMS-WM, the haircut was minimal, but a clawback provision was included. A correct valuation during the time of transfer is key for a successful recovery of the distressed assets in any AMC and a requirement under the EU state aid and bank recovery and resolution frameworks.

Macroeconomic conditions and portfolio composition are also important factors for having successful AMCs. NAMA's portfolio consisted of commercial real estate loans, mostly connected to properties in urban centres in Ireland and the UK (notably in London). Therefore, it benefited from the faster recovery of the UK's economy. The FMS-WM portfolio was more diverse (including complex products) and geographically spread, posing challenges to its recovery. Assets taken over by DUTB were mainly Slovenian loans and thus dependent on domestic economic developments. In case of the CAMC, the portfolio includes mainly residential mortgages in Cyprus, loans secured by land and some unsecured credit, while commercial real estate represents only a small share. Furthermore, proper loan file documentation and data adequacy are also relevant for a successful recovery.

The portfolio disposal strategy is also to be considered. An active AMC management proved to be more efficient than waiting for the assets to recover their market value before being disposed of. Finally, an adequate legal framework that allows for credible NPLs restructuring or enforcement is paramount for the AMC's effectiveness. AMCs should signal a clear break from the past lender-debtor relationship.

Table 1: **Asset management companies**

| **AMC's name** | **NAMA** | **DUTB** | **FMS-WM** | **CAMC (1)** |
|---|---|---|---|---|
| **Country** | Ireland | Slovenia | Germany | Cyprus |
| **Creation date** | 21 December 2009 | 19 March 2013 | 08 July 2010 | 03 September 2018 |
| **Beneficiaries** | several banks | several banks | Hypo Real Estate | CCB |
| **Banking licence** | No | No | No | No |
| **Gross value** (EUR bn) | 74.2 | 5.1 | 175.7 | 6.3 |
| % of GDP | 43.7% | 14.1% | 6.8% | 29.7% |
| **Transfer value** (EUR bn) | 31.8 | 1.6 | 173.0 | 3.7 |
| % of GDP | 18.7% | 4.4% | 6.7% | 19.5% |
| Haircut (on gross value) | 57.1% | 68.6% | 1.5% | 41.3% |
| **Form of financing through debt** | State-guaranteed bonds | State-guaranteed bonds | State-guaranteed bonds: EUR 124bn | EUR 3.5 bn of State deposits |
| **Equity amount (EUR bn)** | 0.1 | 0.2 | | 0.4 |
| **Shareholders** | State: 49%<br>Private: 51% | State: 100% | State: 100%<br>(via SoFFin) | State 99% (including via the Recapitalisation Fund) |

(1) The figures are subject to change due to potential valuation fluctuations of portfolios at the time of transfer.
***Source:*** European Commission, Coping with the international financial crisis at the national level in a European context, Staff Working Document, November 2017

### 3.2. THE THREE-PILLAR NPL REDUCTION STRATEGY

**In 2018, the Cypriot authorities devised and started implementing a three-pillar policy strategy for reducing NPLs in the banking sector.** The strategy comprises: (i) a legislative package, which includes amendments to the foreclosure and insolvency frameworks and to the Sale of Loans Law and the adoption of a Securitisation Law; (ii) the sale of CCB good assets and liabilities, with the rest of assets remaining in the CAMC; and (iii) the setting-up of a temporary subsidy scheme (ESTIA) to deal with the NPLs collateralised by primary residences. Under the first pillar — strengthening of the legal and regulatory framework — the House of Representatives approved in the beginning of July 2018 a series of legal proposals aimed at removing impediments to NPLs resolution. The second pillar — which entails the removal of a big portion of bad loans from the banking sector —materialised in September 2018, when the CCB surrendered its banking license. Under the last pillar, the design of the ESTIA scheme was finalised in November 2018. The scheme is expected to be implemented starting from 2019.

#### The July 2018 legislative package

**The legislative package was designed against the following background:** under-utilised insolvency and foreclosure frameworks, an insignificant number of sales of foreclosed assets and low numbers of debt restructuring applications. The new legislative package includes, amongst others, amendments to the following acts: the Personal Insolvency Law, the Companies Law, the Insolvency Practitioners' Regulations, the Bankruptcy Law, the Sale of Loans Law and the Immovable Property (Transfer and Mortgage) Law, which contains the applicable foreclosure provisions ([18]). The Securitisation Law, which had been under legal vetting since early 2018, was finally approved by the House of Representatives, also as part of the package.

**The changes to the insolvency framework include clarifications on the scope of application of various tools.** In particular, the clarifications introduced for debt relief orders are crucial for debtors who have few or no assets and low income to have a second chance. Along the same line, the scope of application of personal repayment plans has been expanded to increase the use of an essential restructuring tool for individuals that could improve the recovery rates of creditors in Cyprus. To incentivise creditors to approve restructuring plans in examinership proceedings (a restructuring procedure for NFCs deemed viable under the insolvency framework), the 'best interest of creditors test' has been removed from the Companies Law. Furthermore, the rules to determine the remunerations of insolvency practitioners within the Insolvency Practitioners' Regulations have been modified to increase success fees for personal repayment plans and thus incentivise the use of restructuring in Cyprus.

**More work is needed to improve the effectiveness and efficiency of the Insolvency Service and to strengthen the regulatory framework for insolvency practitioners.** These amendments are part of the commitments made by the Cypriot authorities in the July 2018 State Aid decision, which approved the public financing of the orderly market exit of the CCB. An independent review of the operations of the Insolvency Service has been finalised, resulting in a three-year action plan. The action plan was approved by the government in June 2018. The project to improve the regulatory framework for insolvency practitioners in the areas of licensing, remuneration, training, monitoring/supervision and discipline is satisfactorily progressing and is expected to be finalised by June 2019. The project is being carried out with the technical support of the Structural Reform Support Service (SRSS) in cooperation with the European Bank for Reconstruction and Development (EBRD).

**The amendment to the Sale of Loans Law clarified the scope of eligible credit facilities.** In particular, the definition of eligible credit facilities has been expanded, and as a result terminated loans can now fall within the scope of the law. Furthermore, the revised law enables collateral to be transferred without any fee charges.

**The authorities amended the foreclosure legislation to allow for the effective resolution of NPLs.** Clarifications were introduced with respect

([18]) The amendments to the Mortgage Law have further defined the protection of primary residences by adding a limitation of the market of primary residence to EUR 350 000.

to the scope of application of the foreclosure procedure, reducing thus legal uncertainty for both creditors and debtors, meaning it applies to all enforcement proceedings including those that commenced under the previous regime. Under the amended framework, the bank is allowed to buy the property 6 months after the first unsuccessful auction (within a period of 4 months). This significantly shortens the time period needed for foreclosure as under the previous regime, the bank could buy the property only after 1 year. Furthermore, the right of borrowers to seek a suspension of enforcement, foreclosure or bankruptcy has been limited in time and scope (i.e. an application to a Court is not enough under the revised legal framework; instead a Court order needs to be first obtained). Importantly, the notification requirements were amended to allow for alternative means of delivering notices to stakeholders. However, this revised provision requires the creditors to exhaust the registered mail route before using private servicing. This additional step, which was not in place previously, lowers the overall efficiency gains that may be achieved by the recent amendments. Other amendments, such as the introduction of electronic auctions and a right to split a mortgage up into several mortgages in case of cross-collateralisation, are also welcomed.

### The ESTIA scheme

**The ESTIA scheme is designed to provide debt reduction subsidies for eligible borrowers with NPLs backed by primary residences.** Under this scheme, a subsidy will be paid by the government to lower the debt servicing costs, including interest charges, of all eligible performing borrowers by one third. In addition, borrowers with 'negative equity' ([19]), will only have to pay an amount up to the market value of their residence ([20]). In case of a re-default of the borrowers, foreclosure proceeds will be shared *pari passu* between the banks and the government to ensure that (a part of the) subsidies under the ESTIA scheme are paid back to the government. Under the original ESTIA proposal, which was approved by the Council of Ministers in July 2018, the eligibility criteria were as follows:

1. A net household income of up to EUR 50 000;
2. A primary residence with market value of up to EUR 350 000, and with at least 20 % of the outstanding balance of the credit exposure more than 90 days past due as of end September 2017; and
3. Net wealth ([21]) excluding the main residence of up to 125 % of primary residence value.

**The proposed ESTIA scheme raised a number of concerns.** First, it rewards borrowers for non-payment in the past. Second, some borrowers with sufficient wealth to cover their past-due loans might be eligible. Third, the scheme did not distinguish between households with different incomes. Fourth, a similar temporary scheme was introduced in 2016, undermining the credibility of the claim that the current scheme is one-off. Putting these together, there is a concern that certain borrowers may interpret the introduction of such a generous scheme as a reason to stop paying, or continue not paying (i.e. moral hazard). On the other hand, the introduction of such a scheme is seen by both the authorities and the banks as instrumental to (i) increase banks access to the borrowers' information, as the applicants will have to disclose their wealth and income position, (ii) allow banks to enforce their payment claims by making use of the foreclosure procedure and by overcoming stigma issues ([22]), and (iii) ultimately help Cypriot banks with NPLs resolution.

**In order to mitigate some of the concerns raised by different stakeholders, the authorities revised the terms of the ESTIA scheme in November 2018 — by tightening some of the eligibility criteria.** Under the revised scheme, the income eligibility criterion now takes into account the household size, ranging from EUR 20 000 for single applicants to EUR 60 000 for an applicant and his/her spouse that have at least 4 dependent family members ([23]). In addition, the wealth

([19]) I.e. borrowers whose loans exceed the market value of their homes (pledged as collateral).

([20]) The rest of the loan will be treated as in a 'split and freeze' restructuring, which will be fully provisioned and written-off at maturity if the borrower meets all obligations.

([21]) I.e. the household's wealth net of loans.

([22]) Importantly, the foreclosure procedure should be promptly initiated upon re-default under the scheme and also towards the remaining defaulted borrowers outside the scheme.

([23]) Under the final ESTIA design, there are in total 6 income caps depending on the household size.

criterion has been lowered to a net wealth (excluding primary residence) of up to 80 % of the market value of the primary residence, with a cap of EUR 250 000. An additional requirement has also been introduced to use any cash or deposits above the 20 % of the borrower's net household wealth to pay down (i.e. set off) the outstanding loan of the applicant before its restructuring. While the 'set-off' requirement is a positive step, households with substantial illiquid assets, i.e. multiple homes, may still benefit from the scheme. Furthermore, the borrowers' take-up of the scheme and willingness to disclose wealth remain uncertain. In summary, while the tightening of the eligibility criteria helps to somewhat mitigate the fairness and moral hazard issues, the authorities should carefully monitor all the outstanding risks and issues stemming from the scheme.

## 3.3. BROADER FINANCIAL SECTOR ISSUES

**The quality of financial information available on borrowers continues to be limited.** As agreed in the 2017 National Reform Programme, the authorities are improving the Credit Registry by broadening the information that is collected and made available as well as by expanding the set of reporting counterparties. 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 creation of a credit scoring system for physical persons continues to be stalled. Lastly, the credit registry needs further improvements regarding quality, access and management of data, in line with international best practices.

**Following the European Insurance and Occupational Pensions Authority (EIOPA) study and the Ministry of Finance's decision to proceed with the integration of the pension fund and insurance supervisors, the authorities have continued to work on drafting the legal framework.** An independent supervisory body will be set up as a separate entity outside the government. The first draft of the legislation is still being prepared by the Ministry of Finance. At present, there are delays in project completion due to issues over the status of the staff in the planned new entity.

**The failure of Olympic Insurance has resulted in a number of uncertainties, especially in Bulgaria where the insurer has a relatively strong foothold.** The Cypriot insurance supervisor, Insurance Companies Control Service (ICSS), 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. While its presence in Cyprus has been modest, the insurer had an estimated 9 % market share in the motor third party liability insurance (MTPL) segment in Bulgaria, with up to 200 000 policyholders. As it operates through a branch, the unpaid claims of Olympic Insurance in Bulgaria, estimated to be around EUR 28 million, are outside the scope of the insurance guarantee scheme in Bulgaria (and Cyprus). Unless the Bulgarian (or Cypriot) authorities provide an alternative burden-sharing arrangement, these claims will be paid only through the receipts from the liquidation of the insurer's assets (likely to cover only part of the liabilities).

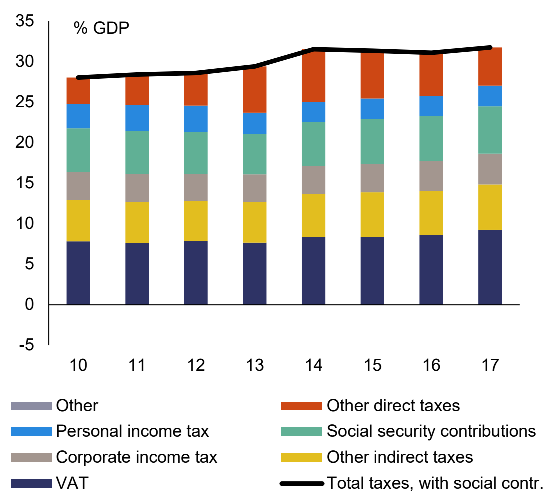
# 4. BUDGETARY OUTLOOK AND FISCAL POLICY STANCE

## 4.1. FISCAL PERFORMANCE

**Public finances continued to outperform budget projections through the end of August 2018.** In the first 8 months of 2018, the general government balance reached a surplus of 3.5 % of GDP, up from 2.2 % of GDP during the same period of the previous year. The primary surplus increased to 5.1 % of GDP, from 4 % a year before. The latest statistical notifications showed significant data revisions of GDP estimates for 2016 and 2017, and data revisions of intermediate consumption and interest expenditure over the past years. This partly explains the differences for these expenditure items and the primary balance between the Commission's spring and autumn forecast ([24]).

