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Post-Programme Surveillance Report

Cyprus, Spring 2017

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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

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

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

RoA: Return on assets

RoE: Return on equity

SB: Structural balance

SGP: Stability and Growth Pact

SMEs: Small and medium-sized enterprises

SOEs: State-owned enterprises

SRB: Single Resolution Board

SREP: Supervisory Review and Evaluation Process

SSM: Single Supervisory Mechanism

SWF: Sovereign Wealth Fund

TSOCy: Transmission System Operator of Cyprus

VAT: Value-added tax

VET: Vocational and Educational Training

EXECUTIVE SUMMARY

This report presents the findings of the second post-programme surveillance (PPS) mission of Commission staff, in liaison with staff from the European Central Bank (ECB), which took place in Cyprus from 27 to 31 March. The mission was coordinated with an International Monetary Fund (IMF) Post-Programme Monitoring (PPM) mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System.

Cyprus is currently benefiting from robust growth and improving conditions in the financial sector. To sustain growth in the future, continued fiscal discipline and a renewed structural reform momentum are crucial. Fiscal consolidation has helped strengthen the credibility of the policy framework and facilitate market access of the sovereign. Important structural reforms adopted in recent years and during the economic adjustment programme have allowed Cyprus to turn the corner, with growth returning and the labour market situation improving. At this juncture, it is crucial to safeguard and build upon these hard earned achievements. On the fiscal side, the increased expenditure pressure should be resisted, allowing for the creation of fiscal space for growth-enhancing public spending. On the structural side, on the back of a noticeably weakening reform momentum, the mission encouraged the authorities and other key stakeholders to renew their efforts to improve Cyprus's growth potential and attract more productivity-enhancing investment.

Growth picked up in 2016 and is expected to remain strong in 2017, while moderating thereafter. Growth is becoming more broad-based, driven by private consumption, investment and strong tourism. Labour market conditions have improved overall in 2016, though the unemployment rate remains high, particularly among the young. Real GDP growth is expected to be 2½% in 2017. However, limited productivity-enhancing investment, insufficient structural reforms, and the persistently high level of private debt continue to weigh on growth prospects.

While fiscal performance has been stronger than expected, supported by robust economic growth, pressures for fiscal relaxation are rising. Despite strong economic growth, the budget for 2017 targets a decline in the primary surplus. This is partly due to the abolition of the Immovable Property Tax, which has narrowed the tax base. Moreover, the pressure for fiscal relaxation has increased; this should be resisted as medium-term fiscal risks remain significant and the downward path of public debt has not yet been firmly anchored. In this context, the authorities should ensure compliance with the provisions under the preventive arm of the Stability and Growth Pact. Strengthening fiscal sustainability also implies a need to contain the public sector wage bill, including by introducing a permanent mechanism to moderate wage growth. A thorough fiscal impact analysis should accompany draft legislation on reforms, including the healthcare reform, to ensure consistency with the existing fiscal space. Looking forward, it will be crucial to increase fiscal space to create the conditions allowing for additional growth-enhancing measures, including higher productivity-enhancing public investment and research and development spending. This could be achieved by broadening the tax base and better prioritising public expenditures.

Important, albeit uneven progress has been made in resolving non-performing loans (NPLs), which remain very high. Strengthening confidence has allowed banks to broaden their deposit base and to improve liquidity and capital buffers. A noteworthy positive development is also the full repayment in January 2017 of the substantial Emergency Liquidity Assistance that had been granted to a Cypriot bank. New lending is picking up from a low base, but the outstanding stock of credit to the economy continues to contract due to necessary balance sheet deleveraging and the workout of NPLs. Banks' profitability is constrained by pressure on net interest margins amid ongoing deleveraging and the need for additional provisioning. The mission recommended more forceful loan restructuring efforts, notably by making full use of all available tools, in order to accelerate the pace of NPL reduction. Moreover, the prevalence of restructurings of already restructured loans suggests that the quality of restructuring solutions needs to be further enhanced. More vigorous efforts by the authorities and the banks are also necessary to increase the implementation and use of the insolvency and foreclosure frameworks. These frameworks have created incentives for borrowers to repay or to seek cooperative restructuring solutions. Nevertheless, a more forceful application would further strengthen these incentives and contribute to reducing strategic defaults. The mission notably highlighted the need to make insolvency-related legal proceedings more efficient, in order to accelerate the deleveraging process.

Renewing the structural reform momentum should be a high priority to enhance long-term growth and fiscal sustainability. The House of Representatives has rejected key reforms, such as the comprehensive reform of the public administration and the privatisation of major state-owned entities. These should remain policy priorities to support fiscal sustainability and long-term growth. To further improve the business environment and attract more investment, progress needs to be made in several essential areas, most notably the modernisation of the justice system, including by establishing a commercial court. Other priorities include a more forceful implementation of the government's action plan for growth, the reform of the electricity market, and the creation of a sustainable and efficient title deeds issuance and transfer system.

Risks for Cyprus's capacity to service its debt to the European Stability Mechanism (ESM) remain low. The State's cash position is expected to remain sufficient until 2018 thanks to a prudent public debt management policy. Borrowing conditions for Cyprus have improved, driven largely by European and global factors. Medium-term financing needs, particularly in 2019 and 2020, remain high. To ensure that they do not pose new challenges later on, continued fiscal discipline and the resumption of efforts towards adopting growth-enhancing structural reforms are required. The debt sustainability analysis shows that the public debt-to GDP ratio should decrease in the medium-term but will remain vulnerable to macro-economic and financial-market shocks.

The next PPS mission will take place in fall 2017.

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1. INTRODUCTION

Cyprus implemented an economic adjustment programme from April 2013 to March 2016. The three-year programme was approved by the ECOFIN Council and the IMF Board in March 2013. The programme provided financing by the European Stability Mechanism (ESM) and the IMF of about EUR 7.8bn. Its objective was to put Cyprus' public finances back on a sustainable path, ensure financial stability, implement structural reforms to restore competitiveness, and regain international capital market access at sustainable rates.

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the second post-programme surveillance (PPS) mission to Cyprus between 27 and 31 March 2017. The mission was coordinated with an IMF Post-Programme Monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country having received financial assistance([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

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

2. MACROECONOMIC OUTLOOK

Strong growth in 2016

The robust and broad-based economic recovery has continued in 2016, with real GDP growth reaching 2.8%. This GDP growth rate was well above the euro area average and confirmed the recovery path after three years of contraction during the crisis. Private consumption was supported by falling prices, increasing employment and rising disposable income. Investment surprised on the upside, surging by 26% compared to 2015, with a few very sizeable registrations of ships adding to the gradual revival of investment in the real economy. These transport equipment registrations also had a major impact on goods imports, which increased by nearly 11% yoy. As a result, the overall contribution to growth from net exports was negative despite strong exports. Exports particularly benefitted from the record-high tourism season (revenues from tourism exceeded 13% of GDP in 2016).

Investment outperformed in 2016. Investment in Cyprus suffered a sharp fall during the crisis and is forecast to gradually recover towards its long-term average. The clear upward trend in investment in housing and other construction, observed in 2016, is expected to continue as the real estate market picks up. While there is large uncertainty surrounding the investment outlook, given its volatility linked to ship registrations, the gradual easing of bank lending conditions, increasing foreign direct investment and improving confidence in the economy are expected to sustain the positive investment momentum.

Business and consumer confidence indicators have improved substantially in 2016. The economic sentiment indicator was on a steady rise in 2016 and further improved in the first quarter of 2017, surpassing its pre-crisis levels. The build-up in confidence across sectors suggests a continuation of the growth momentum.

Growth outlook

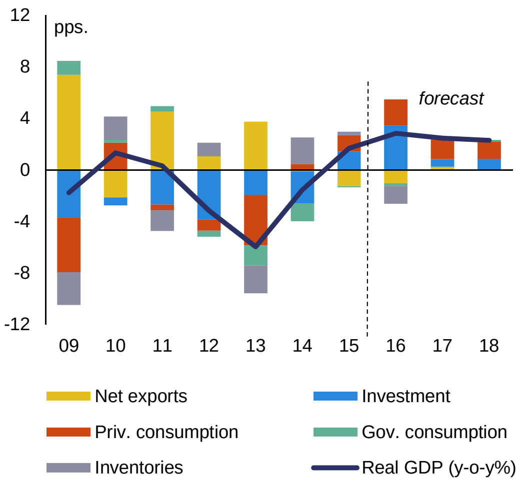
Growth is expected to remain strong while decelerating gradually. Medium-term growth is held back by high private sector debt and NPL ratios as well as weaknesses in the business environment and the loss in the momentum of structural reforms. Overall, this suggests a gradual deceleration of growth over the next years.

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

		2015		2013	2014	2015	2016	2017	2018
		Curr. prices (EUR m)	% of GDP	Annual percentage change					
GDP		17.6	100	-6.0	-1.5	1.7	2.8	2.5	2.3
Private consumption		12.3	69.5	-5.9	0.7	1.9	2.9	2.1	1.9
Public consumption		2.8	15.7	-8.2	-7.9	-0.6	-1.4	0.7	0.8
Gross fixed capital formation		2.3	13.3	-12.9	-17.5	12.0	25.9	3.4	4.9
Exports (goods and services)		10.8	61.2	2.1	4.2	0.0	3.6	3.3	3.2
Imports (goods and services)		10.7	60.9	-4.8	4.6	2.1	5.3	2.9	3.2
GNI (GDP deflator)		17.6	99.6	-7.5	-0.6	5.2	0.4	2.5	2.3
Contribution to growth:	Domestic demand			-7.4	-3.4	2.6	5.2	2.2	2.3
	Inventories			-2.2	2.1	0.3	-1.4	0.0	0.0
	Net exports			3.7	-0.1	-1.3	-1.0	0.3	0.0
Employment				-5.9	-1.8	1.9	2.7	2.3	1.9
Unemployment (1)				15.9	16.1	15.0	13.1	11.7	10.6
Compensation per employee				-5.4	-3.8	-1.1	-0.6	0.7	1.1
Unit labour costs, whole economy				-5.4	-4.0	-0.9	-0.7	0.6	0.8
Real unit labour costs				-4.4	-2.6	0.4	0.6	-0.2	-0.1
GDP deflator				-1.0	-1.5	-1.3	-1.3	0.8	0.9
Harmonised index of consumer prices				0.4	-0.3	-1.5	-1.2	1.2	1.1
Terms of trade				0.2	7.1	3.2	-0.4	0.2	-0.5
Trade balance (goods and services) (2)				-16.2	-16.0	-18.0	-21.2	-22.2	-22.9
Current account balance (3)				-4.9	-4.4	-3.0	-5.7	-5.9	-6.3

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

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



Source: European Commission

In 2017, real GDP growth is forecast at 2.5%, mainly driven by domestic demand. Private consumption is expected to be the engine of growth, fuelled by demand pent up during the crisis years and some significant increase in employment in 2016. Real disposable income is, however, expected to remain stable as, on the one hand, inflation returns to positive territory and, on the other hand, wages grow more strongly. Some support for growth is set to come from government consumption, which is expected to start growing after five years of contraction, and net exports.

In 2018, real growth is forecast to further ease to 2.3%. The main drivers are expected to be private and public consumption as well as investment. As unit labour costs are forecast to rise, the contribution of net exports is expected to become neutral.

Risks to the outlook are on the upside in the short term, and balanced in the medium term. Early indications point to a strong tourism season in 2017, amid ongoing flows from Russia and other countries and with limited impact so far from the depreciation of the pound sterling on tourists from the UK. Over the medium-term, the risks are balanced. Rising domestic confidence, the EU economic recovery and an acceleration of structural reforms could spur growth more than expected, but competition from other tourist destinations could turn out to be greater than anticipated.

