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# Post-Programme Surveillance Report

## Cyprus, Autumn 2016

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European Commission

Directorate-General for Economic and Financial Affairs

# Post-Programme Surveillance Report

Cyprus, Autumn 2016

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## ABBREVIATIONS

AWG: Ageing Working Group	NPL: Non-performing loans
CBC: Central Bank of Cyprus	OECD: Organisation for Economic Co-operation and Development
CCB: Capital conservation buffer	PDMO: Public Debt Management Office
CET1: Common Equity Tier 1	PIT: Personal Income Tax
CIT: Corporate Income Tax	PPM: Post-programme monitoring
CSRs: Country specific recommendations	PPPs: Public-private partnerships
DB: Draft Budget	PPS: Post-programme surveillance
DBP: Draft Budgetary Plan	PSPP: Public sector purchase programme
DSA: Debt Sustainability Analysis	RoA: Return on assets
EC: European Commission	RoE: Return on equity
ECB: European Central Bank	SB: Structural balance
EDP: Excessive Deficit Procedure	SGP: Stability and Growth Pact
EPC: Economic Policy Committee	SMEs: Small and medium-sized enterprises
ESA2010: European System of Accounts 2010	SOEs: State-owned enterprises
ESI: Economic Sentiment Indicator	SRB: Single Resolution Board
ESM: European Stability Mechanism	SREP: Supervisory Review and Evaluation Process
FRBSL: Fiscal Responsibility and Budget System Law	SSM: Single Supervisory Mechanism
GDP: Gross Domestic Product	VAT: Value-added tax
GVA: Gross value added	VET: Vocational and Educational Training
HICP: Harmonised Index of Consumer Prices	WF: Winter forecast
IDR: In-depth review	
IMF: International Monetary Fund	
MIP: Macroeconomic Imbalance Procedure	
MTO: Medium-term objective	
NEET: Not in education, employment or training	
NHS: National Health Service	



## EXECUTIVE SUMMARY

**This report presents the findings of the first post-programme surveillance (PPS) mission of Commission staff, in liaison with staff from the European Central Bank (ECB), which took place in Cyprus from 26 to 30 September 2016.** Given that Cyprus has been identified as experiencing excessive macroeconomic imbalances under the EU Macroeconomic Imbalance Procedure (MIP), this visit also served the purpose of specific monitoring under the MIP. The visit was coordinated with an International Monetary Fund (IMF) staff visit. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to its Early Warning System. The reforms undertaken by Cyprus during the programme have started to bear fruit with robust economic growth and positive developments in the financial sector, which improved its liquidity and capitalisation. Despite sustained loan restructuring efforts, banks remain burdened with a high stock of non-performing loans, which weighs on their profitability. Fiscal consolidation has been crucial for strengthening the credibility of the policy framework and facilitating market access of the sovereign and it is important to safeguard these achievements. The reform momentum has significantly weakened, with crucial legislation still awaiting adoption. Therefore, the authorities should renew their reform efforts to improve Cyprus's growth potential and attract more foreign investment.

**Economic growth in 2016 has been stronger than expected, supporting fiscal performance.** Growth has been driven by tourism and private consumption, which itself was supported by the effect of declining prices on real income and improving labour market conditions. Real GDP growth in 2016 is expected to exceed 2½%, and to remain strong in 2017. Unemployment is perceptibly declining, albeit long term and youth unemployment remain very high. Fiscal consolidation has continued and the government's primary surplus target for 2016 is within reach. With the improved economic environment, the pressure for fiscal relaxation has increased. This should be resisted as fiscal risks remain significant. Fiscal discipline needs to be pursued, including by containing the public sector wage bill. It is also essential that legislative steps with a budgetary impact, such as the abolition of the immovable property tax, be compensated through well-specified measures at all government levels. Moreover, the downward path of public debt still remains to be firmly anchored.

**Accelerated loan restructuring efforts and the more supportive economic environment have led to a decline in the outstanding stock of non-performing loans (NPLs), which remains, though, at a very high level.** The return of confidence has allowed banks to broaden their deposit base, improve liquidity and capital buffers. Their profitability, however, is constrained by a declining net interest margin and rising risk provisioning. While new lending is strengthening, total credit to the economy continued to contract due to the necessary balance sheet deleveraging, including through loan write-offs and restructurings. Banks need to pursue more forcefully the loan restructuring efforts, by making full use of all available tools, in order to accelerate the pace of reduction of NPLs.