**Revenue continued to be buoyant, while expenditure was contained and increased at a slower pace.** More specifically, revenue growth (by 8.8 %) was underpinned by the continued strengthening of the economy and improvement in the labour market. This led to a significant increase in: (i) tax receipts on production and imports (up 10.4 %, mainly thanks to the strong performance in value added taxes); (ii) tax revenues on income and wealth (up 5.4 %, mainly thanks to income tax revenue), and (iii) the social security contributions (up 9.9 %) (see Graph 4.1). The growth in expenditure (up 2.8 %) was mostly driven by the rise in intermediate consumption (up 7.8 %, mainly due to energy-related and pharmaceutical expenditure), followed by other current expenditure (up 3.6 %), social transfers (up 3.1 %), compensation of employees (up 2.8 %) and gross fixed capital formation (up 2.4 %).

Graph 4.1: **Tax revenue contributions**




***Source:*** Ministry of Finance and European Commission

## 4.2. FISCAL OUTLOOK

**Over the medium term, the fiscal performance is expected to sustain sizeable budgetary surpluses, but the potential deficit-increasing impact of banking support measures in 2018 may weigh on the 2018 budget balance.** In 2018, the Commission's autumn forecast projects that the general government surplus will improve to 2.8 % of GDP. However, this excludes the potential deficit-increasing impact of banking support measures related to the Cyprus Cooperative Bank (CCB). Buoyant tax revenue growth underpinned by strong underlying economic growth is expected to continue outpacing expenditure growth. In particular, the revenue from taxes on products is expected to benefit from strong consumption, while income tax revenue and social contributions are expected to be supported by the rise in employment. Expenditure is projected to rise at a slower pace than revenue, mainly due to (i) the government's measure to gradually increase public sector salaries to reverse wage cuts implemented since the crisis, (ii) social transfers related to payment for pensions and (iii) intermediate consumption linked to energy-related expenditure.

In 2019, the headline surplus is forecast to further improve to 3.0 % of GDP, mostly on account of a legislated increase in social security contributions and despite the gradual public sector pay rise and the introduction of the ESTIA scheme (see Section

([24]) GDP growth estimates were revised upwards by 1.4 percentage points to 4.8 % for 2016 and by 0.3 percentage points to 4.2 % for 2017. Data revisions on intermediate consumption and interest expenditure in 2017 amounted to around +0.6 % of GDP and -0.5 % of GDP respectively. These latter revisions were made following a discussion in the competent statistical working group and the advice given by Eurostat. They primarily relate to the calculation of FISIM (i.e. financial intermediation services indirectly measured) on ESM loans, IMF loans and bilateral loans from Russia. For a comparison of vintages of revenue and expenditure for 2017, see Table 2 on the assessment of the 2018 stability programme for Cyprus.

3 on Financial sector issues). In 2020, under a no-policy change assumption, the headline surplus is projected to somewhat decline as growth slows down.

**A sound fiscal position, based on a prudent expenditure management, remains essential to withstand procyclical fiscal pressures.** The structural surplus is forecast to increase to 1.7 % of GDP in 2018 in light of the strong fiscal performance and to decrease after that as the positive output gap widens. Nonetheless, the structural surplus is expected to remain above the medium-term objective of a balanced budget in structural terms. However, the narrowing structural balance in the context of the increasing positive output gap would lead to a procyclical fiscal stance. In that context, expenditure developments should be monitored carefully and increasing pressure for fiscal relaxation should be resisted, especially in light of possible future risks to the robustness of revenues and other risks as presented below.

**The measures related to the CCB sale increased the State's exposure to explicit contingent liabilities and may adversely affect the budget balance in 2018.** The sale of the CCB entailed the establishment of asset protection schemes, which increased the State's explicit contingent liabilities (see Section 3 on Financial sector issues). As explained below, gross public debt projections take into account the government's support in the CCB sale. However, the overall impact on the general government balance in 2018 of the one-off banking support measures granted to the CCB, including the creation of the CCB's residual entity ([25]), will depend on a formal decision on the statistical treatment by Cystat and Eurostat. This decision is expected in the coming months and at the latest during the 2019 spring notification. The assessment of the fiscal impact in 2018 is likely to be based on the net impact approach ([26]). This approach would take into account, among other things, an independent valuation of the assets remaining in the residual entity (mostly NPLs) and an estimation of the present value of expected guarantee calls, in particular regarding the asset protection schemes against potential future claims in relation to assets transferred to Hellenic Bank (see Section 3 on Financial sector issues). The overall fiscal impact will ultimately depend on the effectiveness of the residual entity's management to work out NPLs.

**Risks to the fiscal outlook remain tilted to the downside.** On the expenditure side, the deficit-increasing measure concerning the gradual withdrawal of wage cuts in the broader public sector in 2018-2023 entails the reversal of a consolidation measure undertaken during the economic adjustment programme, with budgetary implications and potential spill-over effects in the private sector. The overall public wage bill increase is envisaged to be below nominal GDP growth, as set in the collective agreements on public wage indexation. However, a permanent mechanism that regulates growth of the public sector wage bill would reduce the risk of fiscal slippages and ensure the sustainability and predictability of public finances. Furthermore, there is a potential fiscal impact from ongoing court cases on the constitutionality of the public sector wage and benefit cuts during the crisis. The ongoing discussions between the government and the labour unions to create a provident fund in 2019 for public sector employees recruited after October 2011 and of indefinite duration might also imply significant incremental fiscal costs. Further costs could also arise from the recently passed law on widowers' pensions, of which one amendment on the retroactive nature of the law has been referred to the Supreme Court. Moreover, the government's intention to introduce new tax reductions in 2019, namely the reduction of the defence levy on interest income and the reform of vehicle taxation, would weigh negatively on the budget balance.

**The study on the fiscal and economic impact of the healthcare reform was cancelled.** Thus, the fiscal impact of the national health insurance system (NHIS) remains uncertain and will need to be carefully monitored since it might create additional budgetary pressures. This could particularly be the case during the 2020-2025 transition period for establishing the financial and operational autonomy of public hospitals and for

([25]) The residual entity is likely to be classified within the general government.

([26]) The net impact approach consists in recording as capital transfer (i.e. deficit increase) the difference between the expected cash outflows (e.g. cash transfers in the form of deposits and costs of guarantees) and the expected cash inflows (e.g. recoveries from the portfolio of assets).

preparing the secondary legislation on service and reimbursement provisions. In addition, after agreeing pay rises for nurses in public hospitals, the government is currently negotiating increases in the remuneration of doctors in the NHIS for 2019.

**Additional fiscal pressure in relation to the banking sector might further weaken Cyprus' fiscal position.** Such pressure may derive from an increase in moral hazard from the ESTIA scheme or the realisation of contingent liabilities from recent banking support measures (such as asset protection schemes provided under the CCB sale), on top of the amount to be included in the 2018 headline balance.

**It is unclear whether the strong tax revenue performance can be sustained.** On the revenue side, the sustainability of the current buoyant tax revenue collection, in particular from value-added tax (VAT) and corporate income tax (CIT), needs to be thoroughly analysed, as this drove budgetary outperformance in the past years. Tax revenue might not continue to increase at the same rate in the future, as growth of the most dynamic component of VAT (i.e. collection from the construction sector) will eventually fade away, and CIT is an inherently volatile source of revenue that can change if (large) companies decide to relocate. Thus, it is important that the government does not use what could be considered windfall revenues to fund additional current spending.

**Taking into account the government's support in the CCB sale, public debt is projected to increase from 96.1 % in 2017 to 105.0 % of GDP in 2018. However, it is expected to steadily decline after that.** The increase in 2018 is mainly due to the issuance of a series of government bonds in April and July 2018. After reimbursement of the first issuance using the proceeds from the second issuance, the outstanding amount of bonds from the CCB sale amounted to EUR 3.2 billion (15 % of GDP). The proceeds from the issuances, which totalled EUR 3.5 billion (17 % of GDP) after the addition of some cash, were deposited with the CCB and have been kept in the CCB residual entity. The transaction represents a level-shift upwards in Cyprus' public debt. However, starting in 2019, public debt is projected to significantly decrease again to 98.4 % in 2019 and 91 % in 2020. This reflects the projected high primary surpluses and favourable debt dynamics, the latter mostly due to strong real GDP growth (see Section 6 and Annex 1 for an analysis of debt sustainability).

**The draft legislation on the sovereign wealth fund is still pending adoption by the House of Representatives.** The draft law sets out the conditions for collecting, managing and using future resources from hydrocarbon exploitation and stipulates that the government will be able to use part of the revenue to reduce government debt. Despite initial expectations to enact the bill in the first half of 2018, the House of Representatives is still discussing some proposed amendments to the bill.

# 5. STRUCTURAL ISSUES

## 5.1. FISCAL STRUCTURAL REFORMS

### Public financial management and budgetary framework

**A rigorous implementation of the fiscal framework is key to contain risks of fiscal relaxation.** Attention is currently on the rigorous implementation of the secondary legislation of the Fiscal Responsibility and Budget System Law, which includes not exceeding the expenditure ceilings set in the medium-term budget framework. Reform of the public financial management is progressing, in particular for the selection and evaluation of public investment projects. The administrative capacity of the key institutions (e.g. ministries, local administrations) involved in assessing investment projects has been improved in recent years through guidelines, templates and training. Furthermore, a new software management system is currently being acquired. It remains to be decided whether or not to set up a unit responsible for public-private partnerships within the Ministry of Transport.

### State-owned enterprises

**Progress on individual privatisation projects has been limited.** ([27]) Privatisation of the Larnaca Port is the most advanced project, as the tender procedure is expected to be finalised by the end of 2018. The draft bill for licensing the activities of the National Lottery has been submitted to the House of Representatives and will be assessed by the European Commission to ensure compliance with EU legislation on gambling. An investor is expected to be selected in the coming months. No progress was reported on the tender procedure on the Troodos residences. The timeline for adopting the draft bill on the corporatisation of the Cyprus Telecommunications Authority (CyTA) is uncertain, as the House of Representatives has not yet started discussions on the bill. No notable progress has been made on privatising other assets, such as the Cyprus Stock Exchange. No progress has been made on the Law on the Governance of State-Owned Enterprises (SOEs), which was submitted to the House of Representatives in 2015. However, progress on the individual privatisation projects could reduce the state's exposure to contingent liabilities from public companies, improve the economic governance and perfomance of SOEs and attract further foreign investment in Cyprus.

### Revenue administration

**Revenue administration reforms are slowly progressing.** Measures to step up the fight against tax evasion are ongoing. The measures are aimed at taxpayers with the biggest impact on public revenue collection and are seeking to achieve more voluntary compliance. Some of the chapters of the Tax Procedure Code are expected to be adopted in 2019. Progress in implementing the integrated tax administration system is slow. There has been some delay in awarding the tender for deploying a new tax IT system. Initially, it was expected the tender would be awarded by the end of 2018. In the meantime, the current online system has been upgraded to improve tax administration (e.g. e-filing, e-payments and debt settlement agreements).

### Public administration reforms

**Reform of the country's public administration is considerably delayed.** A set of bills to modernise (i) the appraisal system of civil servants, (ii) promotion procedures and (iii) the Public Service Commission are currently under discussion with relevant stakeholders following the rejection of these bills by the House of Representatives in 2016. This reform was thoroughly discussed when Cyprus was implementing the macroeconomic adjustment programme. At that time, the proposed bills were agreed between the government and the civil servants' trade unions. The authorities expect to re-submit the draft bills with some amendments by the end of 2018. However, the draft bill establishing a permanent mechanism for increases in the public sector payroll based on the developments in fiscal conditions and nominal GDP growth will not be re-submitted to the House of Representatives. Currently, the spirit of the

([27]) Only individual privatisation projects remain active after the privatisation unit was dismantled and the legal framework for privatisation was abolished. The House of Representatives is now closely scrutinising any progress made on these projects. For further information, see the Post-Programme Surveillance Report for Cyprus of Spring 2018, p. 29.

proposed bill is being implemented in the broader public sector through collective agreements. However, looking forward, the introduction of a binding and permanent mechanism needs to be reconsidered.

**The long-awaited and much needed reform of local governments is gathering political support.** The reform has been stalled in the House of Representatives since 2015. Currently, there appears to be increased political support for this reform and the authorities intend to re-submit an amended draft bill by the end of 2018. The reform will benefit the local communities in a number of ways, such as providing better local public services and ensuring more efficient water and waste management. Also, the reform will play an important role in simplifying the process of issuing title deeds and building permits (see Section 5.2 on Immovable property rights). The reform also intends to establish a common accounting and financial reporting framework for all local governments, which could improve the management of public finances.