Growth has become more broad based

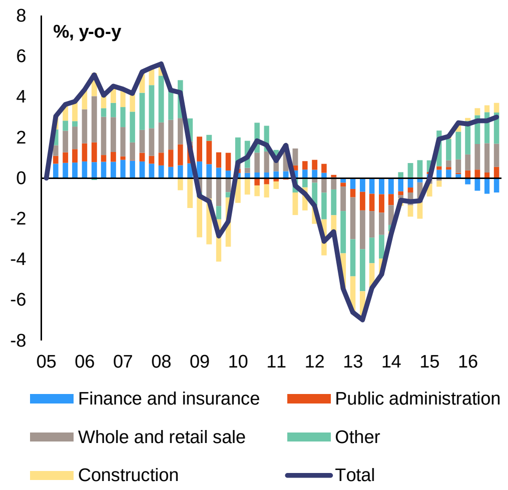
The Cypriot economy continues its rebalancing and the recovery has become more broad-based. In 2016, all sectors except the financial and information and communication sectors contributed to growth (Graph 2.2). Before the crisis, the economy heavily relied on financial services, tourism, construction and business services (Graph 3.3.). The booming tourism is generating an increasingly higher share of value added in related sectors, while construction and real estate-linked activities are very slowly regaining lost ground. New sectors, such as light manufacturing, are becoming more important, contributing to a diversification of the economy.

Tourism has become a key driver of growth but the potential for further strong growth in this sector is limited. Wider air connectivity, extension of the tourist season to the so-called 'shoulder months' and stronger marketing efforts combined with the geopolitical problems in competing destinations led to an all-time high tourism season in 2016. Tourist arrivals soared by 20% to 3.2 million and revenues increased by 12%. As a result, the sector was operating at nearly full capacity. Supply has responded to the new business opportunities and accommodation capacity has been expanded over late-2016 to early-2017, adding some 5% to the existing stock, but further capacity expansion possibilities may be limited. The first quarter of 2017 had a good start, with tourist arrivals increasing by 13.5% y-o-y. To further strengthen the sector, the establishment of a Deputy Ministry for Tourism has been envisaged. This would allow for a better coordination across the government of efforts to promote tourism, notably in view of implementing the upcoming long-term tourism strategy.

The construction sector is recovering, albeit from a very low base compared to the historical average. In 2016, construction was largely concentrated in hotel and housing renovations. The increase in cement sales and a jump in building permits in the last quarter of 2016 suggest that construction activity is accelerating and can be expected to expand further in 2017, including into new construction. Architect services, another indicator of real estate market activity, have witnessed a sharp increase in demand. Real estate prices seem to have finally stabilised, after adjusting down by roughly a third from their peak levels in 2008. The Eurostat indicator tracing real property prices recorded a 2.8% y-o-y hike in the fourth quarter of 2016.

Financial services, and notably banks, continued their downsizing. Banks are still heavily burdened with non-performing loans, despite restructuring efforts, and continue deleveraging. Given that non-performing loans are concentrated in the construction and real estate sectors, improvement in these sectors may accelerate the recovery of the financial sector.

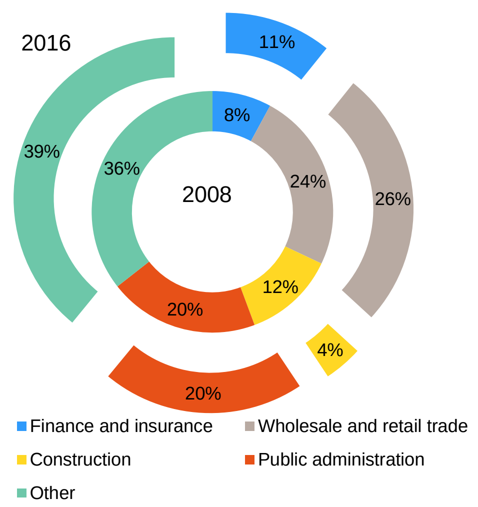
Graph 2.2: **Gross value added and contributions to growth**



Source: Eurostat

The promotion of the shipping industry has become a political priority. The establishment of the Deputy Ministry for Shipping, which is being discussed in the House of Representatives, aims to provide a boost to the industry. The Government's ambition is to expand its merchant fleet, becoming the tenth largest in the world and the third largest in the EU. It is also to expand the range of activities away from the current focus on ship registration, towards services that could have a broader impact on the domestic economy, including ship management, engineering, ship repair and ancillary services.

Graph 2.3: **Structure of the economy 2016 vs 2008**



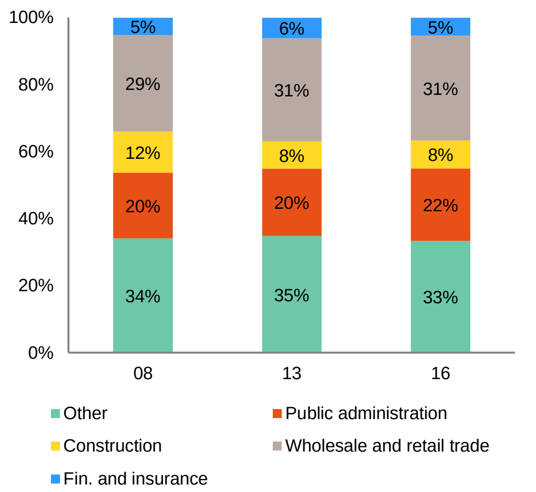
% of GVA, current prices
Source: Eurostat

Improving Labour Market

Employment increased by 2.7% in 2016, with gains across all sectors. It was particularly strong in professional, scientific, technical activities and ICT sectors, which all recorded around 5% y-o-y growth. Employment growth was also solid in sectors that suffered hefty job losses during the crisis, such as industry, construction and manufacturing (in a range of 2-3%). The exceptional tourism season added many jobs in trade, transport, accommodation and food services. Public sector employment was almost stable in 2016, as the recruitment of professional soldiers was offset by the hiring freeze and the natural retirement process. The positive general trend in employment expectations has continued since 2013, with significant improvement recorded in construction and services sectors in early 2017. With the ongoing recovery, job creation is expected to continue in the coming years.

The unemployment rate fell substantially, from 15.0% in 2015 to 13.1% in 2016. This decline was somewhat smaller than expected, as discouraged workers have started returning to the active labour force, once the improving economy brought more jobs. However for some groups, notably young people and long-term unemployed, the situation has not improved and the unemployment rate remains stubbornly high, at close to 30% and nearly 6% respectively. The unemployment rate is expected to gradually decline to 10.6% in 2018.

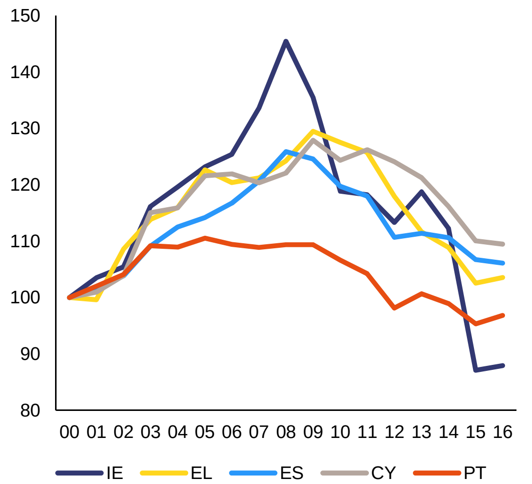
Graph 2.4: **Employment by sector**



Source: European Commission

Unit labour costs continued to fall in 2016. This can be attributed to the still high unemployment, which limits the scope for fast wage increases, and to the aforementioned new jobs in construction, industry and manufacturing, sectors which typically provide low-skilled jobs at lower initial wages. A new collective agreement on public sector wages, which caps the increase in total public wage bill to that of nominal GDP, but allows wage rises within the cap, created certain expectations in the private sector. Unions have entered negotiations with employers, but until now only hoteliers have reached an agreement with a partial reinstatement of wage increases. Meanwhile, negotiations in several other sectors, including banking and construction, are ongoing. The risk of significant wage increases continues to be relatively limited in the short term given some prevailing slack in the economy, but it may be influenced by the political cycle.

Graph 2.5: **Real Effective Exchange Rate, Unit Labour Costs-based**



Source: European Commission

Productivity in 2016 has remained broadly stable, with notable differences across sectors. Several sectors have increased productivity, in particular trade, transport, accommodation, food services, construction, manufacturing and professional business services. Meanwhile the financial sector continued to experience a sharp fall in productivity. Productivity in the public sector remained broadly unchanged.

External position deteriorates

1. **The external position has deteriorated in 2016 with the current account deficit widening to -5.7% of GDP.** While Cyprus's current account balance is strongly influenced by the volatility in trade surplus related to transport equipment registrations, the underlying trend needs to be carefully monitored. Maintaining the underlying trend of a positive trade balance is of particular importance given the highly negative net international investment position, which remains at -125% of GDP([2]).

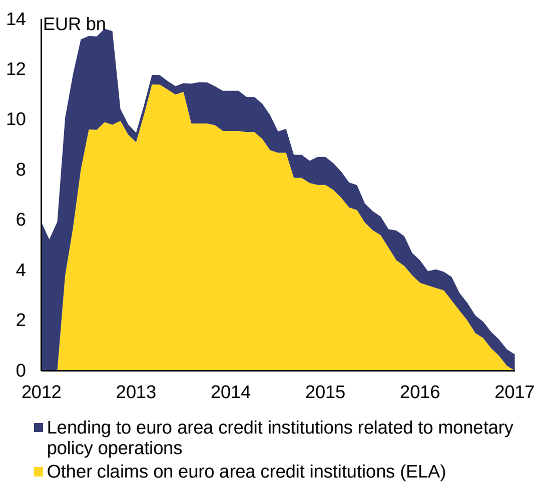
([2]) This is mitigated to some extent by the fact that around half is accounted for by the special purpose entities (SPEs), which have limited impact on Cyprus' economy

3. FINANCIAL SECTOR ISSUES

The financial sector continues to improve its fundamentals with stronger liquidity and capitalisation, and lower non-performing loans. Confidence is returning, providing banks with ample liquidity and reducing reliance on central bank funding. Banks continue to improve their capital buffers and deleverage, although the latter plays a role in limiting the growth of credit supply. There are encouraging signs regarding the level of NPLs, which fell by about EUR 3 bn in 2016, but progress was very uneven across banks. More forceful and higher-quality loan restructuring is necessary, including by increasing the use of the insolvency and foreclosure frameworks.

3.1. LIQUIDITY AND LENDING

Graph 3.1: **Borrowing from the Eurosystem**

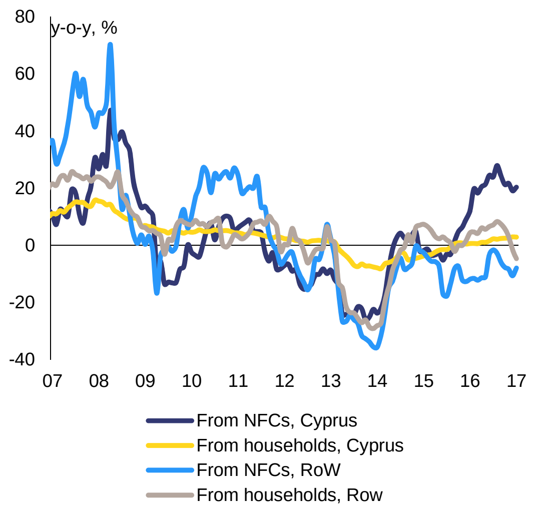


Source: Central Bank of Cyprus

Strong deposit inflows allowed banks to eliminate almost entirely their reliance on central bank funding. As of end of March 2017, central bank net borrowing by Cypriot banks stood at EUR -1.4 bn. Negative borrowing means a larger use of the deposit facility than of the regular open market operations and reflects the structural liquidity surplus prevailing for the Cypriot banking system as a whole. Bank of Cyprus fully repaid the Emergency Liquidity Assistance (ELA) in January 2017, and since then uses only regular open market operations. Deposits rose by about EUR 3 bn in 2016 (Graph 3.2), as domestic residents increased their deposits by EUR 3.6 bn while non-residents reduced theirs by EUR 1.1 bn. Differences on the remuneration rate applied by Cypriot banks are triggering a small redistribution of deposits within the banking system.