**The new insolvency and foreclosure frameworks are important achievements, but their implementation has to be stepped up.** These tools are essential to help reduce the high levels of private debt and NPLs, as they provide debtors and creditors with diversified and efficient means to resolve unviable debts and reallocate economic resources to more productive uses. Their use has been limited so far due to the increasing recourse to debt-to-asset swaps, which is welcome, but also due to slow administrative capacity building and the reluctance of some stakeholders to engage in time-consuming procedures. It is crucial to increase administrative capacity and strengthen the efficiency of legal proceedings, in order to facilitate the use of the insolvency and foreclosure frameworks.

**The pace of structural reform has considerably slowed.** It is crucial to renew the reform momentum, including by legislating critical, but much delayed reforms. This notably includes key areas such as public administration, where the wage bill mechanism and the horizontal reform draft legislation have been awaiting adoption by the House of Representatives since August 2015. This also includes the reform of the national health system, for which draft bills have been submitted to the Parliament. To further improve the business environment and attract more investment, progress needs to be achieved in key areas such as setting up a sustainable and efficient title deeds transfer system and modernising the justice

system. More efforts are also necessary to implement the privatisation plan, and achieve an effective reform of the electricity market.

**Risks for Cyprus's capacity to service its debt to the European Stability Mechanism (ESM) remain low in the short-term.** 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. They require continued fiscal discipline and resumption of efforts towards adopting growth-enhancing structural reforms. 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.

**Cyprus has taken a limited number of new measures relevant to address its excessive macro-economic imbalances.** In April 2016, Cyprus was identified as experiencing excessive macroeconomic imbalances, which requires specific monitoring in the context of the MIP. Overall, a few new measures were taken or announced in 2016 to address the imbalances in the areas of public and private debt, non-performing loans and the labour market. No new measures were taken to accelerate the reduction of private sector debt, while the use of the new insolvency and foreclosure frameworks appears limited. However, there has been a reduction in the stock of NPLs, stemming mainly from loan restructuring efforts by banks, the improved economic environment, and the implementation of measures already in place. Finally, key fiscal-structural measures have yet to be adopted in order to strengthen the long term sustainability of public finance.

The next PPS mission will most likely take place in Spring 2017.



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# 1. INTRODUCTION

**The economic adjustment programme for Cyprus ended in March 2016.** The three-year programme had been approved by the ECOFIN Council and the IMF Board in March 2013. The economic adjustment programme provided financing by the European Stability Mechanism (ESM), and the IMF of about EUR 7.8bn. The objective of the programme was to put Cyprus's 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 first post-programme surveillance (PPS) mission to Cyprus between 26 and 30 September 2016.** The mission was coordinated with an IMF staff visit. 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<sup>(1)</sup>. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

**Following the end of the programme, the standard economic surveillance mechanisms under the European Semester now apply to Cyprus.** During the programme, Cyprus remained in the Excessive Deficit Procedure (EDP) of the Stability and Growth Pact, which was abrogated by the Council on 17 June 2016. Cyprus received country-specific recommendations (CSRs) under the European Semester, as approved by the Council on 29 June 2016, which reflect the need for the continuation of reforms initiated or identified during the programme.

**The PPS mission included specific monitoring under the macroeconomic imbalance procedure (MIP).** The 2016 in-depth review (IDR) carried out for Cyprus under the MIP identified excessive macroeconomic imbalances and as a consequence there is specific monitoring on the progress with reform implementation to address these imbalances<sup>(2)</sup>. A review of the policy measures undertaken is provided in Section 3.5 of this report, while Annex 1 provides an overview of the MIP-relevant reforms.

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<sup>(1)</sup> 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.