### Reform of the welfare system

**The cost of the guaranteed minimum income (GMI) scheme is gradually declining, while the assessment of its impact on reducing poverty and inequality is still pending.** The budget for the GMI scheme fell to EUR 220 million in 2018, compared to around EUR 240 million in 2017. This is mainly due to the improved labour market situation as well as close monitoring of incidences of "voluntary unemployment" (see Section 5.2 on Labour market structural issues). The assessment of the impact of the GMI on poverty and inequality based on the household budget survey is planned for 2019.

## 5.2. OTHER STRUCTURAL REFORMS

### Reform of the justice system

**The reform of the justice system is gaining momentum with the strategy to reduce non-performing loans.** Given the strong link between the judicial process (notably the legal enforcement of commercial claims) and the effective workout of NPLs, the authorities have given high priority to reforming the justice system. This reform will also complement the comprehensive strategy to reduce NPLs (see Section 3.1 on The three-pillar strategy to reduce NPLs) which will therefore help to push forward key aspects of the reform. With the sale of the Cyprus Cooperative Bank, the government has committed to gradually — within 18 months after the decision on 19 June 2018 — implement measures to significantly improve the handling of NPLs cases by the courts.

**Certain aspects of the reform are expected to tighten the legal enforcement of claims and therefore improve the payment culture.** The long awaited amendment to the civil procedure law to make it easier to carry out a court order to seize movable property, and therefore to enforce judgments, is under legal vetting. Also, the review of the rules of civil procedures is expected to be finalised by the end of 2019 with the technical support from the SRSS. The new rules proposed will need to be adopted by the Supreme Court and implemented by the relevant stakeholders. The new rules are expected, among other things, to strengthen the legal framework by providing the courts with more tools to effectively enforce judgments and improve the efficiency of the judicial system as a whole.

**More needs to be done to tackle the backlog of cases.** Measures have been announced to clear the backlog of cases in courts. This includes recruiting additional judges and creating a focused taskforce. Also, judges are expected to be appointed to handle financial dispute cases, which also involve NPLs. Recruitment is being handled as a matter of priority and is expected to be completed in the coming months. The forthcoming establishment of the Administrative Court For International Protection (law adopted in July 2018 with court becoming operational in January 2019), a Commercial Court (draft law still pending for legal vetting) and a Court of Appeal are expected to reduce the high number of delayed cases and shorten long court procedures.

**E-justice — a key pillar of the reform — is still pending.** The current manual procedures are causing great delays in the judicial process. The authorities received technical support from the SRSS in the design phase to introduce an electronic system, which should help to significantly modernise and improve the processing of cases and the overall functioning of

the courts. The project is still in the public procurement phase and is expected to be gradually implemented over the next 2 years.

### Immovable property rights

**Progress on the issuance and transfers of title deeds ([28]) was limited.** Only a slight fall in the high backlog of unissued titles was recorded — about 25 000 were unissued in September 2018, down from 26 000 in March 2018. The delays in procedures, which are mainly caused by the local governments and their reluctance to bear the costs of completing unfinished infrastructure projects and issue the necessary certificates, have not yet been addressed. The local government reform, which will help removing some impediments, is expected to advance in the coming months (see Section 5.1 on Public administration reform). On the legacy cases. i.e. buyers who expect their title deeds for sales registered before 2015, some progress was recorded. About 5 300 transfers were performed out of 16 400 applications, but more effort needs to be made. Furthermore, the ruling of the Supreme Court on the constitutionality of the law providing for an enforced granting of the title deed for the legacy cases is still pending. An amendment to the law that could remedy the situation is under legal vetting, but no timeline was announced. The authorities are currently preparing a draft bill to prohibit submitting a contract for the sale of a property with encumbrances to the Land Registry without the consent of the bank. This new law is expected to avoid in the future the current situation where buyers pay the full amount for the purchase of a property but cannot obtain the transfer of the title deed due to encumbrances.

**Simplification of the procedure for issuing building and planning permits is slowly progressing.** An external study was conducted to tackle the long and burdensome process of issuing building and spatial planning permits. Based on the study's recommendations, an action plan is being prepared by the authorities. The reform of local governments is an essential component for streamlining, as permits are mainly issued at the local level.

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

### Healthcare reform

**Implementation of the national health insurance system (NHIS) is steadily progressing.** The authorities consider this major reform a priority, and key milestones are advancing in accordance with legal commitments. These include reforming primary health care, which will be the backbone of the reform, introducing an IT system and drafting the necessary secondary laws. In parallel, the process of autonomising and upgrading the country's public hospitals is moving forward. On the participation of private healthcare providers in the new NHIS, negotiations are still ongoing and focused in particular on remunerations. There is uncertainty whether the participation of private healthcare providers in the system will be sufficient to ensure a successful roll-out of the reform.

**The reform is expected to benefit the population at large, while there are uncertainties surrounding its fiscal impact.** The NHIS is expected to provide universal health coverage and contribute to a more efficient utilisation of public and private sector resources and a reduction in out-of-pocket payments. However, the fiscal impact of this reform has not been clearly assessed, increasing therefore the risks on to the fiscal position in the short- to medium-term (see Section 4 on the Budgetary outlook and fiscal policy stance).

### Action plan for growth

**The framework to facilitate strategic investments is still pending adoption.** This draft law is a key element of the action plan for growth. Its aim is to significantly reduce the time it takes for a strategic investor to obtain all the necessary permits and licences to invest in Cyprus. However, it is still pending adoption by the House of Representatives and no timeline has been announced.

**Other important aspects of the action plan for growth are progressing.** E-governance is one of the authorities' priorities, and significant progress has been achieved. Efforts are ongoing to help small and medium-sized enterprises (SMEs) gain easier access to finance, mainly through projects under the European Fund for Strategic Investments

(EFSI SME window). But the results are yet to be assessed. On tourism, the national strategy is being implemented, and the Deputy Ministry for Tourism is expected to be operational by January 2019. A new priority is to improve the economy's competitiveness through regular monitoring by the recently established Economy and Competitiveness Council, based on which measures will be designed. Faster progress in implementing the action plan for growth is crucial for improving the business environment and diversifying and strengthening investment.

### Energy

**The opening up of the electricity market in Cyprus has again been postponed.** The much needed opening up of the electricity market is not expected to take place until at least July 2020. The previous timeline announced was July 2019. The delay was caused by problems in the tendering procedure for the deployment of the necessary IT system/platform. As a transitional phase, the authorities are allowing independent electricity suppliers, mainly through renewable energy resources, to strike bilateral contracts with power producers. Already four licences were granted.

**The importing of liquefied natural gas (LNG) is progressing.** The creation of the necessary infrastructure for importing and distributing natural gas to power producers is at the tendering phase. The authorities expect that both the infrastructure and the contract to import LNG will be concluded by the end of 2020. This is expected to diversify Cyprus' energy mix.

**The exploration for hydrocarbons and their utilisation is a priority for the government, but the process is long.** The authorities expect the explorations in Cyprus' exclusive economic zone to continue as planned. Efforts to strengthen intergovernmental cooperation with neighbouring countries are ongoing, but the monetisation of hydrocarbon reserves will likely take several years.

### Labour market structural issues

**The capacity of the public employment services (PES) is being strengthened with 30 additional counsellors.** After a long delay, 30 extra counsellors are now being gradually recruited. Their recruitment started in June 2018 and is expected to be finalised by the end of November 2018. The counsellors offer individualised counselling to priority groups, including young people, recipients of guaranteed minimum income (GMI) and disabled people. They are being employed on a two-year contract, and any extension will be examined based on the future needs and labour market situation. In addition, since early September, an online platform bringing together employers and the unemployed has been running. There has been no formal assessment of its effectiveness yet, but the initial feedback from employers and the unemployed was positive.

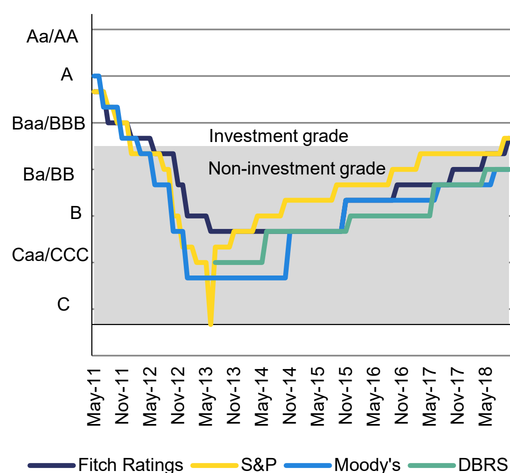
**Although measures helping GMI recipients to find a job have been introduced, results are not yet evident.** Targeted active labour market policies (ALMPs) to bring GMI recipients into the labour market have been in place since 2016. However, the uptake is still low. The authorities have become more concerned with the potential inactivity trap, which may pose financial disincentives for GMI recipients to take up employment. To this end, GMI recipients are now subject to more stringent requirements to look for work. Those who do not register with the PES or refuse to take a job offer are declared 'voluntary unemployed' and no longer receive the GMI benefit. Moreover, they cannot reapply for the GMI benefit for 6 months.

**The assessment of the effectiveness of active labour market policies (ALMPs) is still at an initial stage.** The new system to monitor and evaluate ALMPs, which makes it possible to track participants in ALMPs 6 months after completion, has been in place since the beginning of 2018. The first results are expected by the end of the year and will be used to design future ALMPs — mainly post-2020 policies. Also, an external study evaluating the effectiveness of ALMPs was announced, but the timeline was not specified. For the target group of young people not in employment, education or training (NEETs), which is a priority, a project is in place to reach out to graduates of secondary education, who are not in tertiary education or in employment, and compile their profile in order to take further action.

# 6. SOVEREIGN FINANCING AND ABILITY TO REPAY

**The CCB sale to Hellenic Bank was viewed as market positive by major rating agencies, with two of them recently upgrading Cyprus back to investment grade, for the first time after 6 years.** Cyprus' sovereign long-term credit rating continued to improve after the start of the CCB sale in March 2018, gaining five upgrades since. The most recent upgrades by Standard & Poor's (to BBB-) on 14 September 2018 and Fitch Ratings on 19 October brought Cyprus back to investment grade for the first time since 2012. At the same time, these rating agencies changed the outlook from positive to stable. 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 October, the purchases amounted to EUR 155 million (book value) ([29]). Cyprus is currently rated below investment grade by the other two major rating agencies: two notches below by Moody's, with a stable outlook, and DBRS, with a positive outlook (see Graph 6.1). The next sovereign rating review is scheduled for 23 November 2018 by DBRS.

Graph 6.1: **Sovereign long-term ratings, Cyprus**




***Source:*** European Commission

**Cyprus maintained access to international capital markets at favourable terms in 2018.** Immediately following the rating upgrade by Standard & Poor's on 25 September 2018, Cyprus issued a ten-year EUR 1.5 billion (7.2 % of GDP) international bond, at a yield of 2.4 %. This issuance allowed Cyprus to extend its yield curve with a ten-year benchmark bond. The yield achieved is about one third lower compared to the yield achieved 2 years ago, despite the longer maturity. However, the achieved primary market yield is above that of Portugal (1.9 % in October 2018; for a EUR 0.8 billion bond), Spain (1.6 % in October 2018; EUR 1.3 billion) and Ireland (0.9 % in September 2018; EUR 1 billion) for the same maturity. The bond attracted robust demand with an order book of EUR 5.7 billion (bid-cover ratio of 3.8 ([30]) compared to 4.9 in 2017, 2.5 in 2016 and 3.3 in 2015). The yield has fallen slightly in the secondary market since the issuance.

**After initially moving up in 2018 because of the CCB sale and external events, yields on Cyprus' debt instruments have eased again more recently.** Cyprus' government bond yields in the secondary market have reached 1.8 % and 2.3 % for 7-years-to-maturity (YTM) and 10YTM bonds at the end of October, only somewhat above the low levels achieved at the end of 2017 (see Graph 6.2). At the shorter end of Cyprus' yield curve, the yield for three-month T-bills on the primary market remained negative. In September 2018, the outstanding T-bill stock stood at EUR 300 million, within the target range set out in the medium-term debt strategy (1-4 % of total debt).

**The State's financing needs have increased but remain relatively contained.** The final terms for the sale of the CCB increased sovereign financing needs. This was due to an overall increase of public debt and because of shorter maturities compared to the initial support to the CCB in April (see also Graph 6.3) ([31]). Despite this increase, the financing needed to amortise the debt (excluding fiscal revenue) — not exceeding 10 % of GDP per year until 2025 — appears to be relatively

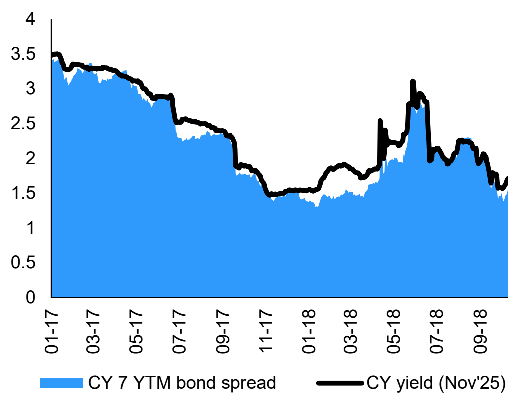
([29]) Source: the ECB (https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html#pspp).

([30]) This compares with a bid-cover ratio of 2.4 for Irish, 2.1 for Spanish and 2.8 for Portuguese 10-year sovereign bonds.