Lending remains subdued despite growing demand for loans as the deleveraging process continues. The gross stock of loans to domestic residents contracted by 8.5% in 2016. While the stock of household loans declined at a relatively slow pace in comparison with previous years, the contraction of lending to non-financial corporates (NFCs) accelerated. This decline reflects primarily the growing use of debt-to-asset swaps and debt write-offs by banks in order to reduce their non-performing exposures, and to a lesser extent loan repayments. In addition, the accrual of interest on non-provisioned NPLs understate the downsizing of loan exposures, since capitalised interest payments appear in the statistics as an increase in loans outstanding.

Graph 3.2: **Deposits developments**



Source: Central Bank of Cyprus

While the outstanding stock of credit continues to decline, new lending is gradually picking up. The Bank Lending Survey showed that credit standards for loans to both NFCs and households remained tight but stable for several quarters despite growing demand for loans. At the same time, the terms and conditions for loans continued to improve, notably due to decreasing interest margins. The slow lending activity (Graph 3.3)

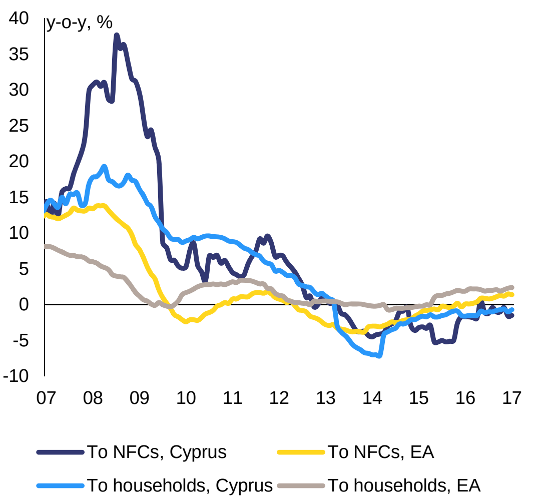
Table 3.1: **Financial Soundness Indicators - Cyprus banking sector**

	2013				2014				2015				2016			
	Mar	Jun	Sep	Dec	Mar	June	Sep	Dec	Mar	June	Sep	Dec	Mar	June	Sep	Dec
NPLs, all loans (% of total)	24.7	30.6	37.3	41.5	43.8	46.4	48.5	47.8	46.1	46.3	47.8	45.8	48.4	49.4	48.6	47.0
NPLs, legal entities (% of total)		30.2	39.7	44.4	45.6	49.1	50.4									
NPLs, loans to NFCs (% of total)								58.0	55.8	55.7	57.0	56.0	55.1	58.3	56.9	56.0
Restructured non-performing (% of total)		8.4	10.9	12.5	14.2	14.6	14.1	23.3	22.4	24.0	25.3	25.9	26.3	27.7	26.9	25.6
Restructured performing (% of total)		15.1	13.7	12.2	11.2	10.2	10.0	5.3	5.4	7.9	7.0	7.5	7.8	9.1	9.1	9.4
NPLs, loans to households (% of total)		35.1	39.4	43.3	47.6	49.4	50.8	52.7	53.9	54.9	56.1	56.2	56.4	56.3	56.6	56.6
Restructured non-performing (% of total)		2.7	4.6	6.7	8.8	8.5	8.4	13.9	15.0	16.5	17.9	18.0	19.0	19.7	20.3	20.0
Restructured performing (% of total)		11.9	12.0	10.4	11.0	10.3	9.1	8.9	8.3	8.6	7.4	6.7	6.2	6.7	7.2	7.8
Provisioning Coverage rate				37.7		35.8	36.3	32.9	32.6	33.1	33.2	37.8	37.1	37.9	38.6	41.2
Cost-to-income ratio	49.9	52.4	53.4	53.4	37.9	37.0	39.3	40.4	41.2	35.3	43.4	44.1	54.2	52.4	52.3	52.3
Net interest margin	1.7	2.0	2.3	2.4	3.1	3.2	3.1	2.9	3.0	2.8	2.8	2.8	2.8	2.7	2.5	2.6
Core Tier 1 ratio	12.1	11.9	11.6	12.1	12.5	12.9	14.8	14.2	14.3	15.1	15.3	15.6	15.4	15.7	16.0	16.1
Return on assets	-5.4	-3.4	-2.5	-4.3	0.1	0.3	0.1	-0.6	0.8	0.7	0.2	-0.5	0.7	0.8	0.6	0.3

Note: The NPL definition and reporting standards changed in December 2014. Since then the categories "loans to legal entities" and "loans to private individuals" include respectively loans to non-financial companies and loans to households only. This explains the break in the data series, namely with respect to the performing restructured loans to NFCs and private individuals. The category "all loans" includes loans to public entities as well as financial corporations.
Source: Central Bank of Cyprus

despite the pick-up in loan demand illustrates the high degree of indebtedness of the private sector and the banks' efforts to maintain prudent credit standards despite the increase in their pool of liquidity.

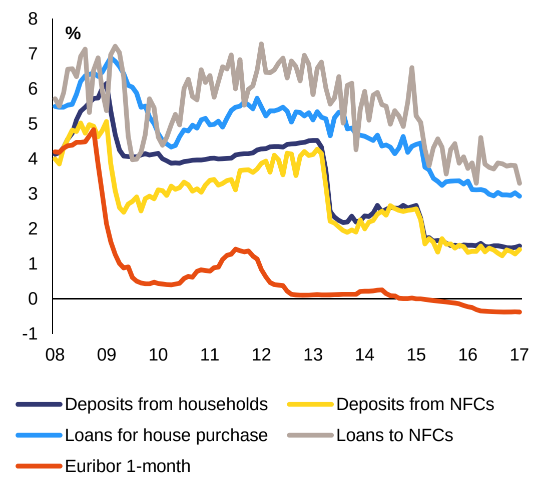
Graph 3.3: **Credit developments**



Source: Central Bank of Cyprus

Interest rates continue to decline, both on deposits and loans. In 2015 the CBC narrowed the allowed maximum spread between Libor and deposit interest rates from 300 to 200 basis points. This action contributed to a sharp decline of both deposit and lending rates, and in particular of the latter, which put additional pressure on the banks' net interest income. In 2016, the decline in interest rates slowed down to about 15 bps for deposits and 25 bps for loans on average (Graph 3.4). Given that some domestic institutions hold a relatively large share of liquid assets and the lending activity is slow to pick up, there may be room for a further reduction of interest rates on deposits that could contribute to a return to sustainable profitability.

Graph 3.4: **Interest rates developments**



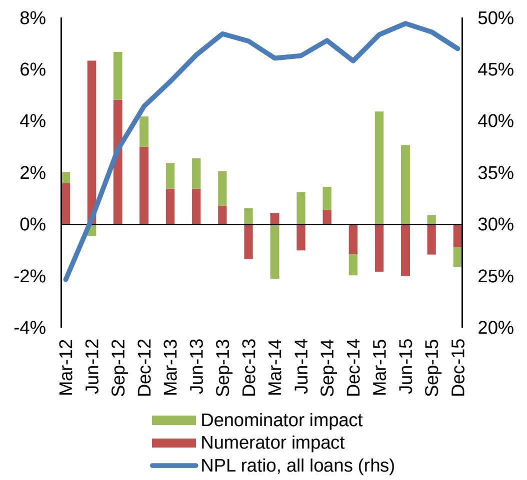
Source: Central Bank of Cyprus

3.2. ASSET QUALITY

The stock of non-performing loans declined by 11% in 2016 but remains very high. The overall NPL ratio declined to 47.0% of gross loans at end-2016 from a peak of 49.7% in May 2016. The NPL ratio remains above the end-2015 level as, since then, the stock of outstanding credit decreased faster than the stock of NPLs. The progress in reducing the stock of NPLs was driven primarily by the migration of restructured NPLs to performing status. Loan write-offs and disposals also played a significant role, including most notably debt-to-asset swaps. This was facilitated by a significant increase in provisions at end-2015 as recommended during the Supervisory Review and Evaluation Process (SREP) exercise conducted by the ECB. The reduction of the stock of NPLs was more important for corporate exposures and accelerated in the second half of 2016. To achieve similar results for households NPLs, a more determined use of the foreclosure and insolvency frameworks is warranted. Growth in the total volume of loan restructuring decelerated substantially in 2016, as the volume of newly restructured loans (i.e. the inflow) was not enough to offset the volume of maturing loans, disposals and write-offs (i.e. the outflow).

The improvement in asset quality is material, albeit uneven among banks. Bank of Cyprus succeeded in materially lowering its stock of NPLs by 21% in 2016. Hellenic Bank also achieved a double-digit reduction of its NPL stock (-12%). By contrast, the NPL stock at the Cooperative Group declined only by 5%. In order to speed-up NPL resolution, Hellenic Bank announced the creation of a joint venture with a specialised loan servicer. Although NPLs would remain on Hellenic Bank's balance sheet, their management would be completely separated, allowing the bank to focus on expanding healthy operations. The Cooperative Group has shown interest in creating a similar structure. This could be a positive development, as the presence of external debt servicers in Cyprus might eventually facilitate the sale of NPLs to distressed debt investors. Going forward, there appears to be varying degrees of ambition between the banks' NPLs reduction strategies. The CBC is therefore examining ways to encourage debt restructuring, including revising its targeting framework consistently with the recent guidelines issued by the ECB. The latter notably recommend that banks adopt an NPL strategy, including time-bound quantitative NPL targets and a related operational plan.

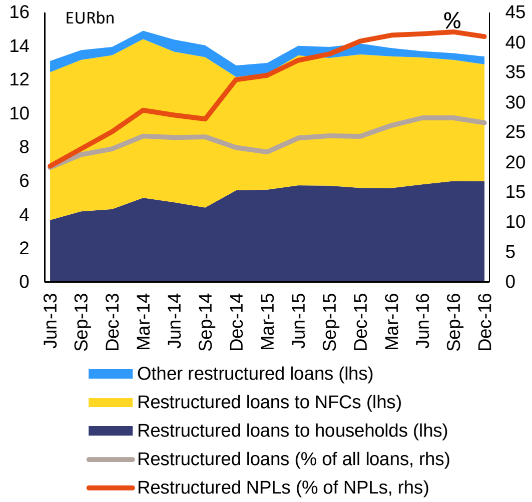
Graph 3.5: **Decomposition of the NPL ratio, all loans**



The figure decomposes the changes in the overall NPL ratio into a numerator (i.e. change in NPL stock) and a denominator (i.e. change in gross volume of loans) impact. The summation of the two impacts gives the actual quarter-on-quarter change.
Source: Central Bank of Cyprus

Loan restructuring appears to have slowed-down due to increasingly difficult negotiations between lenders and borrowers. As of December 2016, the share of restructured loans (performing and non-performing) increased to 35.1% of total loans for NFCs and 27.8% for households, compared with 33.4% for NFCs and 24.7% at end-2015. As a whole, 26.6% of all loans and 41% of all NPLs have been restructured, (Graph 3.6). However, the pace of new loan restructuring has slowed down in 2016, while asset disposal, loan write offs and loan maturing have accelerated. This has led to a contraction of the outstanding stock of restructured loans. After focusing on restructuring the easier cases, notably corporate NPLs, the slow-down in restructuring is partly explained by the difficulties that banks face when engaging with the most distressed borrowers, with whom there are few negotiation possibilities (i.e. the so-called "terminated accounts"), especially within the corporate and households segments.

Graph 3.6: **Loan restructuring**



Source: Central Bank of Cyprus

The sustainability of loan restructuring solutions needs to be ensured. The latest figures from end-2016 suggest that around 28% of all loans that were restructured prior to 2015 have re-defaulted. Although these loans now represent a relatively small portion (around 11%) of the overall portfolio of restructured loans, the figures draw attention to the fact that restructuring solutions adopted so far might prove unsustainable in the long term. Indeed, a substantial portion of the restructuring solutions simply delay payments and involve no debt relief or write-offs of any kind. The so-called "balloon payments", "capitalisation and waive of arrears", "postponed instalment" and "grace period of payments" solutions, which convert all past-due or current obligations into future obligations in their entirety, together accounted for close to half of all restructuring solutions as of end-2016. While these restructuring solutions may be justifiable for clients facing temporary hardship, their wide-spread use puts the possibility of achieving sustainable, long-term results into question. These solutions can only be deemed durable under optimistic assumptions on economic and financial conditions as well as the ability and willingness of borrowers to continue making payments, which may prove unrealistic. Going forward, it is thus crucial for banks to engage in more durable restructuring efforts.