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<sup>(2)</sup> See Communication from the Commission to the European Parliament, the Council and the Eurogroup: '2016 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011'

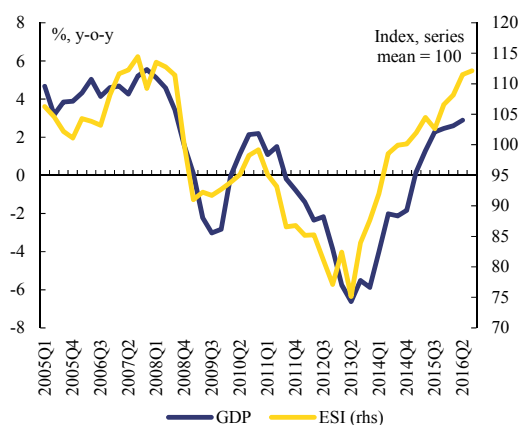


## 2. RECENT ECONOMIC DEVELOPMENTS

### 2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

**Real GDP growth has continued to strengthen in 2016 and the growth outlook has further improved** (Graph 2.1). Real GDP growth reached 2.9% y-o-y in the second quarter of 2016, a sixth consecutive quarter of positive growth. The recovery was primarily driven by private consumption, amid declining consumer prices, and an improving labour market. While investment has started to benefit from early signs of a stabilising housing market, it has been mainly driven by ship registrations. Strong growth in the tourism sector, benefitting from measures to extend the season, improved air connectivity, and weaker competitive pressure due to geopolitical tensions in the region, has provided significant support to exports. The expansion in exports was nevertheless offset by increasing imports, resulting in a negative growth contribution from net trade.

Graph 2.1: Real GDP and economic sentiment



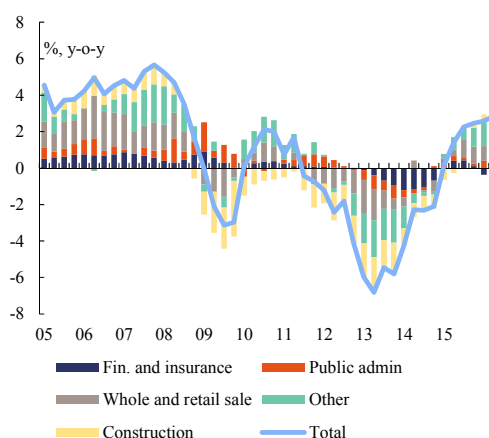
Source: Eurostat and European Commission

**From the sectoral perspective, increasing activity in the retail and wholesale sector has contributed significantly to growth** (Graph 2.2). Real retail and wholesale trade continued to benefit from declining prices, improving labour market conditions, and higher tourist spending. Growth in other sectors picked up as well. Following a reduction of 75% between 2008 and 2014, real construction activity has expanded by 17% since then, supported by signs of a stabilising housing market. Professional business services

continued to improve, up 4.5% y-o-y in the second quarter of 2016. On the other hand, real value added in the financial sector declined 5.3% y-o-y in the second quarter of 2016, reflecting a further reduction in the stock of credit.

**The non-financial private sector balance sheet adjustment is gaining traction.** In August 2016, households and non-financial corporations had reduced their outstanding borrowing by 11pps of GDP compared to August 2015. This decline reflects the increased restructuring efforts by banks, but also the more favourable economic environment that has led to increasing labour income since the beginning of 2016.

Graph 2.2: Gross value added and contribution to growth



Source: Eurostat

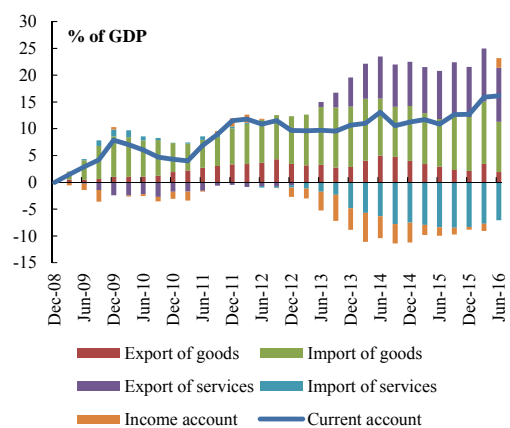
**The external position continued to benefit from increasing exports.** A 15pps of GDP improvement since 2008 has brought the current account to an almost balanced position, supported by increasing exports in recent quarters (Graph 2.3). The improved current account position has helped reduce the negative net international investment position (NIIP), from -160% of GDP in 2013 to -122% of GDP in the second quarter of 2016.