([31]) The newly issued domestic bonds privately placed with the CCB in July 2018 of EUR 3.2 billion (the second bond issuance to the CCB) — taken over by Hellenic Bank since — was used to redeem the bonds of 3 April 2018 (the first bond issuance to the CCB). The second bond issuance to the CCB also entails shorter maturities running up to 2022. Moreover, the pre-existing CCB loan to the Republic of Cyprus was agreed to be repaid early, by the end of 2018.

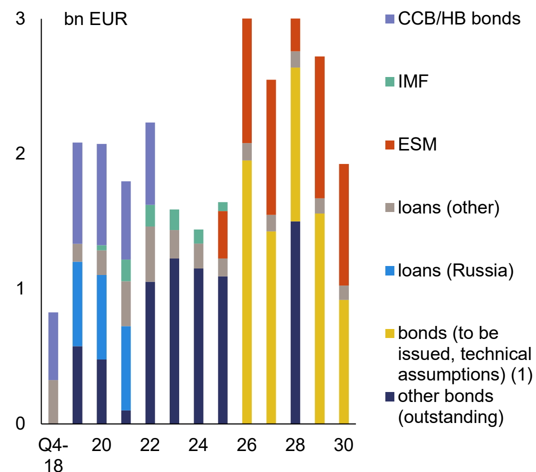
contained (32). Excluding Treasury bills (T-bills), financing needs for 2019 are estimated at around EUR 1.5 billion (consisting of EUR 2.1 billion of debt redemption needs, which are partly offset by EUR 0.6 billion in revenue from the projected headline surplus). The current cash buffer covers all financing needs until and including the third quarter of 2019. Over the medium term, total financing needs are expected to be contained (below 7 % of GDP by 2020), owing to the long maturity of the European Stability Mechanism (ESM) loans and projected government surpluses.

Graph 6.2: **Cyprus 7YTM sovereign bond yield and spread v German sovereign bond**




***Source:*** Bloomberg and own calculations

Graph 6.3: **Medium and long-term debt amortisation**




(1) Assumed 7-year bond issuance.
***Source:*** Ministry of Finance —- Public debt management office and own calculations

**The risk of Cyprus not being able to service its debt to the ESM is considered low in the short term.** While the CCB sale has significantly increased financing needs for the coming years, it perceptibly reduced uncertainty in the financial sector. In addition, the recent return of Cyprus to investment grade has reduced refinancing risks, as it increases the pool of potential investors and makes Cyprus' bonds eligible for ECB monetary operations. It is noteworthy, however, that the CCB sale also increased banks' (i.e. Hellenic Bank's) exposure to the sovereign. Overall, also in view of robust economic growth, large primary surpluses and a sizable cash buffer, short-term risks to Cyprus' capacity to service its ESM debt are considered low. However, medium-term debt dynamics remain sensitive to macroeconomic shocks, vulnerabilities in the financial system, a significant and sustained rise in the interest rates and changes in fiscal performance. Therefore, continued fiscal discipline, a forceful reduction of NPLs and progress on structural reforms that stimulate growth will be of critical importance in consolidating and further improving investor confidence.

(32) 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. Financing needs for debt amortisation to GDP are projected to amount to 9.6 % in 2019, 9.1 % in 2020, 7.7 % in 2021 and 9.4 % in 2022, while total GFN relative to GDP are projected to amount to 6.9 % in 2019 and 6.2 % in 2020. 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 (Policy Paper). It has occasionally been argued (inter alia, by C. Gabriele et al. in the ESM working paper 24/2017, available at: https://www.esm.europa.eu/sites/default/files/wp24final_0.pdf) that an increase in GFN relative to GDP will increase the sovereign spread, all else being equal, notably for higher indebted countries. However, it should be noted that empirical relationships are not a sufficient basis for gauging the future sensitivity of yields to GFN. In times of stress, higher financing needs may weigh perceptibly on investors' risk assessment, particularly in a small country with rather weak market liquidity.

# ANNEX 1
# Specific monitoring of macroeconomic imbalances

**In March 2018, Cyprus was identified as experiencing excessive imbalances in the context of the macroeconomic imbalances procedure (MIP)** ([33]). The identified imbalances mainly relate to the high share of non-performing loans (NPLs) in total loans, which burdens the financial sector, and the significant stock of private, public, and external debt hanging over the economy. This is in a context of still relatively high, even though declining, unemployment and weak potential growth. This section provides an overview of the progress in implementing policy to address imbalances as identified under the MIP framework. In order to avoid an overlap of fiscal surveillance processes, it does not provide an assessment of fiscal targets.

**The country-specific recommendations under the European Semester provided guidance for the policy follow-up**. These recommendations concern a wide range of policy areas: the public sector (CSR1), the judicial system, insolvency and foreclosure frameworks and property rights (CSR2), non-performing loans (CSR3), the business environment and privatisation (CSR4) and the labour market (CSR5).

### A 1.1.1 Evolution of imbalances

**The Cypriot economy continued growing strongly in the first half of 2018.** Real GDP increased by 4 % year-on-year (y-o-y) in the first half of 2018, backed by the solid private consumption, investment and exports. HICP inflation during the first three quarters of the year remained low as prices of non-energy industrial goods came under pressure amid increasing competition, while higher oil prices fed into energy prices with a lag. HICP inflation is expected to remain low for the year as a whole, at 0.8 %.

**The large net international liabilities declined somewhat, but the current account deficit is large**. The current account deficit widened in 2017 to 8.4 % of GDP but contracted somewhat to 6.6 % of GDP by mid-2018 (based on the rolling sum of four quarters). This was the result of a sizable de-registration of ships in the first quarter of 2018. It is important to note that the activities of special purpose entities (SPEs) ([34]) account for a substantial part of the current account deficit in Cyprus and have lately exhibited significant volatility. By contrast, the non-SPEs part remained rather stable, fluctuating at around -3 % of GDP. Despite that, the net international investment position (NIIP) continued to contract to -121.5 % of GDP in 2017 and -112.3 % of GDP in the second quarter 2018. Of this, 76 % of GDP corresponded to the NIIP of non-financial ship-owning SPEs.

**Private sector debt continued to slowly decrease and fell below 300 % of GDP in 2018** (according to the Central Bank of Cyprus). It declined from 316.3 % of GDP in Q4-2017 to 296.6 % of GDP in Q2-2018. This reduction has been driven by both households and non-financial corporations (NFC). In Q2-2018, household debt to GDP stood at 100.2 % and NFC debt-to-GDP stood at 196.4 %. The debt of ship-owning SPEs to GDP, forming a part of NFC debt, remained rather stable over the last 3 years and stood at 76.7 % of GDP in mid-2018. In future, deleveraging is expected to be supported by strong real GDP growth and, to some extent, inflation.

**The property market is recovering.** The Eurostat house price index shows that house prices since the end of 2016 have been modestly increasing (1.2 % y-o-y in the second quarter of 2018), though with substantial regional differences. In the context of a high share of collateralised debt, this may facilitate loan restructuring/repayment through the sale of collateral.

**The high stock of NPLs in the banking sector is expected to decline more significantly in 2018 compared to previous years**. In mid-2018, the NPL ratio stood at 40.3 % (in particular, at 39.4 % for NFC and 52.5 % for households; in absolute

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

([34]) SPEs are legal entities that have limited operations. They relate to corporations, often subsidiaries, which are typically located in other jurisdictions. In Cyprus there are three major types: (i) financial companies, mainly financing and holding companies that channel funds within a worldwide group on behalf of a non-resident parent company, (ii) ship-owning companies (non-financial companies), and (iii) factoring and invoicing companies that are invoicing the sales of the worldwide group on behalf of the parent.

terms NPLs stood at EUR 16.6 billion) ([35]). The large reduction in NPLs this year is due to the removal of the Cyprus Cooperative Bank's (CCB) sizable NPLs portfolio (EUR 5.7 billion) from the banking system when the CCB surrendered its banking licence. It is also due to the Bank of Cyprus' announced sale of a large volume of NPLs (EUR 2.7 billion). Taking into account these two operations, the NPL ratio of the banking sector is expected to drop to 31 % of total loans by the end of 2018 — a reduction of 13 percentage points compared to the end of 2017, all other things being equal.

**Taking into account the government's support to the CCB, public debt is forecast to increase from 96.1 % in 2017 to 105.0 % of GDP in 2018, but to steadily decline after that.** Starting in 2019, public debt is projected to significantly decrease again to 98.4 % and 91 % of GDP in 2019 and 2020 respectively. This mainly reflects the projected high primary surpluses and strong, albeit somewhat decelerating, real GDP growth.

**The labour market situation is rapidly improving**. The unemployment rate fell from 10.3 % at the end of 2017 to 7.5 % in August 2018. Youth and long-term unemployment also declined to 19 % and 2.5 % respectively in Q2-2018. While unemployment is still well above the pre-crisis period, positive employment expectations suggest that unemployment is set to continue falling in the near term.

**Potential growth, even though somewhat increasing, remains subdued**. Following improvements in labour productivity, growth and gross fixed capital formation, potential growth has been revised upwards for 2017 to 1.8 % and is envisaged to be around 2 % in medium term. However, the high dependency on construction investment, the remaining debt overhang and insufficient progress with structural reforms constrain potential growth in the longer term.

([35]) The NPL ratios (i.e. NPLs stock to total gross loans ratios) referred to in this report are based on the data from the Central Bank of Cyprus (CBC) and its definitions. Thus, they differ from the ratios referred to in the 2018 Cyprus country report, which is based on the European Central Bank data. In particular, exposures of banks to central banks and credit institutions and the overseas operations (branches and subsidiaries situated abroad) of the Cyprus-based banking groups are not taken into account in the CBC aggregate NPL ratios.

### A 1.1.2 Policy measures to address macroeconomic imbalances

#### Reducing non-performing loans

**In 2018, the Cypriot authorities devised and started implementing a three-pillar policy strategy for reducing NPLs in the banking sector**. The strategy comprises: (i) a legislative package, including amendments to the foreclosure and insolvency frameworks and to the Sale of Loans Law and the adoption of a Securitisation Law; (ii) the sale of the CCB, which struggled with a high volume of NPLs, putting its residual entity into a wind down mode; and (iii) the setting-up of a temporary State support scheme (ESTIA) for addressing the NPLs collateralised by primary residences. Under the first pillar — strengthening of the legal and regulatory framework — the House of Representatives approved a series of legal amendments in the beginning of July 2018. These are amendments aimed at removing some impediments to NPLs resolution. The second pillar — which entails the removal of a big portion of bad loans from the banking sector — materialised in September 2018, when the CCB surrendered its banking license. Under the last pillar, the design of the ESTIA scheme was finalised in early November 2018. It is expected to be implemented starting from 2019, and thus its effect on NPLs remains to be seen.

**The authorities amended the foreclosure legislation to allow for the effective enforcement of claims**. The scope of application of the new foreclosure procedure was clarified, ensuring that old court decisions are covered as well. The notification requirements were amended to allow for alternative means of delivery, if delivery by registered post is not feasible. The law also allows for electronic auctioning of properties, while the system for e-auctions is in the process of being set up. Importantly, under the amended framework, the bank is allowed to buy the property 6 months after the first unsuccessful auction (within a period of 4 months). This significantly shortens the time needed for foreclosure; under the previous law, the bank could buy the property only after 1 year. Furthermore, the minimum reserve price has been reduced from 80 % to 50 % after the first 3 months, while no reserve price will be required after the first 6 months.

**To make the insolvency procedures more appealing, the July 2018 reform package revamped the legislation on insolvency (used only sporadically before).** In particular, for the various insolvency mechanisms (personal and corporate), the eligibility criteria were broadened and liabilities vis-à-vis the general government were also included, abolishing its preferential treatment. The maximum protection period for non-viable debtors was limited to 12 months. These are debtors whose financial situation deteriorated in 2012 and 2013 and who mortgaged their primary residence or business premises and used all existing measures for restructuring. To take into account the State support schemes for loan repayment, such as ESTIA, the insolvency framework was amended. The amended framework terminated any protection from creditors for borrowers receiving a subsidy but who are at least 3 months late in paying any creditor. Such borrowers would now be subject to enforcement measures for the collection of their debts.

**The Sale of Loans Law was also amended**. The new provisions clarify the scope of eligible credit facilities by expanding the definition of eligible credit facilities to terminated loans, so that they now fall within the scope of the law. Furthermore, the revised law enables collateral to be transferred without any fee charges.

**The authorities adopted the Securitisation Law to facilitate the secondary market for loans. This may in turn enable the efficient transfer of NPLs off the balance sheet of credit institutions.** The law establishes a framework for securitisation in Cyprus and grants the Central Bank of Cyprus (CBC) the power to supervise and regulate the securitisation activity of originators, servicers and securitisation special purpose entities (SSPE). Only credit institutions, financial institutions and credit-acquiring companies can act as originators. The law stipulates that the originators have to notify the CBC of securitisations. Furthermore, the originators are required to notify the underlying debtors, collateral providers and guarantors a number of days in advance of the transfer of exposures to an SSPE.