The increased re-restructuring of loans could raise some concerns. Re-restructuring represented nearly 52% of the total restructuring activity in the second half of 2016, putting its share in the outstanding stock of restructured loans to 22% at end-2016. Re-restructuring activity could potentially reflect delaying tactics, which would be worrisome. Extensive re-restructuring may notably distort performance indicators, including the cure and default rates, if the principal aim is simply to avoid re-defaults in the shorter-term, rather than to improve the chances of re-payment by the borrower.

Table 3.2: **Loan restructuring targets and actual performances**

	2015			2016				2017	
	June	Sept	Dec	Mar	June	Sept		Dec	Mar
Indicators	actual	actual	actual	actual	actual	target	actual	target	target
(1) **Proposed solutions** (%) (non-cumulative)	6.1	6.3	13.3	14.9	25.4	14.6	18.7	15.0	14.3
(2) **Concluded solutions** (%) (non-cumulative)	4.7	6.6	13.0	11.9	16.2	15.0	10.2	15.2	14.9
(3) **Terms-being-met** (%) (cumulative since Jan 2014)	65.8	69.8	69.9	69.0	72.4	72.4	72.7	72.2	72.0
(4) **Early-arrears cured** (%) (non-cumulative)	28.1	31.2	38.6	35.5	35.8	43.9	41.4	44.1	44.1

Source: Central Bank of Cyprus

The performances of banks in meeting the loan restructuring targets set by the CBC have been mixed. An arrears management framework and a code of conduct for the banks were established in 2015 and targets were set to incentivise banks to accelerate the resolution of NPLs. More precisely, specific targets were set for (i) proposed sustainable restructuring; (ii) concluding sustainable restructuring; (iii) share of restructured loans that are less than 8 days in arrears; (iv) cure rates for early arrears. As of September 2016 (Table 3.2), banks continued to meet targets (i) and (iii). In turn, the banks have on average under-performed with regards to targets (ii) and (iv). In the future, and once banks meet these targets, more ambitious targets may be necessary.

3.3. PROFITABILITY AND CAPITALISATION

Despite decreasing net interest income, banks' profitability was reinforced by lower risk provisions in 2016. After an overall loss (before tax) of EUR 608 m in 2015, local banks recorded a profit (before tax) of EUR 172 m in 2016. The improved performance took place despite a decrease in net interest income of about 14% year-on-year (y-o-y), which was offset by significantly lower risk provisioning, from EUR 1.6 bn in 2015 to EUR 720 m in 2016. Net non-interest income grew by around 22% y-o-y, contributing to better financial results. As some banks accrue interest on the non-provisioned part of their NPLs, the decline in the net interest income may be understated. Of the three major Cypriot banks, only Hellenic Bank posted losses due to a one-off de-recognition of its deferred tax assets (DTAs). Despite lower provisioning in 2016, the banks' coverage ratio of NPLs with provisions increased from about 33% at end-2015 to 41.2% at end-2016, closer to the EU average. This has provided banks the leeway to engage in more sustainable loan restructuring and debt-for-assets swaps. However, further loan loss provisioning may be needed if the banks accelerate the cleaning up of their balance sheets. Overall, the banks' capacity to generate profits remains under pressure in a context of declining interest rates and further balance sheet deleveraging. In addition, higher administrative expenses due to voluntary redundancy schemes led to a deterioration of the cost-to-income ratio from 44.1% at end-2015 to 52.3% at end-2016. This is expected to constitute a one-off effect.

The Common Equity Tier 1 (CET1) capital ratio of all domestic banks increased slightly to 16.1% at end-2016. This 0.5pp improvement from end-2015 follows the 2015 SREP exercise which highlighted the need for stronger capital buffers. This notably led the Cooperative Group (Coops) to benefit from a EUR 175 m capital injection from the Cypriot recapitalisation fund in December 2015. The higher CET1 ratio also stemmed from a further reduction in the aggregate risk-weighted assets, as the deleveraging process continued. Preserving a sufficient level of capitalisation of the banking sector is highly dependent on the successful reduction of NPLs and the associated provisioning of losses on delinquent borrowers.

3.4. RESTRUCTURING OF MAIN BANKS

Both Bank of Cyprus and the Cooperative Group have made progress with the implementation of their restructuring plan. As shown by the evolution of their key performance indicators (Table 3.3), both institutions have strengthened their asset quality, funding, and position. In particular, the CET1 ratios for the two institutions are close to the mid-term target of 15%. Meanwhile, the loan-to-deposit (LTD) ratio continued its downward trend in 2016 for Bank of Cyprus, dropping from 121% at end-2015 to 95% at end-2016, well below the mid-term target. The Cooperative Group also reduced its LTD ratio, although more modestly, from 74% to 70%. Both developments reflect an improvement in depositors' confidence. The stock and share of loans that are at least 90 days past due have declined, most significantly for Bank of Cyprus. The banks also increased their provisioning coverage ratios, now aligned with their mid-term goals. In turn, the progress on the efficiency positions has been more mixed. Net interest margins([3]) declined to 3.5% for Bank of Cyprus and 2.1% for the Cooperative Group at end-2016. At the same time, the cost-to-income ratios increased slightly to 41% at Bank of Cyprus and to 49% for the Cooperative group at end-2016 but remain within the mid-term targets.

Bank of Cyprus has also made progress with the deleveraging of its balance sheet. The bank continued its deleveraging policy by reducing its non-core exposures. Most of the impact has been through write-offs, with a net P&L impact of around EUR 0.8 bn (gross impact, i.e. not including the recovered amounts, was around EUR 1.1 bn). This has also contributed to a substantial NPL reduction for corporate exposures, while the retail and SME segments showed a substantially slower progress.

Despite recent progress, a permanent return to sustainable viability remains a key challenge for the Cooperative Group. There has been notable progress in the restructuring of the group. In particular, the shareholders decided on 30 December 2016 to legally merge the 18 local Cooperative Credit Institutions with the Central Cooperative Bank. As of May 2017, the legal merger was still pending supervisory approvals. It is expected that the merger will help to overcome legal hurdles and political interference in the restructuring operations, thereby contributing to a swifter centralisation of key functions and an increased efficiency. This will, however, require a

([3]) It is important to note that the recognition of interest income on the non-provisioned part of NPLs tends to distort the net interest figures and thereby the cost-to-income ratios.

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

Category	Key performance indicators	Bank of Cyprus			Cooperative Group		
		Dec 2015	Dec 2016	Medium-term targets	Sep 2015	Dec 2016	Medium-term targets
Asset quality	90 days past due coverage	48%	54%	> 50%	50%	58%	> 45%
	Provisioning charge	4.3%	1.7%	< 1.0%	3.8%	1.2%	< 2.0%
	90 days past due loans (bn EUR)	11.3	8.3	< 20% of loans	6.9	5.7	< 4.5
Funding	Eurosystem funding (% total balance)	16%	1%	0%			
	Loans to deposit ratio	121%	95%	100-120%	74%	70%	< 85.0%
Capital	Common equity tier 1	14.0%	14.7%	> 15%	12.0%	16.2%	> 15%
Efficiency	Net interest margin	3.8%	3.5%	~ 3%	2.5%	2.1%	> 2.5%
	Fees and commissions/total income	15%	17%	> 20%			
	Cost-to-income ratio	39%	41%	40-45%	41%	49%	< 42%
	Number of branches				253	248	< 200
	Number of employees				2,749	2,677	< 2700

Source: Bank of Cyprus, Cooperative Banking Group

fast implementation – including the necessary redeployments of staff and branch optimisation – following the regulatory approvals. Meanwhile, the Government is taking steps to accelerate the public listing of the Cooperative Group, as part of its commitment to fully divest its stake gradually by 2020, as specified by the Group's commitments under its current restructuring plan. In particular, the Government has announced its plans to distribute freely a 25% stake in the Group's capital to existing depositors and borrowers. This will allow the Cooperative Group to achieve the level of shareholder dispersion required before initiating a stock exchange listing.

3.5. REGULATORY DEVELOPMENTS

The authorities have managed to ensure a satisfactory degree of compliance with the implementation of the recently established supervisory framework, despite some shortcomings. Since the last review, no new legal initiatives have been undertaken. The regulation on loan impairment and provisioning effectively put in place the IAS-39 ([4]) provisioning standards while paving the way for the upcoming IFRS-9 rules where forward-looking losses can also be addressed. The regulation on loan origination directive that entered into force in 2016 has been further amended. Incentives have been created, including the legal initiative for a bill on securitisation, for the creation of a secondary market for bank loans even though asset sales continue to remain insignificant. The credit register is providing a much needed input to the determination of macro-prudential policy set by the Central Bank of Cyprus (CBC). However, the credit registers for commercial and cooperative banks are yet to be fully integrated, which limits the scope of borrower information available in the market.

Progress has been made with the important requirement to integrate the regulation and supervision of insurance companies and pension funds into a single supervisor. A working group was set up, including representatives of the two current supervisors, the Ministry of Finance and experts from EIOPA, with the view to establish the legal, financial and operational options for achieving the supervisory integration. These options, together with a description of the characteristics and main risks of the non-bank financial sector, were presented in a report submitted to the authorities at end-October 2015. A technical project management team was set up in September 2016 with a view to implementing the integration of the regulation and supervision of the sectors. The team is in the process of working on the legal framework for an independent supervisor with a view to have it approved by end-

([4]) The international accounting standard 39 (IAS39) outlines the requirements for the recognition and measurement of financial assets and financial liabilities and will be replaced in 2018 by the international financial reporting standard 9 (IFRS9) which includes requirements for recognition and measurement, impairment, de-recognition and general hedge accounting.

2017. The transposition of the Solvency II directive has not caused a difficult transition for Cypriot insurance companies. Only one medium-sized company is below the capital requirements and has taken measures to restore compliance.

3.6. LEGAL FRAMEWORK FOR PRIVATE DEBT RESTRUCTURING

The use of the new corporate and personal insolvency processes remains limited. Further regulations and rules of court are required for the insolvency framework to be fully effective. Banks have a major responsibility to make full use of the new tools to help address the very high level of NPLs and offer sustainable restructuring solutions to clients who do not have a sufficient repayment capacity. This implies efforts to inform insolvent clients of the possibilities offered by the new insolvency frameworks and active participation to insolvency proceedings within the framework of loan restructuring.

The new Insolvency Service of Cyprus started operating in June 2015 but needs more resources. There is an intention to establish the Service as an independent organisation. While the Service has received additional resources to improve its performance (staff, IT), it needs to be further strengthened in order to properly carry out its tasks. It has made significant efforts to publicise the new insolvency framework yet debtor awareness appears insufficient.

Table 3.4: **Insolvency framework - Cumulated statistics as of March 2017**

Personal Insolvency Arrangements (PIA) (debt repayment plans)			
Applications to Insolvency Service	Applications to Court for protection certificate	Court-issued protection certificates	Approved PIAs
57	20	18	4
Debt Relief Order (DRO) (debt forgiveness process for up to €25k)			
Applications to Insolvency Service	Applications processed to date	Referred to the District Court for final approval	Court-issued DROs
1116	259	154	118
Examinership (corporate debt restructuring)			
Applications to Court for temporary protection from creditors	Withdrawn by applicant/Rejected by Court	Before the Court	
3	2	1	

Source: Insolvency Service of Cyprus

It is critical to identify and remove any impediments to the effective application of the new insolvency framework. The Cypriot authorities have committed to monitor the implementation and performance of the new insolvency framework to ensure that it supports its objectives and principles. Under the leadership of the Ministry of Energy, Commerce, Industry and Tourism (MECIT), a working group was created with relevant stakeholders (Central Bank, Ministries of Finance and Interior) to start the review process.