Table 2.1: Main features of macroeconomic forecast

	2015		2013	2014	Forecast (Autumn 2016)			2018
	Curr. prices (EUR m)	% of GDP			2015	2016	2017	
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	2.4	1.8	1.5
Public consumption	2.8	15.7	-8.2	-7.9	-0.6	-0.1	0.9	0.9
Gross fixed capital formation	2.3	13.3	-12.9	-17.5	12.0	9.1	8.3	6.4
Exports (goods and services)	10.8	61.2	1.9	4.2	-0.3	5.5	4.6	3.9
Imports (goods and services)	10.7	60.9	-4.9	4.6	2.1	5.7	4.7	3.6
GNI (GDP deflator)	17.6	99.6	-7.5	-3.3	-0.7	1.9	-0.7	1.9
Contribution to growth:	Domestic demand		-7.4	-3.4	2.6	2.9	2.5	2.1
	Inventories		-2.2	2.1	0.3	0.0	0.0	0.0
	Net exports		3.7	-0.1	-1.4	-0.1	0.0	0.2
Employment			-5.9	-1.9	0.8	1.8	1.6	1.5
Unemployment (1)			15.9	16.2	15.0	12.5	11.1	10.0
Compensation per employee			-5.4	-3.6	-0.5	1.2	1.5	1.9
Unit labour costs, whole economy			-5.4	-4.0	-1.5	0.3	0.5	1.1
Real unit labour costs			0.0	-2.5	-0.2	1.3	0.2	-0.1
GDP deflator			-1.0	-1.5	-1.3	-1.1	0.3	1.2
Harmonised index of consumer prices			0.4	-0.3	-1.5	-1.1	0.7	1.3
Terms of trade			-1.1	0.6	-0.4	0.5	-0.7	-0.4
Trade balance (goods and services) (2)			0.3	0.4	0.1	0.1	0.0	0.0
Current account balance (3)			-4.9	-4.4	-3.0	-2.8	-3.3	-3.4

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

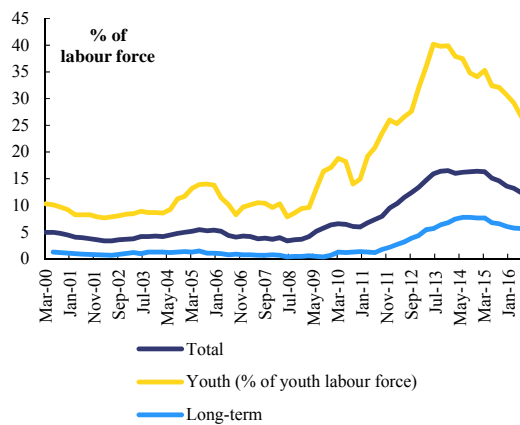
Graph 2.3: Cumulative current account adjustment since 2008



Source: Eurostat

**The recovery has benefitted the labour market** (Graph 2.4). Increasing employment and a declining labour force have helped reduce the unemployment rate to 12.4% of the labour force in the second quarter of 2016, down from a peak of 16.5% at the end of 2013. While youth unemployment has declined to 26.7% in the second quarter of 2016, down from a peak of 40% in mid-2013, long-term unemployment has declined to a lesser extent and only since mid-2015. The improved labour market conditions combined with the renewal of collective agreements has put upward pressure on labour costs. As a result, compensation per employee has started to increase. Combined with low productivity growth, increasing compensation per employee has halted the unit labour cost adjustment observed since 2012 (Graph 2.5).

Graph 2.4: Unemployment



Source: Labour Force Survey

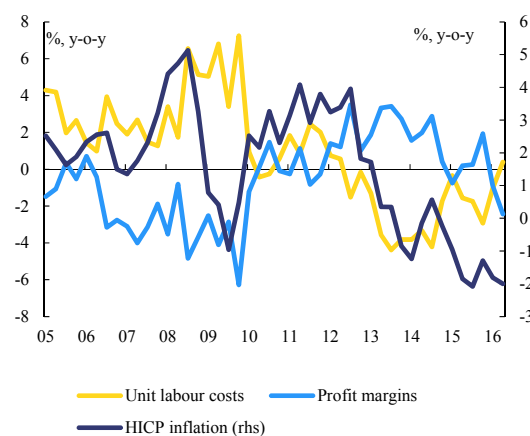
**HICP inflation rates remained in negative territory**, averaging -1.9% y-o-y in the first half of 2016 (Graph 2.5). The decline in consumer prices is broadly based among a high, albeit declining, number of sub-components. It reflects both the economic slack in the economy, as well as declining energy prices. The downward adjustment in consumer prices has been limited compared to the drop in unit labour costs. This implies that companies have increased their profit margins instead of passing the entire decline in labour costs on to consumer. In the first half of 2016, however, indicators suggest that profit margins have declined somewhat, although they remain relatively high.<sup>(3)</sup> The decline in consumer prices observed in the first half of 2016 was also reflected in the evolution of the GDP deflator, which declined by 2.1% y-o-y.