**The sale of the State-owned CCB to Hellenic Bank (HB) allowed CCB to make an orderly market exit and removed a significant volume of NPLs from the banking sector**. Under the terms of the CCB-HB agreement, most of the CCB's performing assets and customer deposits were integrated into HB, while the remaining parts (mainly NPLs) remained within a residual entity, owned and funded by the Cypriot government ([36]). The residual entity task is to maximise recovery and repay the State as much and as timely as possible, by managing the NPLs under its perimeter. The winding-down of the CCB put the banking sector on a sounder footing, reduced uncertainty and improved depositor confidence.

**To address the most challenging NPLs segment — NPLs collateralised with primary residence — the government designed the ESTIA scheme**. Under the scheme, the government will provide subsidies to eligible distressed borrowers to incentivise them to begin re-servicing their loans. Besides the debt relief by the creditor, the scheme provides a State subsidy amounting to one third of the borrower's repayment obligation — thus significantly lowering the debt servicing costs, including interest charges. The original ESTIA proposal, which was approved by the Council of Ministers in July 2018, raised a number of concerns (mainly related to its broad eligibility criteria) from different stakeholders, including the European Commission. It was stressed that the final design of the ESTIA scheme should mitigate moral hazard risks and fairness issues. To that end, the authorities revised the terms of the ESTIA scheme in November 2018, notably by tightening the eligibility criteria ([37]). Narrowing the criteria helps to address fairness and moral hazard issues to some extent. However, some concerns remain. In particular, the behaviour of currently performing borrowers may be affected. Also, the

([36]) The entity is almost entirely funded by the State, namely the equity remaining from the recapitalisations of 2014 and 2015, as depleted by losses since, and State deposits provided in the context of the CCB sale in April and July 2018 (of EUR 3.5 billion).

([37]) Under the revised scheme, the income eligibility criterion is revised to take into account the household size, ranging from EUR 20 000 for single applicants to EUR 60 000 for an applicant and his/her spouse that have at least 4 dependent family members (in total 6 income caps). In addition, the wealth criterion is also lowered to a net wealth of up to 80 % of primary residence market value (excluding primary residence), with a cap of EUR 250 000. An additional requirement was also introduced to use any cash or deposits in excess of 20 % of the borrower's net household wealth to pay down (i.e. set off) the loan before its restructuring.

take-up of the scheme and the rate of re-default under the scheme remain uncertain. Moreover, the implications of the scheme on banks' provisioning needs are unclear. Therefore, the scheme's implementation will need to be closely monitored.

**Addressing the inefficiencies of the justice system, in particular in relation to NPLs, is a key priority for the authorities.** The current judicial process weakens the enforcement of contracts and deters banks from using the available legal framework to reduce NPLs. Moreover, the performance of the ESTIA scheme referred to above depends to a great extent on the efficiency of the judicial system in ordering foreclosures for re-defaulters and non-eligible borrowers. In order to significantly improve the handling by the courts of NPLs cases, the government has given high priority to reforming the judicial system, thus complementing the comprehensive strategy for reducing NPLs. In the context of the CCB sale, the government agreed that within 18 months after the adoption of the Decision of 19 June 2018 ([38]) it would take measures for the effective workout of NPLs, including revising the rules of civil procedure. It would also introduce accompanying measures to improve the administration and functioning of the courts. Such measures include appointing specific judges to handle financial disputes, modernising case management procedures, and establishing and introducing basic electronic systems. The government is also planning to implement a full e-justice system in the longer term. The plan to establish the Commercial Court in addition to the expected taskforce to deal with the backlog of cases will help to reduce the build-up of cases. Another important aspect of the reform is the amendment of the Civil Procedure Law. Together with the revision of the rules of civil procedure, this amendment aims to strengthen the legal framework for enforcing judgments.

### Reducing private sector debt

**Two of the three pillars of the NPLs reduction strategy, i.e. the amended foreclosure and insolvency frameworks and the ESTIA scheme, may lead to a sharper reduction of private debt ([39]).** The amended foreclosure framework could make the process more efficient, making it easier to reduce private debt by foreclosing on assets pledged as collateral. The July 2018 amendments to the insolvency framework enlarged the framework's scope, thus potentially increasing its take-up by borrowers. In addition, the ESTIA scheme, referred to above, provides more attractive terms to the borrowers than the insolvency framework. It thus aims to forcefully resolve the legacy NPLs, mostly related to the housing boom before the 2013 crisis. The scheme is expected to have a positive impact on private indebtedness. However, the overall impact of the measures will depend on their take-up by creditors and borrowers.

**Cyprus plans to improve the efficiency and effectiveness of the Insolvency Service and regulate the profession of insolvency practitioners by June 2019 ([40]).** A project is being implemented to resolve the backlog of insolvency procedures at the Insolvency Service resulting from inefficiencies and bottlenecks, so that the Service can operate better ([41]). Ongoing too is the project to improve the regulatory framework for insolvency practitioners through training, supervision and discipline. The Structural Reform Support Service (SRSS) is providing technical support for the project in cooperation with the European Bank for Reconstruction and Development. The Cypriot authorities have also recently appointed a ministerial committee to give more political impetus to the working group set up in March 2017 to review the insolvency and foreclosure frameworks. The group's current focus is on the insolvency procedure. This review process comes on top of the legislative changes introduced in July 2018.

**The quality of the financial information available on borrowers continues to be limited, partly preventing effective loan restructuring.** Legislation to extend application of the Credit Registry to credit-acquiring companies and

([38]) Commission Decision of 19.6.2018; SA.35334 (2018/N-2), available at: http://ec.europa.eu/competition/state_aid/cases/274927/274927_2013239_283_2.pdf.

([39]) See also the preceding sub-section on policy measures reducing non-performing loans.

([40]) See Commission Decision of 19.6.2018; SA.35334 (2018/N-2), p. 38 (commitment 21(d)).

([41]) The project was preceded by an independent review of the operations of the Insolvency Service, resulting in an action plan that was approved by the Council of Ministers in June 2018.

mortgage institutions is still to be adopted. The scope and quality of the financial information available to the registry — for credit risk assessment (including the situation with title deeds), access and management — remain to be improved in line with international best practices.

**It is essential that Cyprus tackles the shortcomings of the current system for issuing and transferring title deeds** ([42]) **to enable liquidation of collaterals.** The liquidation of collateralised immovable properties by debtors or banks is deterred in cases where property rights are not defined. This relatively frequent phenomenon in Cyprus complicates foreclosure procedures, prevents active deleveraging and poses difficulties with the valuation of collaterals. The authorities envisaged some measures to improve the system in the 2018 national reform programme. However, limited progress has been achieved. These measures include the ongoing application of the 'Legacy Law' ([43]). Also, some administrative arrangements, such as accepting cases with relatively minor breaches of planning conditions, were put in place to accelerate the issuance and transfer of title deeds. Despite this, the process is still slow and the backlog remains high. The authorities are preparing to further amend the Transfer and Mortgage Law to address legal impediments faced by the 'Legacy Law'. Moreover, to prevent a build-up of future cases, a bill is being drafted prohibiting the submission of a property sale contract to the Land Registry if the property has encumbrances and the bank does not give its consent. A set of reforms is still being prepared to streamline the procedures for obtaining building and spatial planning permits. The local government reform is crucial in simplifying these procedures, as permits are mainly issued at the local level. However, the reform has still not been adopted. Establishing a sustainable and reliable system for issuing and transferring property rights remains essential.

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

([43]) The Legacy Law is an amendment of Law 9/65 on Transfers and Mortgages. The Legacy Law aims to protect the 'trapped buyer', namely anyone who has submitted a contract of sale to the Land Registry up until 31 December 2014 (legacy cases).

### Reducing general government debt

**The policy measures to reduce NPLs have a temporary negative impact on public debt**. The projected increase in public debt in 2018 is mainly due to the issuance of a series of government bonds in April and July 2018. Once the first issuance was reimbursed with the proceeds from the second issuance, the outstanding amount of bonds related to the CCB sale amounted to EUR 3.2 billion. The proceeds from the issuances, which totalled EUR 3.5 billion after the addition of some cash, were deposited with the CCB. These proceeds are currently in the CCB residual entity. The transaction represents a level-shift upwards in Cyprus' public debt. The strategy to reduce NPLs, and especially the resolution of the CCB, marks a decisive step in dealing with the crisis and pre-crisis legacy of a large NPLs overhang and in achieving consolidation in the banking system. It has reduced risks from the banking sector, boosted investor confidence and helped to upgrade the sovereign rating of Cyprus to investment grade status, thus reducing the cost of refinancing for the government. However, it has also significantly increased public debt and explicit contingent liabilities vis-à-vis the banking sector. These contingent liabilities stem from government counter-guarantees to HB in the form of the asset protection schemes (APSs) for the sale of the CCB ([44]).

**Cyprus' active debt management operations allowed windfall gains to be used to reduce public debt more quickly.** Over the past few years, Cyprus has engaged in active debt management, including early debt repayments, to smooth the maturity profile of outstanding debt and to reduce the debt faster. Cyprus is expected to continue pursuing this policy, mainly targeting domestic loans.

**Over the past years, measures have been adopted to strengthen the long-term sustainability of public finance.** Pursuant to the economic adjustment programme that Cyprus agreed with the Commission, the authorities adopted a series of measures to contain the growth of public expenditure in the long term. These measures include the adoption of the Fiscal

([44]) The scope of the APSs also covers NPLs previously State-guaranteed though not yet called by the CCB.

Responsibility and Budget System Law and of a mechanism capping the growth of the public wage bill at nominal GDP growth through collective agreements signed in 2016 ([45]). While the collective agreements formally cover only 2017 and 2018, the mechanism will continue to be in effect after that, unless it is amended ([46]). The authorities have not committed to adopting a permanent legal mechanism. However, such a mechanism would provide more reassurance about long-term wage moderation in the public sector. The growth in the public wage bill was also constrained by the temporary freeze on new recruitments, with a mechanism for exceptions. Since June 2017, this measure has become permanent and exceptions to it require parliamentary approval.

**However, the draft legislation on the sovereign wealth fund is still pending adoption by the House of Representatives.** The draft bill sets out the conditions for collecting, managing and using future resources from hydrocarbon exploitation and stipulates that the government will be able to use part of the revenue to reduce government debt. Despite initial expectations that the bill would be enacted in the first half of 2018, discussions are still ongoing in the House of Representatives on proposed amendments to the bill. Moreover, draft laws on the new framework for the governance and monitoring of State-owned entities and local government are still pending in the House of Representatives.

### Reducing unemployment

**Policy measures were implemented to improve public employment services (PES).** In the 2018 national reform programme, Cyprus is committed to further improve and modernise the PES. To this end, there has been noticeable improvement in the capacity of the PES to handle the still high, although rapidly declining, level of unemployment. The recruitment of 30 additional counsellors started in June 2018 and is expected to be completed by November 2018. The online platform for employers has been operational since September 2018. Since 2017, the issuance of job placement vouchers for private sector job placement agencies has also helped to alleviate some of the pressure on the PES. In parallel, the IT system for job placements is being upgraded, and the legal framework of the PES operation is currently being developed to help manage the job seekers.

**Targeted measures to reduce youth and long-term unemployment are ongoing.** As stated in the 2018 national reform programme, Cyprus has launched several active labour market policies to reduce youth and long-term unemployment and unemployment among other vulnerable groups, such as persons with disabilities and recipients of a guaranteed minimum income. A monitoring and evaluation system has been developed to assess the impact of active labour market policies, and the first results are expected to be available end 2018. Training schemes to improve the skills of the workforce in Cyprus and promote lifelong learning are being implemented. They cover a wide range of beneficiaries. For young people not in employment, education or training (NEETs), the authorities are working on identifying unregistered NEETs. When this is completed, they will design outreach policy measures accordingly.

### Increasing potential growth

**Measures to improve the efficiency and productivity of the public sector are still on hold.** The 2018 national reform programme reconfirmed the authorities' commitment to a horizontal reform of public administration. This was a commitment from the economic adjustment programme. However, apart from the law adopted in 2017 on the mobility of public employees, limited progress has been made on the other draft laws aimed at overhauling the procedures for recruitment, assessment and promotion. These are still under discussion. Moreover, as mentioned above, the reform of local government and the new framework for the governance of State-owned entities are still pending in the House of Representatives. In this context, the ongoing reform of the justice system is also crucial and is expected to significantly improve the business environment.

**Implementation of the action plan for growth continues.** Noticeable progress has been made on institutional measures. This has been done by setting up the Deputy Ministry for Shipping, and

([45]) The measures mentioned in this section extend also to the broader public sector.
([46]) See Cyprus — Stability programme 2018, page 8.

the Deputy Ministry for Tourism (to become operational in January 2019) and by setting up the Economy and Competitiveness Council. However, plans to set up the Deputy Ministry for Growth and Competitiveness have been put on hold. Since the end of 2017, the authorities have been implementing the national tourism strategy and making progress on e-government projects. Meanwhile, adoption of the law to facilitate major investments through fast-track procedures is still pending in the House of Representatives.

**Limited progress has been made on privatisation.** Despite the authorities' commitment in the economic adjustment programme to privatise a number of State-owned entities, the House of Representatives abolished the legal framework for privatisation in 2017. Since then, only individual privatisation projects remain active. A few are making some progress, such as the privatisation of the Larnaca port and the National Lottery activities. Further progress on individual projects could attract more foreign investment in Cyprus, modernise key sectors of the economy and reduce the State's exposure to contingent liabilities.