The use of the foreclosure framework continues to be limited. Foreclosure auctions under the new legislation started only in June 2016 and have proved rather unsuccessful as the majority did not attract satisfactory bids. In the second half of 2016, as little as 18 residential properties were sold, while 150 residential properties were the subject of notice for auction and 364 foreclosure auctions were scheduled. Compared to the outstanding total amount of NPLs (EUR 27.3 bn or 160 % of GDP at end-2016), those where the underlying collateral is to be auctioned represented only about EUR 100 m. This confirms that banks have so far used the foreclosure tool mainly as a way to improve the payment discipline of borrowers via a signalling effect rather than as a primary way to collect outstanding debts. However, a more forceful use of the foreclosure framework, notably towards residential and commercial properties, would provide greater incentives for strategic defaulters to agree to a loan restructuring.

The authorities started the process of modernising legal procedures to increase the efficiency of the new frameworks. The Supreme Court adopted new Rules of Court for personal insolvency in October and the drafting of Rules for corporate insolvency is underway. The Minister for Justice and Public Order has proposed amendments to the Civil Procedure Law to improve the efficiency of court applications, better enforcement of court decisions and enhancement of the availability of financial information to Courts and enforcement agents. These proposals were submitted to the House of Representatives in autumn 2016 and are still under discussion.

The reform of the system of title deeds transfers remains constrained by lack of support from private stakeholders. A substantial number of property buyers, despite having paid the full purchase price, still have not yet received their title deed. The adoption of the legacy cases law (for property sales up to end of 2014) created some momentum. Out of the 13 642 applications received as of end March 2017 linked to legacy cases, nearly 5 700 title deeds were issued which led to approximately 2 000 transfers of titles. This is positive progress, thanks to supportive efforts by the Department of Land and Surveys, including website information, training, and an instruction manual sent to all relevant staff. However, following numerous legal actions taken by banks against the transfer of titles, a court ruled in May 2017 that the legacy law is unconstitutional. Pending a possible appeals court decision, the application of the law is now uncertain, which calls for the design of a stable and implementable solution.

Substantial efforts are necessary to engage stakeholders to agree on a new system for the transfer of future title deeds. There is general agreement that a future system should ensure that buyers who pay the full purchase price will get their titles quickly and have no possibility to refuse them (for example to avoid paying overdue taxes). The Ministry of Finance continues to examine proposals, but with little apparent progress in recent months, in part due to the political sensitivity of this issue.

There is still considerable work to be done to address the backlog of issuance of new title deeds. At the current rate of title deeds issuance, it would take approximately ten years to address the backlog of unissued title deeds (about 30 000 titles were pending as of March 2017). However, the Ministry of Interior is making progress towards the streamlining of issuance procedures, notably through technical assistance by the Commission. Measures were also taken to assist the issuance and, thus, the transfer of title deeds where relatively minor breeches of planning conditions have occurred. The main bottleneck preventing a faster issuance of title deeds appears to be the local government's low capacity to face their obligations, notably regarding the issuance of certificates of approval. This problem might be solved through the proposed reform of local governments, but more immediate action appears warranted.

4. BUDGETARY OUTLOOK AND FISCAL POLICY STANCE

4.1. FISCAL PERFORMANCE

Fiscal performance in 2016 has been stronger than expected, supported by robust economic growth. The robust economic recovery has led to relatively high tax revenue growth, while expenditure remained contained. As a result, the primary balance in 2016 reached 3%, better than the 2.5% expected in the Commission winter forecast, and the third highest in the euro area.

General government revenue increased by 1.5% in 2016. This increase was largely driven by an increase in taxes on production and imports (+5.1%) due to a sizeable increase in VAT receipts, reflecting the improved economic conditions and rising private consumption thanks to a strong tourism season. Improved tax collection and administration also played a role in increasing revenue. Social security revenues also increased (+3.7%) as a result of an improvement of labour market conditions. These positive developments were partly offset by a decline in current taxes on income and wealth (-0.3%) related to the gradual abolition of the immovable property tax, while revenues collected from other current resources (-5.0%) were negatively affected by the lower dividends received from the Central Bank of Cyprus (-0.2% of GDP). The latter is due to lower profits of the Central Bank of Cyprus mostly related to the partial repayment of the emergency lending facility in 2015.

General government expenditure decreased by 2.4% in 2016. This development was led by a decrease in total current expenditures (-0.6%) and a reduction in total capital expenditures (-19.5%). Prudent budget execution and a fall in the compensation of employees, driven by lower lump-sum payments to retirees, supported the overall reduction. Intermediate consumption registered a notable decrease. Some partly offsetting factors were an increase in social transfers due to increased payments related to the Guaranteed Minimum Income (GMI) scheme, and higher gross fixed capital formation, notably transport equipment acquisition. The reduction in other capital expenditures can be explained by the fall of payments related to guarantees, as well as the fact that the expenditure in 2015 was sizeably increased (by EUR 175 m) due to the recapitalisation of the banking sector.

Public debt remained at around 108% of GDP in 2016. New debt issuance combined with debt buy-backs are helping to spread out maturities and improve the risk profile. Following the issuance of a domestic bond of EUR 300 m in January 2017, the authorities' cash buffer increased to EUR 1.3 bn, covering the financing needs until end 2018. (see Section 4 on Sovereign Financing and Capacity to Repay).

4.2. FORECAST

For 2017, some fiscal relaxation is expected. According to the Commission spring forecast, the general government deficit is set to deteriorate marginally to 0.2 % of GDP (corresponding to a deterioration in structural balance to -0.2% of GDP), with a corresponding deterioration of the primary surplus to 2.7% of GDP. This deterioration in the fiscal position is mostly due to the unwinding of fiscal measures without compensation. The main relaxation measures on the revenue side include the abolition of the immovable property tax and the expiration of the temporary contribution paid by public and private employees. The main additional expenditure is related to the cost of switching to a professional soldiers' regime from 2017 onwards. In addition, some revenue shortfalls outside the control of the government are expected to further deteriorate the fiscal position in 2017, namely a reduction in the dividend payments by the Central Bank of Cyprus and the implementation of new EU place-of-supply rules regarding VAT for e-commerce services as well as provisions for guarantees.

In 2018, the primary surplus is expected to increase somewhat, underpinned by continued economic growth. According to the Commission spring forecast, the primary surplus is expected to increase to 3.0% of GDP in 2018 thanks to an improvement of the labour market, which contains social expenditure, as well as a contained rate of growth in compensation of employees. However, according to the Government's 2017 Stability Programme the structural balance is expected to deteriorate steadily over 2017-2018. Cyprus' ability to achieve a headline surplus from 2018 onwards, as committed during the programme, remains however vulnerable to a potential rise in interest rates and the pressure for fiscal relaxation.

Significant risks remain as regards the evolution of the fiscal position. The government's exposure to large, albeit declining, contingent liabilities (financial sector, SOEs) and potentially adverse macroeconomic developments pose fiscal risks. The increasing pressure for relaxation of fiscal discipline may also pose a risk to the fiscal performance. In addition, medium term wage pressures in the public sector might lead to slippages of the wage bill, as the 2017-2018 collective framework agreement contains the growth rate of the compensation of public employees only temporarily.

Given the still high level of public debt, the continuation of a prudent fiscal policy is key. According to the Commission spring forecast, public debt is expected to decline to slightly below 100% of GDP in 2018. However, the debt path remains vulnerable to macroeconomic and fiscal shocks and therefore maintaining an appropriately high primary surplus is essential. A continuously prudent implementation of fiscal policy in 2017 and 2018 would be warranted not only to counter the risks to the downward debt trajectory but also to create some fiscal space for productivity enhancing public investment. Public investment in Cyprus, as a share of GDP, was among the lowest in the EU in 2016, reflecting a clear deterioration compared to previous years. In particular, public spending on R&D (0.4 % of GDP in 2016) remains one of the lowest in the EU. Public policy could therefore better support potential growth by shifting expenditure towards more long-term productivity-enhancing projects, in particular investment in R&D and infrastructure, in a fiscally neutral manner. Finally, having exited the Excessive Deficit Procedure in 2015, the authorities should ensure the compliance with the provisions under the preventive arm of the Stability and Growth Pact.

5. STRUCTURAL ISSUES

5.1. FISCAL-STRUCTURAL REFORMS

5.1.1. Public Financial Management and Budgetary Framework

Some progress has been made concerning the implementation of the fiscal framework and public investment management. The secondary legislation for the Fiscal Responsibility and Budgetary Framework Law (FRBFL) is being implemented. This legislation lays down, inter-alia, procedures for budget preparation, requirements for within-year budgetary adjustments, and the responsibilities of commitment control officers. Progress was also made to improve public investment management with a special emphasis on the pre-selection and selection of investment projects. The implementation of this reform is expected to take several years, with the current efforts focusing on building administrative capacity in the key institutions involved by providing specific guidance, training programmes and acquiring proper IT management systems.

5.1.2. State-Owned Enterprises

The implementation of the privatisation plan is at a standstill. The privatisation plan designed during the economic adjustment programme aimed to improve economic efficiency, attract investment in Cyprus and reduce public debt. No notable progress was made in implementing the privatisation plan since granting the concession of Limassol port's commercial services in April 2016. The House of Representatives rejected budgetary appropriations earmarked for privatisation projects in the budget for 2017, leading the government to dismantle its privatisation unit and cancel decrees placing the Cyprus Telecom Authority (CyTA) and the Cyprus Stock Exchange (CSE) under privatisation. Only minor privatisation projects remain officially active, but any further progress on these files will depend on prior approval by the House of Representatives. These developments represent a significant rollback of one of the key reform commitments made under the programme, sending a negative signal to investors. They also expose the state to contingent liabilities due to the weakening competitiveness of public companies such as CyTA.

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

No notable progress was made regarding the privatisation of other assets. The sale of land assets has not been centralised, contrary to the advisers' recommendation. Line ministries will therefore proceed with the sale of their respective assets separately, without the benefits of an integrated marketing approach or economies of scale. The privatisation process of the National Lottery and of the Troodos residences remain ongoing but are facing delays compared to their initial schedule. A study was commissioned to establish a long term strategy for the Cyprus Stock Exchange, which might lead to its eventual privatisation.

The law on the State-Owned Enterprises' (SOEs) corporate governance has still not been adopted. The law aims at improving the corporate governance of SOEs to ensure a more effective monitoring of their functioning, while minimising fiscal risks. The law has been submitted for discussion at the Economic and Financial Parliamentary Committee in early April 2015. Even though the law specifically applies to companies not intended for privatisation, it has been nevertheless associated by the stakeholders as part of the wider privatisation strategy. The delays in the adoption of the SOEs law are ultimately damaging the efficiency of the public sector, as the governance of SOEs needs to be improved and the SOE-related fiscal risks need to be mitigated.

5.1.3. Revenue Administration

Some progress has been achieved with the revenue administration reforms, although at a slower pace than expected. The single tax registration process has been completed for direct and indirect taxes, which now share common procedures. However, the integration of the debt collection function is facing delays. The tender procedure for a new IT system is expected to take place in 2017, but the full deployment of the new system is estimated to take several years. Therefore the current online system is being upgraded to improve performance in the transition phase (e.g. allowing for online debt payments). The Tax Procedure Code has been drafted and is expected to be adopted in 2017.

5.1.4. Public Administration Reforms

The horizontal reform of the public administration is facing significant obstacles. The House of Representatives rejected in December 2016 most of the legislative proposals put forward to modernise the public administration. The draft laws, inter alia, provided for a new mechanism safeguarding the fiscal sustainability of the wage bill, including both the compensation and the number of public employees. The substance of this proposal was however included in a collective agreement between the Government and labour unions, in force until end-2018. The proposed public administration reform also aimed to modernise the appraisal system through written exams and interviews, and to improve the promotion system by opening promotion posts to all qualified candidates and by linking further merit and promotion. Importantly, a law aiming to incentivise staff mobility and enhance staff redeployment rules was adopted in May 2017, which is expected to significantly facilitate resource allocation within the public administration. Overall, the slow pace of reform in the public administration poses a risk for public finance sustainability over the medium- and long-term.