**The housing market appears to have reached a trough.** The decline in nominal house prices moderated to -1.6% y-o-y in the second quarter, according to the Central Bank of Cyprus. Housing demand is picking up from subdued levels, as reflected in the slow increase of housing transactions amid improving labour market conditions and signs of looser credit conditions. Housing supply appears to have bottomed out,

(3) See also Box 2.1 in European Commission (2014) "The Economic Adjustment Programme for Cyprus – Fourth review Spring 2014", Occasional Paper 197, July 2014 and Box 2.2 in European Commission (2015) "The Economic Adjustment Programme – Cyprus 7<sup>th</sup> Review Summer 2015" Institutional Paper 009, October 2015 for further discussion of profit margins.

with construction confidence becoming less pessimistic and housing investment up. Looking forward, the Bank Lending Survey suggests some pick-up in housing demand in the second half of 2016, but credit standards are likely to remain tight in the short-term. Housing market developments could also be affected by the implementation of the new foreclosure framework whose application so far has remained limited.

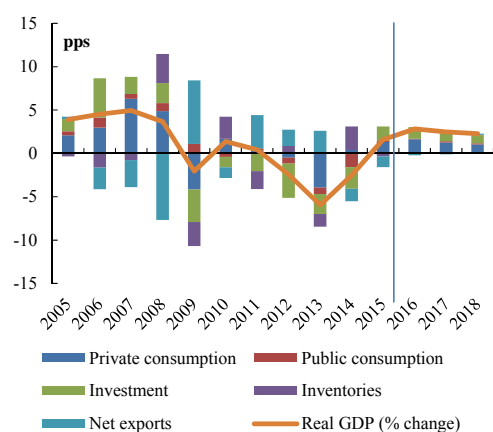
Graph 2.5: Prices, unit labour costs and profit margins



Source: Eurostat

**Real GDP is expected to grow by 2.8% in 2016 as a whole and then to moderate to 2.3% by 2018** (Graph 2.6). The growth forecast is primarily being driven by domestic demand, supported by low inflation, while exports are forecast to also support growth albeit to a lesser extent, benefitting from a bright outlook in the tourism sector. Job creation is expected to rise while unemployment is expected to ease. The improving labour market is likely to intensify the upward pressure on wages, which in combination with weak productivity growth would reverse some of the recent price-competitiveness gains. Profit margins are forecast to narrow, limiting the pass-through of higher unit labour costs to consumer prices. Real GDP growth is expected to moderate next year and slow down to 2.3 % in 2018, due to slowing growth of the tourism sector and fading support from the negative inflation. Moreover, higher debt servicing due to deleveraging pressure and continued loan restructuring efforts by banks is also projected to weigh on domestic private demand. Consumer prices are expected to increase moderately alongside gradually declining unemployment.

Graph 2.6: Real GDP growth and contributions



Source: European Commission

**Risks remain broadly balanced.** On the upside, lagged effects of declining energy prices and a stronger labour income could support consumption more than currently envisaged, while FDI could perform better than currently forecast. Moreover, the performance in the tourism sector may turn out stronger than forecast. On the downside, weaker demand from main trading partners (Greece, UK, Russia) and the impact from the UK's referendum to leave the EU could weigh more on activity than forecast. In the financial sector, the slow reduction of the high level of non-performing loans could lead to a more prolonged period of tight credit conditions, which would not support the recovery.

## 2.2. PUBLIC FINANCES

**Fiscal performance until August 2016 has been strong, mostly due to better than expected GDP growth supporting tax revenues.** Better macroeconomic performance has led to a relatively high tax collection for the first eight months of the year, while total expenditure remained contained. As a result, the primary balance for the first eight months of 2016 reached 2.8% compared to an annual forecast of 2.2% in the spring forecast.