### Conclusion

**Since the spring of 2018, important measures have been introduced to reduce NPLs and private indebtedness.** A strategy to significantly reduce NPLs was initiated in 2018 and it has already led to a significant reduction of NPLs in the banking sector throughout this year (partly due to the statistical effect of moving NPLs from the former CCB to the government-owned residual entity). Nonetheless, its overall effect will need to be judged over time and will crucially depend on the willingness of banks to proceed with foreclosures. On the fiscal impact, the sale of the publicly-owned CCB has led to a significant increase in public debt in 2018, as well to explicit contingent liabilities. Therefore, continuing fiscal discipline remains crucial to ensuring the reduction of public debt. In order to design measures to address macroeconomic imbalances, the Cypriot authorities have continued to request technical support from the SRSS in various areas, including justice, growth and the business environment, education, operation of the insolvency service and practitioners, public financial management and taxation.

**In other areas relevant to addressing the macroeconomic imbalances, there has been less progress, as a number of reform commitments are still pending.** In order to strengthen the payment culture and to significantly reduce NPLs, there has to be progress in reforming the justice system, in particular for handling NPLs in the courts. There also have to be measures to improve the legal enforcement of claims. This reform has cross-cutting implications for the proper functioning of the economy because of its impact on the business environment. The creation of a reliable system of issuance and transfer of title deeds is not in place to help active deleveraging. Moreover, the project of improving the efficiency of the Insolvency Service remains to be implemented, as committed to by the authorities. There are priority areas of the action plan for growth that have not yet been implemented. Action in these areas is needed to attract and diversify investment, raise potential growth, and improve the business environment. Legislation on the sovereign wealth fund, whose aim is to further improve the long-term sustainability of public finances, has not yet been adopted.

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

| **Reduce non-performing loans** | | | |
|---|---|---|---|
| **Financial services** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected in 2019:** Establishment of an electronic auction system for properties subject to foreclosure proceedings.<br><br>Legislation on credit registry extending its application to credit-acquiring companies and mortgage institutions. No timeline was announced. | **2018:** The securitization of loans law has been adopted.<br><br>**2018:** The sale of loans law has been amended.<br><br>**2018:** Foreclosure framework has been amended.<br><br>**2018:** Insolvency framework has been amended.<br><br>**2018:** The Council of Ministers adopted the ESTIA scheme. | **2018:** Cyprus Cooperative Banks's (CCB) NPLs have been carved out of the banking system as a result of selling parts of the CCB to HB and winding down the CCB residual entity. | **CSR 3 (2018):** Accelerate the reduction of non-performing loans by implementing a comprehensive strategy, including legislative amendments allowing for the effective enforcement of claims and facilitating the sale of loans (reinforced by the commitment 21(b) of the State aid decision of 19.6.2018 regarding the establishment of an electronic auction system for foreclosures). |
| **Civil justice** | | | |
| *Announced measures[1]* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected in 2018:** Creation of a taskforce of judges to tackle the backlog of cases, including judges for the handling of financial disputes.<br><br>**Expected in 2019:** Creation of the Commercial Court.<br><br>**Expected by end-2019:** Revision of Rules of Civil Procedure.<br><br>**Expected in 2019:** Bill amending the Civil Procedure Law to strengthen the legal framework for the enforcement of Court decisions.<br><br>**Expected in 2019:** Initiation of the pilot phase of the e-justice.<br><br>**Expected in 2019:** Additional measures to promote the use of alternative dispute resolution processes in consumer disputes.<br><br>**Expected in 2019:** Establishment of a training school for judges. | **2018:** Law for the establishment and operation of the Administrative Court of International Protection. | **2018:** Functional review study for the Courts' system.<br><br>**2018:** Study regarding judicial mediation and ways to incentivise it.<br><br>**2018:** Training courses for judges. | **CSR 2 (2018):** Step up efforts to improve the efficiency of the judicial system by revising civil procedures, increasing the specialisation of courts and setting up a fully operational e-justice system (reinforced by the commitment 21(e) of the State aid decision of 19.6.2018, relating to the reform of the judicial process). |

*(Continued on the next page)*

Table (continued)

| Reduce private sector debt | | | |
|---|---|---|---|
| **Private indebtedness – Insolvency, foreclosure and State support scheme** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected in 2019:** Improving the efficiency and effectiveness of the operation of the Insolvency Service of Cyprus.<br><br>**Expected in 2019:** Regulating the profession of the insolvency practitioners. | **2018:** Insolvency framework has been amended.<br><br>**2018:** Foreclosure framework has been amended.<br><br>**2018:** The Ministerial Committee was appointed to oversee the working group reviewing the insolvency and foreclosure frameworks.<br><br>**2018:** a government decision on the ESTIA scheme was adopted. | | **CSR 2 (2018):** Take measures to fully operationalise the insolvency and foreclosure frameworks and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights (reinforced by the commitment 21(d) of the State aid decision of 19.6.2018 , relating to the efficiency and effectiveness of the operation of the Insolvency Service of Cyprus and insolvency practitioners). |
| **Housing market** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected in 2019:** Amendment of the legacy law (for cases before 2015).<br><br>Legislation to tackle non-legacy and new property transactions by prohibiting the submission of sale contracts at the Land's Registry for properties with encumbrances without the consent of the banks. No timeline was announced.<br><br>**Expected in 2019:** Reform of procedures for obtaining building and spatial planning permits based on recommendations of external experts.<br><br>**Expected in 2019:** Local governments reform simplifying the procedures for building permits and issuance of title deeds. | | | **CSR 2 (2018):** Take measures to fully operationalise the insolvency and foreclosure frameworks and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. |
| **Reduce General Government debt** | | | |
| **Long term sustainability of public finances** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| Adoption of the Sovereign Wealth Fund law. No timeline was announced. | | **2018:** Application of collective agreements containing the growth of the compensation of public sector employees until end-2018. In the absence of any amendments to the current agreements, the mechanism will continue to be in effect.<br><br>**2018:** Full implementation of the secondary legislation for the Fiscal Responsibility and Budget System Law. | |

(Continued on the next page)

*Table (continued)*

| Increase potential growth | | | |
|---|---|---|---|
| **Public administration** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected in 2018:** Creation of a unified centre for receiving information on public services from multiple communication channels.<br>**Expected in 2019:** Legislation modernising the recruitment, assessment and promotion in the public administration.<br>**Expected in 2019:** Legislation for the reform of local governments.<br>Adoption of legislation overhauling the monitoring and governance of State-owned enterprises. No timeline was announced. | | | **CSR 1 (2018):** Adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration and the governance of State-owned entities and local governments. |
| **State owned enterprises - Privatisation** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| Adoption of legislation overhauling the monitoring and governance of State-owned enterprises. No timeline was announced.<br>Adoption of legislation for the corporatisation of CyTA. No timeline was announced.<br>**Expected in 2019:** Commercialisation of the operations of the port of Larnaca.<br>**Expected in 2019:** Selection of a private licensee for the National Lottery's activities. | | | **CSR 4 (2018):** Improve the performance of State-owned enterprises including by resuming the implementation of privatisation projects. |
| **Business environment** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **By end-2018:** Publication of the national competitiveness report.<br>**Expected in 2019:** Legal framework for strategic investments. | **2018:** Establishment of the Deputy Ministry for Tourism. | **2018:** Extension of e-government projects.<br>**2018:** Operation of the Deputy Ministry for Shipping<br>**2018:** Creation of the Economy and Competitiveness Council<br>**2018:** Implementation of the National Tourism Strategy | **CSR 4 (2018):** Prioritise the implementation of key elements of the action plan for growth, in particular fast-tracking strategic investments, and take additional measures to improve access to finance for small and medium-sized enterprises. |
| **Reduce unemployment** | | | |
| **Incentives to work, job creation, labour market participation** | | | |
| *Announced measures* | *Adopted measures* | *Implemented measures* | *Sources of commitment* |
| **Expected end 2018:** Results from assessment of the impact of the active labour market policies.<br>**Expected in 2019:** Targeted measures for young people not in employment, education or training (NEETs). | | **2018:** Introduction of the employers' IT platform.<br>**2018:** Reinforcement of Public Employment Services staff.<br>**2018:** Introduction of active labour market policies monitoring and evaluation tool.<br>**2018:** Identification of unregistered young people not in employment, education or training (NEETs). | **CSR 5 (2018):** Complete reforms aimed at increasing the capacity and effectiveness of the public employment services and reinforce outreach and activation support for young people who are not in employment education or training. |

Notes: [1] The list covers some essential elements of the reform and it is not exhaustive.
***Source:*** European Commission

# ANNEX 2
## European Commission Debt Sustainability Analysis

**Based on standard Commission methodology, the Commission's autumn 2018 forecast and the debt sustainability analysis point to a substantial increase of the government debt-to-GDP ratio in 2018 and a steadily declining path afterwards over a 10-year period.** After a significant fall by the end of 2017 to 96.1 % of GDP, public debt is projected to increase to 105.0 % of GDP in 2018 due to banking support measures related to the CCB sale (totalling EUR 3.5 billion). The banking support measures have also increased explicit contingent liabilities for the government and led to a higher exposure of the banking system (i.e. Hellenic Bank's) to the sovereign. However, in the baseline scenario, public debt is projected to steadily decline after that and reach 61.9 % of GDP in 2029. This debt sustainability analysis uses the Commission's autumn 2018 forecast (2018-2020) 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 methodology: (i) the structural primary balance, before the cost of ageing, is kept at a surplus of 2.9 % 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 ([47]).

**The evolution of the debt trajectory continues to be vulnerable to the macroeconomic and fiscal performance and to a sustained increase of interest rates.** A weaker fiscal performance could seriously undermine the favourable projected trend in the baseline, further exacerbated by a sustained shock to long-term interest rates. In order to illustrate the sensitivity to the macroeconomic and interest rates shocks as well as deviations from the fiscal path, three adverse scenarios are considered (see Graph A2.1). The first adverse scenario is a standard macro shock that assumes a decrease in real GDP growth (by 0.5 percentage point (pp.) compared to the baseline) over the forecast period. In this scenario, it is assumed that the lower growth path does not have any repercussions on the government balance. This keeps the debt trajectory on a steadily declining path but at a slower pace compared to the baseline scenario, with the public debt being higher by 1.4 % of GDP in 2021 and 4.6 % of GDP in 2029. The second adverse scenario assumes a fiscal shock of the structural primary balance gradually converging towards its 15-year historical average (a surplus of 1.3 % of GDP). In this second scenario, public debt declines at a much slower pace, ending up 12 % of GDP higher in 2029 compared to the baseline. The third adverse scenario assumes, in addition to the fiscal shock, negative feedback effects on interest rates and GDP growth, both sustained over the entire projection period ([48]). In this scenario, public debt — after declining in the first years (until 2025) — starts rising again, reaching around 92 % of GDP by 2029, as higher interest rates feed through new and rolled-over debt. By 2029, public debt is therefore higher by around 30 % of GDP compared to the baseline. Given Cyprus' high level of public debt and, in the context of the CCB sale, increased explicit contingent liabilities in relation to the financial sector, continued fiscal discipline and sustained structural reform efforts are necessary to firmly anchor the debt-to-GDP ratio on a sustainable downward path.

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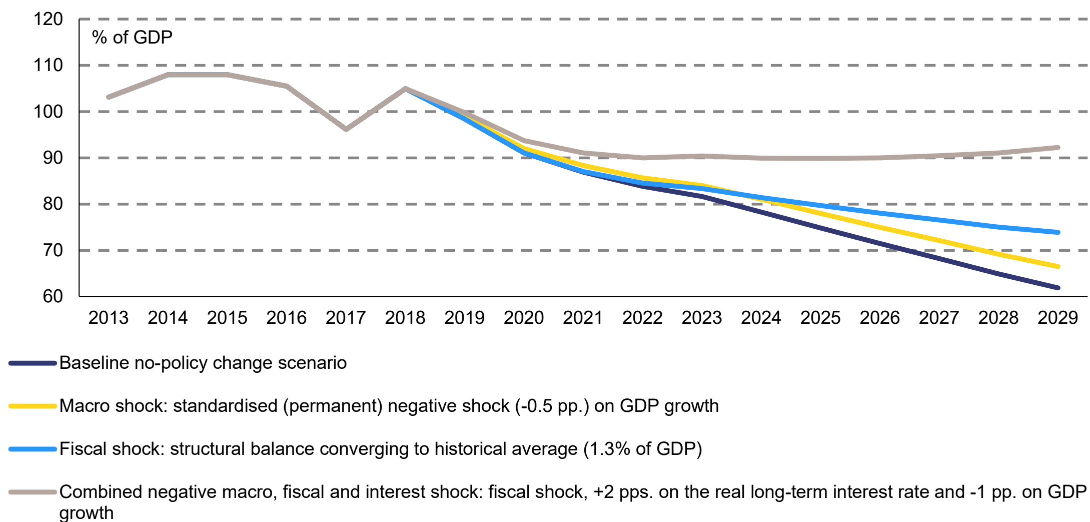
([47]) European Commission and the EPC/Council, 'The 2018 Ageing Report. Economic and budgetary projections for the EU Member States (2016-2070)', European Economy 79/2018.

([48]) 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 1.3 % 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.