The reform of line ministries has started following the completion of the reviews. Implementation of specific reform plans has started in the ministries of agriculture and education. The ministries of foreign affairs, defence as well as justice and public order are scheduled to start implementing their own reform plans in 2017.

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

5.1.5. Reform of the Welfare System

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

The new GMI scheme has been comprehensively rolled out. By April 2017, about 26,000 households benefitted from the GMI, or about 47,000 individuals. Of the latter, about 19,000 were beneficiaries from the previous public assistance system. There were 500 new applications per month on average in 2016. Registration with the public employment services (PES) is an obligation for new applicants, but not for those already in the system. The PES still lack the capacity to respond to their enhanced tasks. In specific cases, the social welfare services may also refer GMI beneficiaries for social intervention. In 2017, an impact study analysing the impact of the introduction of the new GMI scheme on poverty will be produced by the statistical service based on the 2016 EU Statistics on Income and Living Conditions (SILC) data.

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

Changes in the legislation on disability benefits have been delayed but there is progress with implementing the system for the assessment of disabilities. The aims of this reform were to create an umbrella legislation encompassing all kinds of disability benefits, to progressively replace cash payments with benefits in kind (goods and services), and to introduce a unified system for the certification of disabilities, while safe-guarding the budget neutrality of the overall reform. Although there are delays with the first two pillars of the reform, the implementation of the unified system for certification has progressed with the setting-up of two certification centres, one in Larnaca and one in Limassol, which add to the one already operating in Nicosia. The aim is not only to certify new applicants for disability benefits, but also to reassess existing beneficiaries. This process has already started and most of the required checks on existing beneficiaries have been made.

5.1.6. Healthcare

The legislation on the National Health System (NHS) remains under discussion. There is currently no universal health care in Cyprus, which results in high out-of-pockets payments by Cypriot residents. The NHS bill which has been submitted to the House of Representatives foresees the implementation of a universal NHS on the basis of a single-payer system, funded by payroll contributions from the State, employers and employees. The proposed reform intends to significantly lower out-of-pocket costs for healthcare from over 50% to below 15% of overall health costs. An impact study has been commissioned by the Ministry of Finance to assess the potential impact of the NHS on the economy, notably on labour costs, and to update the estimated budgetary needs of the new system. The study would allow the government to identify and propose necessary amendments to the legislation before the full implementation of the NHS. It is essential to ensure the fiscal sustainability of the proposed reform in the medium-to-long-term, including by safeguarding against accumulation of arrears by public hospitals. So far the timeline for NHS implementation envisages an opening of the NHS for outpatient care from June 2019, while the full-blown NHS would be operational from June 2020. This timeline depends on the duration of parliamentary discussions and on the successful roll-out of the NHS IT solutions, for which a contract has been signed.

The hospital autonomisation bill is also under discussion by the House of Representatives. The bill foresees granting financial and operational autonomy to all public hospitals under the supervision of an independent public entity, with small independent management teams present in each hospital. The autonomisation process is expected to start in June 2017 and be completed by June 2020. The envisaged timeline appears challenging and leaves little room for preparing public hospitals for competition with private hospitals. The Ministry of Finance commissioned a study to remedy the lack of information regarding the financial situation and performance of public hospitals and to better identify the challenges of hospital autonomisation, including potential fiscal risks resulting from overspending and accumulation of arrears by hospitals. To ensure a realistic approach to hospital autonomisation, parliamentary discussions should be used to define a detailed implementation roadmap.

5.2. STRUCTURAL REFORMS

5.2.1. Labour Market

Tripartite negotiations on indexation to inflation of the cost of living allowance (COLA) in the private sector are still ongoing. Wage indexation in the private sector remains suspended, as both employers and employees agree that the system should be reformed but disagree on the parameters of the new system. Wages remain frozen until the conclusion of the negotiations, which should ensure that wages evolve in line with productivity growth.

In the construction sector, discussions continue on whether to legislate the automatic extension of certain elements of the collective agreement. There is an agreement in principle on the merit to adopt legislation which would ensure that certain provisions of collective agreements are automatically extended beyond the duration of the collective agreements. This is expected to include wage floors, working hours, and provident fund contributions. Although this move is advertised as setting minimum standards for the industry, the unionization rate in this sector has fallen below 50%. Thus, the extension of an agreement reached between minority players might not cater to the needs of the entire sector. It is also important to highlight that current wage floors in the construction sector are the highest of all sectors in Cyprus with EUR 1 645 - EUR 1 905 a month depending on the skill level.

Active labour market policies (ALMPs) are being implemented. ALMPs include measures targeting the youth under the National Action Plan for Youth Employment as well as measures targeting other vulnerable groups, such as the long-term unemployed, persons with disabilities, but also GMI recipients. The impact of ALMPs on the activation of the unemployed in Cyprus has not yet been fully assessed, as the monitoring and evaluation system was put in place only recently. The first evaluation results are expected by May 2017, when Cyprus has to report to the European Social Fund (ESF).

The public employment services (PES) are not yet equipped to respond effectively to their enhanced tasks, especially in the context of the welfare reform. Additional staff is expected to be recruited during the summer of 2017, which could more than double the current capacity. The authorities are also working towards a number of measures for reforming the services. Besides their important role in reducing searching and matching frictions in the labour market, the PES are a crucial pillar of the welfare reform, together with social intervention. The reduction of welfare dependence hinges to a large extent on the PES response capacity. As a response to the PES' very low job placement rate, a new platform is being implemented to allow employers to reach out directly to job seekers through the PES.

More efforts were made to reach out to the non-registered unemployed. There have been increased efforts in coordination with the Ministry of Education and Youth organisations to reach out to the non-registered unemployed (young in particular) and to identify those who are not in employment, education, or training (NEETs). However, no statistics on the success of these initiatives are yet available.

5.2.2. Energy

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

Gas exploration in Cyprus' Exclusive Economic Zone (EEZ) is expected to intensify. Following the renewal of exploration licenses for blocks 2, 3, 9 and 11 of the EEZ (ENI/KOGAS and Total) until 2018, new exploration licenses were granted in April 2017 for blocks 6, 8 and 10. The exploration licenses have been granted to well-known companies (ExxonMobil, Qatar Petroleum, Eni and Total), leading to signature bonuses of around EUR100m. Exploration drilling is expected to resume in the summer of 2017.

A plan for importing liquefied natural gas (LNG) to Cyprus has been adopted. The authorities aim to import LNG before 2020 in order to diversify the energy mix in line with EU2020 objectives and in order to facilitate competition between electricity generators. In May 2017, the Council of Ministers approved a plan to publish two separate tenders, respectively to build and operate the gas import and distribution infrastructure, and to import natural gas on the long term. The cost of the project, its financial model and its detailed implementation steps and timeline have not yet been communicated by the Ministry of Energy.

Parliamentary discussions continue with regard to setting up a Sovereign Wealth Fund (SWF). The SWF bill, which lays out the governance structure of the SWF, and the draft legislation defining inflow and outflow rules of the fund continue to be discussed by the House of Representatives. The adoption of the legislation is key to ensure a sustainable use of revenue stemming from the exploitation of hydrocarbon reserves.

The timeline for the ownership unbundling of the Electricity Authority of Cyprus (EAC) depends on the effective implementation of the accounting and functional unbundling. The Government committed in January 2016 to proceed with the ownership unbundling of EAC's network activities (transmission and distribution) from its commercial activities (generation and supply). However, the Cyprus Energy Regulatory Authority requested that ownership unbundling should occur only once the accounting and functional unbundling of EAC has been implemented and assessed. This is likely to push any definitive decision regarding ownership unbundling to 2019.

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

5.2.3. Justice System Reform

The Cypriot justice system faces serious challenges as regards its efficiency. According to data collected through the European Justice Scoreboard([5]), Cyprus is among the worst performers regarding the time needed to reach a final judicial decision and the backlog of pending decisions. These problems mainly stem from inefficient procedures, low level of IT resources, lack of specialisation, and under-use of alternative dispute resolution mechanisms. The inefficiency of the justice system is an obstacle to the proper implementation of the insolvency and foreclosure frameworks, and more generally deters investment as it prevents or delays the enforcement of contracts. A comprehensive reform is considered of key importance to improve the enforcement of contracts, strengthen the business environment and encourage investment.

Reform initiatives have been launched, while a more comprehensive strategy is pending. The Supreme Court has drafted a reform plan highlighting the priorities in improving the justice system. This plan proposes the creation of intermediate courts levels, specialised jurisdictions, the streamlining of procedures, hiring of judges, upgrading of facilities and development of IT resources. In parallel, the Government announced its interest in creating a commercial court by early 2018. Technical assistance provided by the Commission is expected to lead to the formulation of a comprehensive strategy for the reform of the judicial system, involving the Supreme Court and the ministries of Finance and Justice.

5.2.4. Action Plan for Growth

An institutional framework is being designed to support growth-friendly policies. To better address the priorities of the Action Plan for Growth, the Government envisages the creation of three Deputy Ministries – Deputy Ministry for Growth and Competitiveness, Deputy Ministry for Tourism and Deputy Ministry for Shipping. These initiatives implement the recommendations made by external experts within the framework functional reviews carried out during the programme. They all intend to ensure a better coordination of public resources in implementing the Government's strategies for each sector. The respective bills were submitted to the House of Representatives at the end of 2016 and are expected to be discussed by the House of Representatives in 2017.

([5]) http://ec.europa.eu/justice/effective-justice/scoreboard/index_en.htm

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

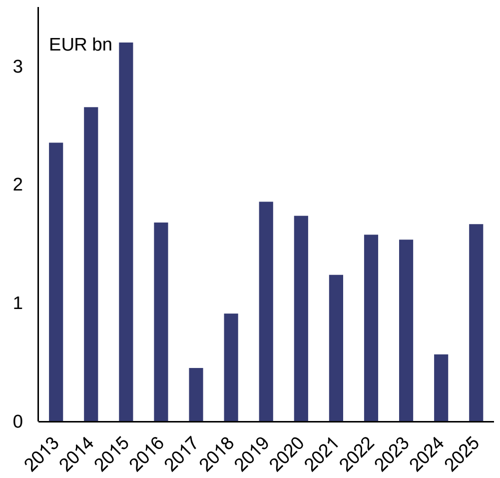
Other key elements of the plan are making progress. As part of the Investment Framework, one of the key pillars of the Action Plan for Growth, legislation on the new procedural and legal framework on strategic investments, including the set-up of a fast-track mechanism, has been delayed but is expected to be put in place in 2017. With respect to the development of a Strategic Framework for Promoting Entrepreneurship and Enhancing SMEs Competitiveness, the first progress report has been prepared in January 2017, including more sophisticated policy proposals.

6. SOVEREIGN FINANCING AND ABILITY TO REPAY

Cyprus has maintained access to international as well as domestic capital markets at favourable terms. Following the issuances of a seven-year Eurobond of EUR 1.0bn in July 2016, Cyprus issued a EUR 300m domestic bond with a coupon of 3.25% in January 2017. The main objectives of these transactions were to further increase the cash balance, diversify the funding sources, develop the yield curve, and improve the debt profile. The 7-year EUR 1.0bn bond issued in July 2016 at 3.75% was priced at the lowest coupon rate achieved by Cyprus for a euro benchmark bond.

Low financing needs in 2016 allowed Cyprus to smoothen the maturity profile. Proceeds from the market issuances allowed Cyprus to redeem debt maturing in 2019 and 2020, resulting in the reduction of the financing needs to more affordable levels (Graph 6.1). Part of the proceeds also allowed Cyprus to increase its cash balance in line with the objective of having at least EUR 1.0bn of liquid funds by end-2016, as set out in the Medium Term Debt Strategy.