Graph A2.1: **Debt projections**




***Source:*** European Commission

**The indicator-based analysis this time signals high fiscal sustainability risks in the short term, mainly due to the economy's macroeconomic, financial and competitiveness factors, exacerbated by increased public debt.** In the short term, risks to fiscal sustainability have been identified, based on the Commission's early detection indicator of fiscal stress (the S0 indicator). Cyprus moved slightly above its critical threshold in this exercise (see Table A2.1). As in the past, the high value is driven by the financial-competitiveness S0 sub-index being above its critical threshold. However, while the fiscal S0 sub-index is still below its critical threshold, its value has increased significantly since the last review, due to the increased public debt.

**In view of the initial high public debt stock and contingent liabilities related to the financial sector, the analysis also points to the existence of risks to medium- and long-term sustainability.** Based on standard Commission methodology, Cyprus is deemed to be at medium fiscal sustainability risk in the medium term due to medium risks attached to the debt sustainability analysis ([49]). The medium-term fiscal sustainability risk indicator S1, at -0.7 pp. of GDP, points to low risks in the medium term (a negative value indicates that no upfront fiscal adjustment effort is needed to reduce the debt below the reference value of 60 % of GDP by 2033). Despite the high level of government debt at present, under the baseline scenario it would decline noticeably given an assumed continuation of the structural primary surplus. This indicator has slightly improved compared to the fourth PPS review (based on the Commission's spring 2018 forecast). In the long term, Cyprus is also deemed to be at medium fiscal sustainability risk. Indeed, despite the negative long-term fiscal sustainability indicator S2 (at -0.9 pp. of GDP), the vulnerabilities linked to the debt burden — captured by the DSA risk assessment — point to medium fiscal sustainability risks. This change in the long-term risk assessment, compared to the Commission's spring 2018 forecast, is due to a changed methodology. As recognised in the past (see Debt Sustainability Monitor 2017 — Box 3.2), the long-term fiscal sustainability risk indicator S2 relies on a well-grounded theoretical framework, i.e. the inter-temporal budget constraint. Yet, it largely abstracts from risks linked to high debt levels. Therefore, in order to improve the assessment of long-term fiscal risks, the revised methodology takes into account the DSA risk assessment. The Commission risk *classification* does not formally account for risks related to potential contingent liabilities stemming from the financial sector. However, the Commission framework includes an extensive analysis of such contingent liabilities, which is used in order to further qualify the *assessment*. In the case of Cyprus, the

([49]) This assessment also includes sensitivity analysis, i.e. several deterministic debt projections, as well as stochastic projections (for more details, see Debt Sustainability Monitor 2017).

identified risk factors refer in particular to a high share of NPLs in total loans and a relatively elevated theoretical probability of public finances being hit by more than 3 % of GDP in case of a systemic event involving banks excess losses and recapitalisation needs ([50]).

**Overall, the debt sustainability analysis shows that in the baseline scenario the debt-to-GDP ratio declines after the upward level shift in 2018.** However, there are large uncertainties surrounding these projections. In particular, public debt would still be high and remain vulnerable to unfavourable macroeconomic, fiscal and financial market shocks. As illustrated above, a scenario that combines these various adverse shocks could result in the debt ratio no longer being on a declining path over the projection period. These risks underscore the importance of maintaining fiscal discipline over the medium to long term in order to safeguard a declining trajectory of the debt-to-GDP ratio going forward. In addition, the baseline debt reduction path hinges on medium and long-term economic growth, which points to the need to persevere with the implementation of structural reforms in order to improve competitiveness and boost the potential GDP of the Cypriot economy.

([50]) In accordance with the Commission's systemic model of banking originated losses (Symbol), simulating the short- and medium-term fiscal impact of a financial crisis similar to the 2008 crisis. The short-term simulation is run on the basis of December 2017 data for the first quarter of 2019. Symbol estimates the public bailout required to keep the systemic banks open and sufficiently capitalised after applying the safety net tools (in the form of increasing capital requirements, bail-in and national and supranational resolution funds, being put in place gradually). For more details, see Debt Sustainability Monitor 2017 and Country Report Cyprus 2018 (Section 4.1.1).

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

| *Time period* | | | | No-policy-change scenario | | PPS fourth review (spring 2018) | |
|---|---|---|---|---|---|---|---|
| **Short-term** | | | | **HIGH risk** | | **LOW risk** | |
| | **S0 indicator** [1] | | | 0.46 | | 0.44 | |
| | Fiscal sub-index | | | 0.27 | LOW risk | 0.19 | LOW risk |
| | Financial & competitiveness sub-index | | | 0.57 | 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 | -0.6 | LOW risk |
| | *of which* | | | | | | |
| | | Required adjustment given initial budgetary position (IBP) | | -2.9 | | -3.5 | |
| | | Debt requirement | | 2.3 | | 3.0 | |
| | | Required adjustment due to cost of ageing (CoA) | | -0.1 | | -0.1 | |
| | | *of which* | | | | | |
| | | | Pensions | 0.5 | | 0.6 | |
| | | | Healthcare | 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] | | | -0.9 | | -1.3 | |
| | *of which* | | | | | | |
| | | Required adjustment given IBP | | -1.7 | | -2.2 | |
| | | Required adjustment due to CoA | | 0.9 | | 0.9 | |
| | | *of which* | | | | | |
| | | | Pensions | 1.7 | | 1.9 | |
| | | | Healthcare | 0.2 | | 0.3 | |
| | | | Long-term care | 0.2 | | 0.2 | |
| | | | Other | -1.3 | | -1.4 | |

[1] The S0 indicator, which captures short-term fiscal challenges, aims at the early detection of fiscal stress associated with fiscal risks within a one-year period 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 fundamentally differs 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 financial-competitiveness sub-indexes, the thresholds are 0.36 and 0.49* respectively.
[2] Debt sustainability analysis is performed based on 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 the medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to reduce 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 period (i.e. from 2020); it must then be 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, a value between which indicates medium risk. If S1 is below 0 or above 2.5, it indicates low and high risk respectively*.
[4] The S2 indicator is the long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite period, including the costs of ageing. The critical thresholds for S2 are 2 and 6, a value between which indicates medium risk. If S2 is below 2 or above 6, it indicates low and high risk respectively*, **.
* For more information, see the Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.
** The long-term assessment method has been revised to take into account the DSA risk assessment. HenceforthTherefore, in order to provide comparable results and take into account this revision, the spring 2018 long-term results have been here updated here compared in relation to the PPS fourth review to take into account this revision.
***Source:*** European Commission

# ANNEX 3

## European Commission macroeconomic and fiscal projections (2018 Autumn Forecast)

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

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| *Real economy* | | | *(percent change)* | | | | |
| Real GDP | -1.2 | 2.0 | 4.8 | 4.2 | 3.9 | 3.5 | 2.9 |
| Domestic demand incl. inventories | -1.8 | 3.9 | 6.1 | 8.3 | 4.7 | 4.6 | 3.5 |
| Total consumption expenditure | -0.8 | 1.9 | 3.5 | 3.9 | 3.7 | 3.9 | 3.0 |
| Private consumption expenditure | 1.2 | 2.4 | 4.5 | 4.1 | 4.2 | 3.8 | 3.1 |
| Government consumption expenditure | -5.3 | -0.5 | -0.8 | 3.1 | 1.7 | 4.1 | 2.4 |
| Gross fixed capital formation | -22.5 | 13.8 | 41.8 | 26.8 | 8.3 | 7.5 | 5.3 |
| Exports of goods and services | 4.5 | 5.2 | 4.6 | 6.0 | 6.2 | 1.7 | 1.7 |
| Imports of goods and services | 4.2 | 8.4 | 6.6 | 12.2 | 7.3 | 3.5 | 2.7 |
| *Contribution to growth* | | | *(percentage points)* | | | | |
| Domestic demand (excl. inventories) | -3.3 | 3.2 | 8.4 | 8.0 | 4.8 | 4.8 | 3.6 |
| Foreign trade | 0.4 | -1.9 | -1.3 | -4.1 | -1.0 | -1.3 | -0.7 |
| Changes in inventories | 1.6 | 0.6 | -2.3 | 0.3 | 0.0 | 0.0 | 0.0 |
| | | | | | | | |
| *Inflation* | | | *(percent change)* | | | | |
| GDP deflator | -1.8 | -1.2 | -0.6 | 1.5 | 2.1 | 1.3 | 1.7 |
| HICP | -0.3 | -1.5 | -1.2 | 0.7 | 0.8 | 1.3 | 1.4 |
| | | | | | | | |
| *Labour market* | | | *(percent change, unless otherwise stated)* | | | | |
| Unemployment rate (% of labour force) | 16.1 | 15.0 | 13.0 | 11.1 | 8.2 | 6.3 | 4.8 |
| Employment | -1.8 | 1.5 | 4.6 | 3.8 | 3.9 | 2.8 | 2.3 |
| Compensation per employee | -3.5 | -1.3 | -1.1 | 0.7 | 1.5 | 2.2 | 2.2 |
| Labour productivity | 0.7 | 0.5 | 0.2 | 0.4 | 0.4 | 1.0 | 0.9 |
| Unit labour costs | -4.2 | -1.7 | -1.4 | 0.4 | 1.5 | 1.5 | 1.6 |
| | | | | | | | |
| *Public finance* | | | *(percent of GDP)* | | | | |
| General government balance | -9.0 | -1.3 | 0.3 | 1.8 | 2.8 | 3.0 | 2.9 |
| Total revenue | 39.8 | 39.3 | 38.3 | 39.3 | 40.0 | 40.1 | 39.7 |
| Total expenditure | 48.8 | 40.6 | 38.0 | 37.5 | 37.2 | 37.0 | 36.8 |
| General government primary balance | -5.8 | 1.9 | 3.1 | 4.3 | 5.5 | 5.5 | 5.2 |
| Gross debt | 108.0 | 108.0 | 105.5 | 96.1 | 105.0 | 98.4 | 91.0 |
| | | | | | | | |
| *Balance of payments* | | | *(percent of GDP)* | | | | |
| Current external balance | -4.7 | -2.0 | -5.1 | -8.4 | -8.2 | -9.3 | -9.5 |
| Ext. bal. of goods and services | 1.8 | 0.2 | -0.6 | -3.5 | -3.2 | -4.3 | -4.6 |
| Exports goods and services | 62.0 | 64.5 | 64.5 | 65.0 | 65.8 | 64.7 | 63.8 |
| Imports goods and services | 60.3 | 64.3 | 65.1 | 68.5 | 68.9 | 69.0 | 68.4 |
| Balance of services | 17.7 | 16.9 | 20.4 | 20.8 | 19.6 | 19.5 | 19.3 |
| Balance of goods | -16.0 | -16.7 | -21.0 | -24.3 | -22.8 | -23.8 | -24.0 |
| Balance of primary income | -3.7 | 0.7 | -2.0 | -2.7 | -3.0 | -3.0 | -3.0 |
| Balance of secondary income | -2.8 | -2.9 | -2.5 | -2.1 | -2.0 | -1.9 | -1.8 |
| | | | | | | | |
| Memorandum item | | | *(EUR bn)* | | | | |
| Nominal GDP | 17.6 | 17.7 | 18.5 | 19.6 | 20.8 | 21.8 | 22.8 |

***Source:*** European Commission

Table A3.2: **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 | 4.2 | 3.8 | 3.1 |
| 2. Government consumption expenditure | -7.5 | -0.5 | -0.8 | 3.1 | 1.7 | 4.1 | 2.4 |
| 3. Gross fixed capital formation | -19.0 | 13.8 | 41.8 | 26.8 | 8.3 | 7.5 | 5.3 |
| 4. Domestic demand excl. inventories | -3.4 | 3.3 | 8.5 | 7.9 | 4.6 | 4.6 | 3.5 |
| 5. Changes in inventories (contr. to growth) | 1.6 | 0.6 | -2.3 | 0.3 | 0.0 | 0.0 | 0.0 |
| 6. Domestic demand incl. inventories | -1.8 | 3.9 | 6.1 | 8.3 | 4.7 | 4.6 | 3.5 |
| 7. Exports of goods and services | 4.3 | 5.2 | 4.6 | 6.0 | 6.2 | 1.7 | 1.7 |
| 7a. - of which goods | 2.1 | 1.7 | -8.9 | 0.3 | 20.9 | -0.7 | 0.2 |
| 7b. - of which services | 5.3 | 6.4 | 9.1 | 7.6 | 2.4 | 2.4 | 2.2 |
| 8. Final demand | 0.5 | 4.4 | 5.5 | 7.4 | 5.3 | 3.5 | 2.8 |
| 9. Imports of goods and services | 3.6 | 8.4 | 6.6 | 12.2 | 7.3 | 3.5 | 2.7 |
| 9a. - of which goods | 3.9 | 6.6 | 11.4 | 13.7 | 7.3 | 4.3 | 3.2 |
| 9b. - of which services | 3.3 | 10.5 | 1.5 | 10.5 | 7.2 | 2.5 | 2.1 |
| 10. GDP at market prices | -1.3 | 2.0 | 4.8 | 4.2 | 3.9 | 3.5 | 2.9 |
| *(Contribution to change in GDP)* | | | | | | | |
| 11. Final domestic demand | -3.3 | 3.2 | 8.4 | 8.0 | 4.8 | 4.8 | 3.6 |
| 12. Changes in inventories | 1.6 | 0.6 | -2.3 | 0.3 | 0.0 | 0.0 | 0.0 |
| 13. Net exports | 0.4 | -1.9 | -1.3 | -4.1 | -1.0 | -1.3 | -0.7 |