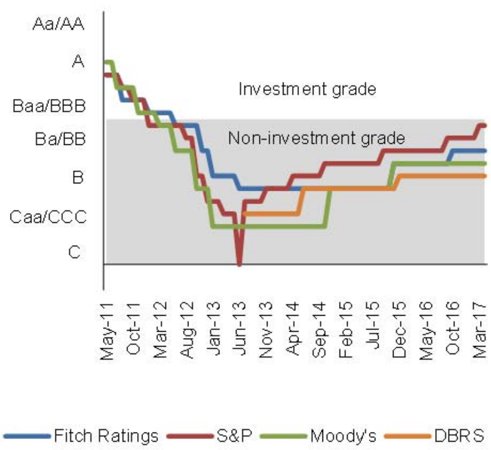
Graph 6.1: **Medium and long-term debt amortisation**



Source: Public debt management office, Cyprus.

Yields on Cyprus' debt instruments have been on a decreasing path since the spring of 2016. After having increased somewhat in first months of 2016, the yield for the 3-month T-bills on the primary market fell gradually, dipping into negative territory in early 2017. By January 2017, the outstanding T-bill stock stood at EUR 420m, broadly in line with the target of EUR 400m enshrined in the Medium Term Debt Strategy. Yields on longer term debt have also declined in parallel, as 10-year bonds reached a historical low in April 2017 at 3.23% as a result of improved macroeconomic conditions and better market perception of Cyprus sovereign risk. If maintained, this trend will facilitate proactive debt management policies, such as optimisation of the costs and debt amortisation profile.

Graph 6.2: **Sovereign long-term ratings, Cyprus**



Source: European Commission

Cyprus' sovereign credit rating has improved but remains below investment grade. Over the past year, the four major rating agencies upgraded Cyprus' sovereign rating. In November 2016 Moody's maintained its rating at "B1", but changed its outlook from "stable" to "positive". Around the same time, Fitch Ratings upgraded Cyprus from "B+" to "BB-", keeping its outlook at positive. In December 2016, DBRS confirmed the rating of Cyprus at "B" and changed the outlook to positive from stable. In March 2017, Standard & Poors (S&P), upgraded its rating from "BB" to "BB+" with a "stable" outlook. Cyprus' most favourable rating, by S&P, remains one notch below investment grade (Graph 4.2). Better-than-expected macroeconomic, public debt and fiscal budgetary developments were the main drivers for the recent upgrades. However, vulnerabilities related mainly to the high level on non-performing loans in the financial sector and still high public and private debt could hold back further upgrades.

The sovereign's financing situation remains comfortable. Based on the updated macro and fiscal projections, and supported by long maturity of ESM loans, total debt redemptions and fiscal needs until end-2018 are contained and lower than the existing cash buffer of an estimated EUR 1.3bn at the end of 2016. In 2017, debt redemptions are estimated at EUR 0.5bn.

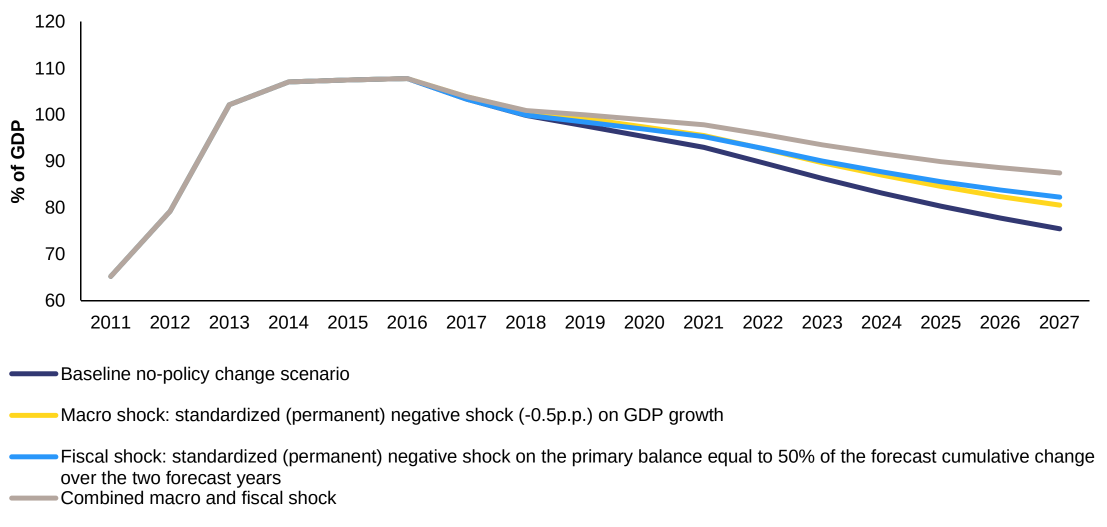
Risks for Cyprus' capacity to service its debt to the European Stability Mechanism thus remain low in the short-term, but high public debt implies higher financing needs in the long term. The redemption of existing debt is somewhat higher in the medium-term, particularly in 2019 and 2020 where redemption amounts to around 8-9% of GDP each year. Furthermore, medium-term debt dynamics are sensitive to macroeconomic shocks, vulnerabilities in the financial system, the fiscal performance, and the continuation of market access on favourable terms.

ANNEX 1
Debt Sustainability Analysis

Following a peak at 107.8% of GDP in 2016, public debt is expected to decline steadily to 75.5% of GDP in 2027. This Debt Sustainability Analysis (DSA) uses the Commission 2017 Spring forecast (2017-2018) as a starting point to ensure cross-country consistency. For the outer years, the analysis rests on the following assumptions: (i) the structural primary fiscal balance remains at a surplus of 2.0 % of GDP under the no-fiscal policy change assumption; (ii) inflation converges to 2.0 % by 2021 and remains stable thereafter; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5 % by the end of the 10-year projection horizon, in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group (AWG); (iv) real GDP grows at the rate projected by the EPC's Output Gap Working Group until t+10 and thereafter according to the AWG's projections (average rate of around 1.5 %); and (v) ageing costs develop according to the Commission and EPC's 2015 Ageing Report([6]).

The evolution of the debt trajectory continues to be vulnerable to the macroeconomic and fiscal performance. A decrease of real GDP growth by one standard deviation over the horizon would trigger an upward revision of the debt trajectory, by 2.0 pps of GDP in 2020 and 5.0 pps of GDP in 2027, resulting in a lower reduction of the debt ratio compared to the baseline scenario. Moving to a more dynamic setting, a combined macroeconomic and fiscal shock would lead to a noticeably more gradual decline trajectory in the initial years of the projection (2018-2021). Given Cyprus' high level of public debt, continued fiscal discipline and sustained structural reform efforts are therefore necessary to firmly anchor the debt to GDP ratio on a sustainable downward path.

Graph A1.1: **Debt projections**



Source: European Commission

Given the initial high public debt stock, there are also risks to medium term sustainability stemming from ageing-related costs. The S1 medium-term sustainability indicator is assessed as a medium risk at 0.7% of GDP, falling by 2.2 pps of GDP compared to the first PPS review (based on the Commission 2016 Autumn forecast). The improvement of the S1 indicator is mostly due to the more favourable forecast regarding the initial budgetary position (see table A1.1). According to the updated analysis based on the Commission 2017 Spring forecast , a cumulative improvement in the structural primary balance of 0.7% of GDP over five years (from 2019 to 2023) is needed to reach the debt reference value of 60% of GDP by 2031. The S2 long-term sustainability indicator is assessed as a low

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

risk at -1.9% of GDP, improving by 1.2 pps of GDP compared to the Commission 2016 autumn forecast. The improvement in the S2 indicator compared to the first PPS review is also due to a better initial budgetary position (i.e. a higher structural balance anticipated in 2018).

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

Table A1.1: **Sustainability indicators (in % of GDP)**

	Cyprus	
	No-policy-change scenario	**PPS First review (Autumn 2016)**
S2*	-1.9	-0.7
of which :		
Initial budgetary position (IBP)	-1.2	-0.1
Long-term cost of ageing (CoA)	-0.7	-0.7
of which:		
pensions	0.2	0.2
healthcare	0.2	0.2
long-term care	0.2	0.2
others	-1.3	-1.3
S1**	0.7	2.9
of which:		
Initial budgetary position (IBP)	-2	-0.2
Cost of delaying adjustment	0.1	0.5
Debt requirement (DR)	3.1	3.1
Long-term cost of ageing (CoA)	-0.4	-0.4
S0 (risk for fiscal stress)***	0.4	
Fiscal subindex	*0.1*	
Financial-competitiveness subindex	*0.6*	
Debt as % of GDP (2016)	107.8	

(1) The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.
(2) The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the autumn 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.
(3) The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.
Source: European Commission

ANNEX 2

European Commission macroeconomic and fiscal projections (2017 Spring Forecast)

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

	2012	2013	2014	2015	2016	2017	2018
Real economy			*(percent change)*				
Real GDP	-3.2	-6.0	-1.5	1.7	2.8	2.5	2.3
Domestic demand incl. inventories	-4.0	-9.4	-1.4	2.9	3.9	2.2	2.3
Total consumption expenditure	-1.6	-6.4	-1.1	1.4	2.1	1.9	1.7
Private consumption expenditure	-1.3	-5.9	0.7	1.9	2.9	2.1	1.9
Government consumption expenditure	-2.3	-8.2	-7.9	-0.6	-1.4	0.7	0.8
Gross fixed capital formation	-20.5	-12.9	-17.5	12.0	25.9	3.4	4.9
Exports of goods and services	-2.7	2.1	4.2	0.0	3.6	3.3	3.2
Imports of goods and services	-4.5	-4.8	4.6	2.1	5.3	2.9	3.2
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	-5.2	-7.4	-3.4	2.6	5.2	2.2	2.3
Foreign trade	1.1	3.7	-0.1	-1.3	-1.0	0.3	0.0
Changes in inventories	1.1	-2.2	2.1	0.3	-1.4	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.9	-1.0	-1.5	-1.3	-1.3	0.8	0.9
HICP	3.1	0.4	-0.3	-1.5	-1.2	1.2	1.1
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	11.9	15.9	16.1	15.0	13.1	11.7	10.6
Employment	-3.2	-5.9	-1.8	1.9	2.7	2.3	1.9
Compensation per employee	1.5	-5.4	-3.8	-1.1	-0.6	0.7	1.1
Labour productivity	0.0	0.0	0.2	-0.2	0.1	0.1	0.3
Unit labour costs	1.5	-5.4	-4.0	-0.9	-0.7	0.6	0.8
Public finance (1)			*(percent of GDP)*				
General government balance	-5.6	-5.1	-8.8	-1.2	0.4	0.2	0.7
Total revenue	36.1	36.5	39.6	39.2	39.2	38.1	38.1
Total expenditure	41.7	41.6	48.4	40.4	38.9	37.9	37.5
General government primary balance	-2.4	-1.8	-6.0	1.7	3.0	2.7	3.0
Gross debt	79.3	102.2	107.1	107.5	107.8	103.4	99.8
Balance of payments			*(percent of GDP)*				
Current external balance	-5.9	-4.9	-4.4	-3.0	-5.7	-5.9	-6.3
Ext. bal. of goods and services	-1.5	1.8	2.1	0.3	-0.4	-0.6	-1.0
Exports goods and services	53.5	58.7	62.2	61.2	62.0	63.0	63.7
Imports goods and services	55.0	56.9	60.1	60.9	62.4	63.6	64.7
Balance of services	16.6	18.0	18.1	18.3	20.8	21.7	21.8
Balance of goods	-18.0	-16.2	-16.0	-18.0	-21.2	-22.2	-22.9
Balance of primary income	-3.0	-4.6	-3.7	-0.4	-2.7	-2.7	-2.7
Balance of secondary income	-1.4	-2.1	-2.8	-3.0	-2.6	-2.6	-2.6
Memorandum item			*(EUR bn)*				
Nominal GDP	19.5	18.1	17.6	17.6	17.9	18.5	19.1