***Source:*** European Commission

Table A3.3: **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 | 5.1 | 5.1 | 4.5 |
| 2. Government consumption expenditure | -11.9 | -1.1 | -1.2 | 4.9 | 3.5 | 5.6 | 4.1 |
| 3. Gross fixed capital formation | -19.9 | 12.2 | 41.7 | 25.4 | 9.3 | 8.8 | 7.1 |
| 4. Domestic demand excl. inventories | -4.8 | 1.8 | 7.4 | 8.5 | 5.7 | 6.0 | 5.0 |
| 5. Changes in inventories (contr. to growth) | 0.1 | 0.2 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 |
| 6. Domestic demand incl. inventories | -3.3 | 2.4 | 5.0 | 8.9 | 5.7 | 6.0 | 5.1 |
| 7. Exports of goods and services | 2.7 | 4.8 | 4.2 | 6.7 | 7.4 | 3.1 | 3.3 |
| 7a. - of which goods | 3.5 | 2.5 | -9.8 | 0.7 | 22.0 | 0.5 | 2.0 |
| 7b. - of which services | 2.4 | 5.6 | 8.9 | 8.3 | 3.6 | 3.8 | 3.6 |
| 8. Final demand | -1.0 | 3.3 | 4.7 | 8.0 | 6.4 | 4.8 | 4.4 |
| 9. Imports of goods and services | 2.2 | 7.5 | 5.5 | 11.4 | 6.7 | 4.9 | 3.9 |
| 9a. - of which goods | -0.6 | 4.1 | 10.9 | 13.7 | 7.4 | 5.8 | 4.2 |
| 9b. - of which services | 5.6 | 11.4 | -0.1 | 8.7 | 5.9 | 3.7 | 3.4 |
| 10. Gross national income at market prices | -2.0 | 5.3 | 1.4 | 5.1 | 5.8 | 4.8 | 4.7 |
| 11. Gross value added at basis prices | -4.3 | 0.9 | 3.9 | 4.9 | 6.5 | 5.1 | 5.0 |
| 12. Gross domestic product at market prices | -2.9 | 0.8 | 4.2 | 5.8 | 6.1 | 4.8 | 4.7 |

***Source:*** European Commission

Table A3.4: **Implicit deflators**

| *percent change* | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| 1. Private consumption expenditure | -0.8 | -1.6 | -1.4 | 0.9 | 0.9 | 1.3 | 1.4 |
| 2. Government consumption expenditure | -4.8 | -0.6 | -0.4 | 1.8 | 1.8 | 1.4 | 1.6 |
| 3. Gross fixed capital formation | -1.1 | -1.4 | -0.1 | -1.1 | 1.0 | 1.2 | 1.7 |
| 4. Domestic demand incl. inventories | -1.5 | -1.5 | -1.0 | 0.6 | 1.0 | 1.3 | 1.5 |
| 5. Exports of goods and services | -1.5 | -0.4 | -0.3 | 0.6 | 1.1 | 1.3 | 1.5 |
| 6. Final demand | -1.5 | -1.0 | -0.7 | 0.6 | 1.1 | 1.3 | 1.5 |
| 7. Imports of goods and services | -1.4 | -0.8 | -1.0 | -0.7 | -0.5 | 1.3 | 1.1 |
| 8. Gross domestic product at market prices | -1.6 | -1.2 | -0.6 | 1.5 | 2.1 | 1.3 | 1.7 |
| HICP | -0.3 | -1.5 | -1.2 | 0.7 | 0.8 | 1.3 | 1.4 |

***Source:*** European Commission

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

| *Percent change unless otherwise stated* | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| 1. Labour productivity | 0.5 | 0.5 | 0.2 | 0.4 | 0.0 | 0.7 | 0.6 |
| 2. Compensation per employee | -3.5 | -1.3 | -1.1 | 0.7 | 1.5 | 2.2 | 2.2 |
| 3. Unit labour costs | -4.0 | -1.7 | -1.4 | 0.4 | 1.5 | 1.5 | 1.6 |
| 4. Total population | -1.1 | -0.6 | 0.5 | 0.9 | 0.6 | 0.7 | 0.6 |
| 5. Population of working age (15-64 years) | -2.1 | -1.6 | -0.1 | 0.3 | 0.3 | 0.3 | 0.4 |
| 6. Employment | -1.9 | 1.5 | 4.4 | 3.8 | 3.9 | 2.8 | 2.3 |
| 7. Unemployment rate (1) | 16.1 | 15.0 | 13.0 | 11.1 | 8.2 | 6.3 | 4.8 |

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

Table A3.6: **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 | 3.2 | 3.3 |
| 2. Imports of goods (fob) | 5.6 | 5.8 | 6.5 | 7.4 | 7.9 | 8.4 | 8.7 |
| 3. Trade balance (goods, fob/fob) (1-2) | -2.8 | -3.0 | -3.9 | -4.8 | -4.7 | -5.2 | -5.5 |
| *3.1 p.m. (3) as % of GDP* | -16.0 | -16.7 | -21.0 | -24.3 | -22.8 | -23.8 | -24.0 |
| 4. Exports of services | 8.1 | 8.6 | 9.3 | 10.1 | 10.5 | 10.9 | 11.3 |
| 5. Imports of services | 5.0 | 5.6 | 5.6 | 6.0 | 6.4 | 6.6 | 6.9 |
| 6. Service balance (4-5) | 3.1 | 3.0 | 3.8 | 4.1 | 4.1 | 4.2 | 4.4 |
| *6.1 p.m. 6 as % of GDP* | 17.7 | 16.9 | 20.4 | 20.8 | 19.6 | 19.5 | 19.3 |
| 7. External balance of goods and services (3+6) | 0.3 | 0.0 | -0.1 | -0.7 | -0.7 | -0.9 | -1.1 |
| *7.1 p.m. 7 as % of GDP* | 1.8 | 0.2 | -0.6 | -3.5 | -3.2 | -4.3 | -4.6 |
| 8. Balance of primary and secondary incomes | -1.1 | -0.4 | -0.8 | -0.9 | -1.1 | -1.1 | -1.1 |
| *8.1 - of which, balance of primary income* | -0.6 | 0.1 | -0.4 | -0.5 | -0.6 | -0.7 | -0.7 |
| *8.2 - of which, balance of secondary income* | -0.5 | -0.5 | -0.5 | -0.4 | -0.4 | -0.4 | -0.4 |
| *8.3 p.m. 8 as % of GDP* | -6.4 | -2.2 | -4.5 | -4.8 | -5.1 | -5.0 | -4.8 |
| 9. Current external balance (7+8) | -0.8 | -0.4 | -0.9 | -1.6 | -1.7 | -2.0 | -2.2 |
| *9.1 p.m. 9 as % of GDP* | -4.7 | -2.0 | -5.1 | -8.4 | -8.2 | -9.3 | -9.5 |
| 10. Net capital transactions | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 11. Net lending (+)/net borrowing (-) (9+10) | -0.8 | -0.3 | -0.9 | -1.6 | -1.7 | -2.0 | -2.2 |
| *11.1 p.m. 11 as % of GDP* | -4.7 | -1.7 | -4.9 | -8.2 | -8.1 | -9.3 | -9.5 |

***Source:*** European Commission

Table A3.7: **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 | 3,382 | 3,539 | 3,668 |
| Taxes on income and wealth | 1,812 | 1,761 | 1,755 | 1,835 | 1,948 | 2,023 | 2,100 |
| Social contributions | 1,445 | 1,483 | 1,545 | 1,710 | 1,880 | 2,073 | 2,178 |
| Other current resources | 1,028 | 1,024 | 1,005 | 998 | 1,016 | 1,002 | 1,009 |
| **Total current revenue** | 6,884 | 6,876 | 7,043 | 7,599 | 8,227 | 8,637 | 8,954 |
| Capital transfers received | 130 | 101 | 43 | 89 | 89 | 89 | 89 |
| **Total government revenue** | 7,014 | 6,976 | 7,086 | 7,688 | 8,317 | 8,727 | 9,044 |
| Compensation of employees | 2,341 | 2,271 | 2,260 | 2,354 | 2,477 | 2,627 | 2,773 |
| Intermediate consumption | 625 | 655 | 625 | 708 | 740 | 776 | 787 |
| Social transfers | 2,469 | 2,468 | 2,564 | 2,620 | 2,696 | 2,781 | 2,884 |
| Interest payments | 557 | 566 | 510 | 504 | 551 | 533 | 513 |
| Subsidies | 80 | 72 | 97 | 55 | 56 | 56 | 57 |
| Other current expenditure | 395 | 463 | 397 | 464 | 513 | 533 | 563 |
| **Total current expenditure** | 6,466 | 6,495 | 6,453 | 6,705 | 7,033 | 7,306 | 7,578 |
| Total capital expenditure | 2,125 | 718 | 574 | 639 | 694 | 758 | 804 |
| **Total government expenditure** | 8,592 | 7,213 | 7,027 | 7,344 | 7,727 | 8,064 | 8,382 |
| General government balance | -1,577 | -236 | 59 | 344 | 589 | 663 | 662 |
| General government primary balance | -1,021 | 330 | 569 | 849 | 1,140 | 1,196 | 1,175 |
| | | | % of GDP | | | | |
| Taxes on production and imports | 14.8 | 14.7 | 14.8 | 15.6 | 16.3 | 16.3 | 16.1 |
| Taxes on income and wealth | 10.3 | 9.9 | 9.5 | 9.4 | 9.4 | 9.3 | 9.2 |
| Social contributions | 8.2 | 8.4 | 8.4 | 8.7 | 9.1 | 9.5 | 9.6 |
| Other current resources | 5.8 | 5.8 | 5.4 | 5.1 | 4.9 | 4.6 | 4.4 |
| **Total current revenue** | 39.1 | 38.7 | 38.1 | 38.8 | 39.6 | 39.7 | 39.3 |
| Capital transfers received | 0.7 | 0.6 | 0.2 | 0.5 | 0.4 | 0.4 | 0.4 |
| **Total government revenue** | 39.8 | 39.3 | 38.3 | 39.3 | 40.0 | 40.1 | 39.7 |
| Compensation of employees | 13.3 | 12.8 | 12.2 | 12.0 | 11.9 | 12.1 | 12.2 |
| Intermediate consumption | 3.6 | 3.7 | 3.4 | 3.6 | 3.6 | 3.6 | 3.5 |
| Social transfers | 14.0 | 13.9 | 13.9 | 13.4 | 13.0 | 12.8 | 12.7 |
| Interest payments | 3.2 | 3.2 | 2.8 | 2.6 | 2.7 | 2.4 | 2.2 |
| 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 | 2.5 | 2.4 | 2.5 |
| **Total current expenditure** | 36.7 | 36.6 | 34.9 | 34.3 | 33.9 | 33.6 | 33.2 |
| Total capital expenditure | 12.1 | 4.0 | 3.1 | 3.3 | 3.3 | 3.5 | 3.5 |
| **Total government expenditure** | 48.8 | 40.6 | 38.0 | 37.5 | 37.2 | 37.0 | 36.8 |
| General government balance | -9.0 | -1.3 | 0.3 | 1.8 | 2.8 | 3.0 | 2.9 |
| General government primary balance | -5.8 | 1.9 | 3.1 | 4.3 | 5.5 | 5.5 | 5.2 |
| Nominal GDP | 17.6 | 17.7 | 18.5 | 19.6 | 20.8 | 21.8 | 22.8 |

***Source:*** European Commission

Table A3.8: **Debt developments**

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| Gross debt (% of GDP) | 108.0 | 108.0 | 105.5 | 96.1 | 105.0 | 98.4 | 91.0 |
| Real GDP growth (% change in PYP) | -2.5 | 0.3 | 3.6 | 3.6 | 5.5 | 5.7 | 4.2 |
| Nominal GDP (EUR bn) | 17.6 | 17.7 | 18.5 | 19.6 | 20.8 | 21.8 | 22.8 |
| General government balance (% of GDP) | -9.0 | -1.3 | 0.3 | 1.8 | 2.8 | 3.0 | 2.9 |
| | | | | | | | |
| Change in gross debt ratio (pps change) | 4.9 | 0.0 | -2.5 | -9.4 | 8.8 | -6.6 | -7.3 |
| | | | Contribution to the change in stock | | | | |
| Primary balance | 5.8 | -1.9 | -3.1 | -4.3 | -5.5 | -5.5 | -5.2 |
| Snow-ball effect | 6.3 | 2.3 | -1.6 | -3.2 | -2.9 | -2.4 | -2.2 |
| of which | | | | | | | |
| Interest expenditure | 3.2 | 3.2 | 2.8 | 2.6 | 2.7 | 2.4 | 2.2 |
| Real growth effect | 1.4 | -2.1 | -5.0 | -4.2 | -3.5 | -3.5 | -2.7 |
| Inflation effect | 1.7 | 1.3 | 0.6 | -1.6 | -2.0 | -1.3 | -1.7 |
| Stock-flow adjustments | -7.2 | -0.5 | 2.2 | -1.8 | 17.2 | 1.3 | 0.0 |

***Source:*** European Commission

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