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

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

percent change unless otherwise stated	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	-1.3	-5.9	0.7	1.9	2.9	2.1	1.9
2. Government consumption expenditure	-2.3	-8.2	-7.9	-0.6	-1.4	0.7	0.8
3. Gross fixed capital formation	-20.5	-12.9	-17.5	12.0	25.9	3.4	4.9
4. Domestic demand excl. inventories	-5.0	-7.4	-3.4	2.7	5.3	2.2	2.3
5. Changes in inventories (contr. to growth)	1.1	-2.2	2.1	0.3	-1.4	0.0	0.0
6. Domestic demand incl. inventories	-4.0	-9.4	-1.4	2.9	3.9	2.2	2.3
7. Exports of goods and services	-2.7	2.1	4.2	0.0	3.6	3.3	3.2
7a. - of which goods	-0.2	-12.5	2.1	-12.3	-1.3	2.5	3.1
7b. - of which services	-3.7	7.8	4.9	3.9	4.9	3.5	3.2
8. Final demand	-3.5	-5.5	0.7	1.8	3.8	2.6	2.6
9. Imports of goods and services	-4.5	-4.8	4.6	2.1	5.3	2.9	3.2
9a. - of which goods	-7.9	-15.3	5.1	3.0	10.7	4.7	3.7
9b. - of which services	1.4	11.4	3.9	1.1	-1.2	0.6	2.6
10. GDP at market prices	-3.2	-6.0	-1.5	1.7	2.8	2.5	2.3
(Contribution to change in GDP)							
11. Final domestic demand	-5.2	-7.4	-3.4	2.6	5.2	2.2	2.3
12. Changes in inventories	1.1	-2.2	2.1	0.3	-1.4	0.0	0.0
13. Net exports	1.1	3.7	-0.1	-1.3	-1.0	0.3	0.0

Source: European Commission

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

percent change unless otherwise stated	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	1.1	-5.9	0.2	0.2	1.7	3.3	3.2
2. Government consumption expenditure	-3.2	-12.4	-12.2	-1.2	-1.8	2.4	2.4
3. Gross fixed capital formation	-21.1	-12.7	-19.9	14.1	31.9	5.0	6.4
4. Domestic demand excl. inventories	-3.8	-8.1	-4.9	1.6	5.2	3.4	3.6
5. Changes in inventories (contr. to growth)	0.2	-0.2	0.1	0.2	-0.2	-0.2	-0.2
6. Domestic demand incl. inventories	-2.7	-10.0	-3.3	2.2	2.7	3.4	3.7
7. Exports of goods and services	-0.3	2.1	2.7	-1.2	2.8	4.9	4.4
7a. - of which goods	0.4	-10.7	3.5	-11.6	-2.2	5.0	4.2
7b. - of which services	-0.5	7.4	2.4	2.4	4.3	4.9	4.4
8. Final demand	-1.9	-5.8	-1.0	0.9	2.8	4.0	3.9
9. Imports of goods and services	-2.9	-3.7	2.5	1.6	4.1	5.2	5.1
9a. - of which goods	-6.5	-13.7	-0.6	0.5	10.2	7.0	5.4
9b. - of which services	3.4	12.1	6.2	2.9	-2.7	2.9	4.7
10. Gross national income at market prices	-4.3	-8.5	-2.1	0.4	1.5	3.3	3.2
11. Gross value added at basis prices	-1.5	-6.7	-4.4	0.7	1.1	3.4	3.2
12. Gross domestic product at market prices	-1.3	-6.9	-3.0	0.4	1.5	3.3	3.2

Source: European Commission

Table A2.4: **Implicit deflators**

percent change	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	2.4	0.0	-0.5	-1.7	-1.1	1.1	1.2
2. Government consumption expenditure	-0.9	-4.6	-4.6	-0.7	-0.4	1.6	1.7
3. Gross fixed capital formation	-0.7	0.2	-2.9	1.9	4.7	1.5	1.4
4. Domestic demand incl. inventories	1.3	-0.6	-1.9	-0.7	-1.1	1.2	1.4
5. Exports of goods and services	2.5	0.2	-1.5	-0.9	-0.6	1.5	1.2
6. Final demand	1.7	-0.3	-1.7	-0.8	-0.9	1.4	1.3
7. Imports of goods and services	1.7	1.3	-2.0	-0.5	-1.0	2.2	1.8
8. Gross domestic product at market prices	1.9	-1.0	-1.5	-1.3	-1.3	0.8	0.9
HICP	3.1	0.4	-0.3	-1.5	-1.2	1.2	1.1

Source: European Commission

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

Percent change unless otherwise stated	2012	2013	2014	2015	2016	2017	2018
1. Labour productivity	0.0	0.0	0.2	-0.2	0.1	0.2	0.3
2. Compensation per employee	1.5	-5.4	-3.8	-1.1	-0.6	0.7	1.1
3. Unit labour costs	1.5	-5.4	-4.0	-0.9	-0.7	0.6	0.8
4. Total population	1.5	-0.2	-1.1	-0.6	0.6	0.0	0.6
5. Population of working age (15-64 years)	1.5	-0.8	-2.1	-1.6	-0.1	0.3	0.3
6. Employment	-3.2	-5.9	-1.8	1.9	2.7	2.3	1.9
7. Unemployment rate (1)	11.9	15.9	16.1	15.0	13.1	11.7	10.6

Source: European Commission

Table A2.6: **External balance**

EUR bn unless otherwise stated	2012	2013	2014	2015	2016	2017	2018
1. Exports of goods (fob)	3.0	2.7	2.8	2.5	2.4	2.5	2.7
2. Imports of goods (fob)	6.6	5.7	5.6	5.6	6.2	6.7	7.0
3. Trade balance (goods, fob/fob) (1-2)	-3.5	-2.9	-2.8	-3.2	-3.8	-4.1	-4.4
3.1 p.m. (3) as % of GDP	-18.0	-16.2	-16.0	-18.0	-21.2	-22.2	-22.9
4. Exports of services	7.4	7.9	8.1	8.3	8.7	9.1	9.5
5. Imports of services	4.2	4.7	4.9	5.1	5.0	5.1	5.3
6. Service balance (4-5)	3.2	3.3	3.2	3.2	3.7	4.0	4.2
6.1 p.m. 6 as % of GDP	16.6	18.0	18.1	18.3	20.8	21.7	21.8
7. External balance of goods and services (3+6)	-0.3	0.3	0.4	0.1	-0.1	-0.1	-0.2
7.1 p.m. 7 as % of GDP	-1.5	1.8	2.1	0.3	-0.4	-0.6	-1.0
8. Balance of primary and secondary incomes	-0.9	-1.2	-1.1	-0.6	-1.0	-1.0	-1.0
8.1 - of which, balance of primary income	-0.6	-0.8	-0.6	-0.1	-0.5	-0.5	-0.5
8.2 - of which, balance of secondary income	-0.3	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5
8.3 p.m. 8 as % of GDP	-4.5	-6.7	-6.4	-3.3	-5.3	-5.3	-5.3
9. Current external balance (7+8)	-1.2	-0.9	-0.8	-0.5	-1.0	-1.1	-1.2
9.1 p.m. 9 as % of GDP	-5.9	-4.9	-4.4	-3.0	-5.7	-5.9	-6.3
10. Net capital transactions	0.2	0.4	0.0	0.1	0.1	0.1	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-0.9	-0.5	-0.8	-0.4	-0.9	-1.0	-1.1
11.1 p.m. 11 as % of GDP	-4.8	-3.5	-4.4	-2.2	-5.2	-5.3	-5.8

Source: European Commission

Table A2.7: **Fiscal accounts**

	2012	2013	2014*	2015	2016	2017	2018
			levels, EUR m				
Taxes on production and imports	2,703	2,475	2,593	2,601	2,733	2,802	2,892
Taxes on income and wealth	1,924	1,874	1,812	1,761	1,755	1,650	1,751
Social contributions	1,510	1,362	1,445	1,483	1,538	1,587	1,630
Other current resources	786	736	973	971	951	957	961
Total current revenue	6,923	6,447	6,823	6,817	6,977	6,996	7,234
Capital transfers received	105	160	130	101	43	43	43
Total government revenue	7,028	6,608	6,953	6,917	7,019	7,039	7,277
Compensation of employees	2,844	2,594	2,337	2,267	2,256	2,342	2,409
Intermediate consumption	800	735	647	684	646	648	654
Social transfers	2,580	2,484	2,469	2,468	2,563	2,606	2,660
Interest payments (1)	613	605	496	508	465	452	451
Subsidies	95	95	80	72	97	98	99
Other current expenditure	526	403	395	463	393	374	381
Total current expenditure	7,459	6,916	6,423	6,461	6,420	6,520	6,655
Total capital expenditure (2) (3)	654	624	2,071	665	535	481	495
Total expenditure	8,113	7,540	8,494	7,126	6,955	7,000	7,150
General government balance	-1,084	-933	-1,541	-209	64	38	126
General government primary balance	-471	-328	-1,045	299	529	490	578
			% of GDP				
Taxes on production and imports	13.9	13.7	14.8	14.7	15.3	15.2	15.2
Taxes on income and wealth	9.9	10.3	10.3	10.0	9.8	8.9	9.2
Social contributions	7.8	7.5	8.2	8.4	8.6	8.6	8.5
Other current resources	4.0	4.1	5.5	5.5	5.3	5.2	5.0
Total current revenue	35.6	35.6	38.8	38.6	39.0	37.8	37.9
Capital transfers received	0.5	0.9	0.7	0.6	0.2	0.2	0.2
Total government revenue	36.1	36.5	39.6	39.2	39.2	38.1	38.1
Compensation of employees	14.6	14.3	13.3	12.9	12.6	12.7	12.6
Intermediate consumption	4.1	4.1	3.7	3.9	3.6	3.5	3.4
Social transfers	13.3	13.7	14.1	14.0	14.3	14.1	13.9
Interest payments (1)	3.1	3.3	2.8	2.9	2.6	2.4	2.4
Subsidies	0.5	0.5	0.5	0.4	0.5	0.5	0.5
Other current expenditure	2.7	2.2	2.3	2.6	2.2	2.0	2.0
Total current expenditure	38.3	38.1	36.5	36.6	35.8	35.2	34.8
Total capital expenditure (2) (3)	3.4	3.4	11.8	3.8	3.0	2.6	2.6
Total expenditure	41.7	41.6	48.4	40.4	38.9	37.9	37.5
General government balance	-5.6	-5.1	-8.8	-1.2	0.4	0.2	0.7
General government primary balance	-2.4	-1.8	-6.0	1.7	3.0	2.7	3.0
Nominal GDP	19.5	18.1	17.6	17.6	17.9	18.5	19.1

* Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014
(1) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem.
(2) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013.
(3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).

Source: European Commission

Table A2.8: **Debt developments**

	2012	2013	2014*	2015	2016	2017	2018
Gross debt (% of GDP)	79.3	102.2	107.1	107.5	107.8	103.4	99.8
Real GDP growth (% change)	-3.2	-6.0	-1.5	1.7	2.8	2.5	2.3
Nominal GDP (EUR bn)	19.5	18.1	17.6	17.6	17.9	18.5	19.1
General government balance (% of GDP)	-5.6	-5.1	-8.8	-1.2	0.4	0.2	0.7
Change in gross debt ratio (pps change)	14.0	22.9	4.9	0.4	0.3	-4.4	-3.5
	Contribution to the change in stock						
Primary balance	2.4	1.8	6.0	-1.7	-3.0	-2.6	-3.0
Snow-ball effect	4.0	9.3	6.1	2.4	1.0	-1.0	-0.9
of which							
Interest expenditure	3.1	3.3	2.8	2.9	2.6	2.4	2.4
Real growth effect	2.1	5.1	1.6	-1.8	-3.0	-2.6	-2.3
Inflation effect	-1.2	0.9	1.6	1.3	1.4	-0.8	-0.9
Stock-flow adjustments	7.6	11.9	-7.1	-0.4	2.2	-0.8	0.4

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

Source: European Commission

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