**General government revenue for the first 8 months of 2016 has increased by 1% y-o-y.** This increase was largely driven by an expansion of the current taxes on income and wealth (+7.1%)<sup>(4)</sup>, taxes on production and imports (+1.4%) and social security revenues (+3.2%). These positive developments were partly offset by a decline in revenues collected from other current resources (-22.3%) due to lower dividends received from the Central Bank of Cyprus (by 0.2% of GDP) as commercial banks continue to repay Emergency Liquidity Assistance (ELA), thus reducing the interest collected on these loans. VAT revenues were positively affected by increased economic activity. Social security contributions also increased. This was not only due to better employment performance, particularly from the self-employed, but also thanks to administrative measures aimed at improving tax collection.

**General government primary expenditure until August increased marginally by 0.1% y-o-y.** This development was led by an increase in total current expenditures (+0.3%) compensated to some extent by lower capital expenditures (-2%). Prudent budget execution and a fall in the compensation of employees, driven by lower gratuity payments to retirees, supported the overall reduction. Similar developments were registered also in intermediate consumption. Some partly offsetting factors were an increase in subsidies and, more importantly, in social transfers and pension benefits.

**Public debt is expected to have peaked at around 108% of GDP in 2015.** New debt issuance combined with debt buy-backs are helping to spread out maturities and improve the risk profile (see Section 4 on Sovereign Financing and Capacity to Repay).

<sup>(4)</sup> This includes EUR144.8m of taxes recorded until August but not allocated yet to the respective ESA revenue categories.



Table 2.2: Financial soundness indicators

in %	2012				2013				2014				2015				2016	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	June	Sep	Dec	Mar	June	Sep	Dec	Mar	June
<b>NPLs, loans to legal entities (% of total)</b>	18.0	18.9	20.3	22.6	24.7	30.2	39.7	44.4	45.6	49.1	50.4							
<b>NPLs, loans to NFCs (% of total)</b>												58.0	55.8	55.7	57.0	56.0	55.1	58.3
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
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
<b>NPLs, loans to private individuals,</b>	18.0	18.9	20.3	22.6	24.7	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
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
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
<b>Provision coverage rate (% of NPE)</b>				47.9				37.7		35.8	36.3	32.9	32.6	33.1	33.2	37.8	37.1	37.9
<b>Cost-to-income ratio</b>	41.0	49.7	51.6	55.6	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
<b>Net interest margin</b>	2.8	2.4	2.3	2.3	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
<b>Core Tier 1 ratio</b>	6.1	7.3	6.9	4.5	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
<b>Return on assets</b>	1.6	-1.9	-1.7	-3.4	-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

Source: Central Bank of Cyprus

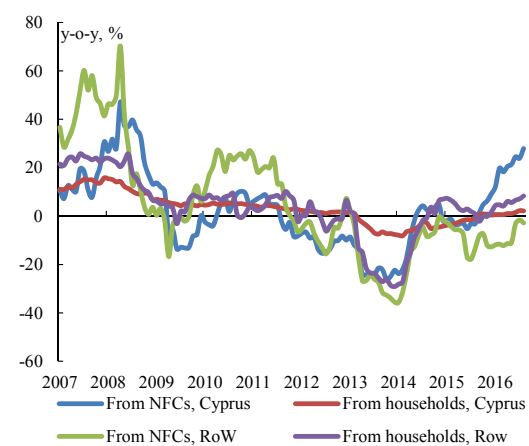
### 2.3. FINANCIAL STABILITY

**The recovery of the banking sector continued as banks improved their liquidity, consolidated further their solvency positions, and increased their efforts on loan restructurings.** Helped by a supporting macroeconomic environment, Banks made progress towards deleveraging and the cleaning-up of balance sheets. There is evidence that the amount of NPLs has passed the peak and is coming down, thanks to a stronger implementation of financial sector reforms and the banks' efforts in terms of arrears management. The pace of loan restructurings has picked up significantly, in particular for large non-financial corporates. Yet, the transition of restructured loans into the performing category is subject to a minimum period of proven performance and can only be ascertained in the next few months and over a longer period of time. The long-term sustainability of banks is dependent upon reducing their excessively high levels of non-performing loans. This is reflected in the weak profitability of banks resulting from declining operating profits which were absorbed by new provisions in the last quarters of both 2014 and 2015.

**Deposits have increased again in 2016, on the back of strengthened confidence.** Since the short-lived instability related to the Greece political turmoil during the summer of 2015, deposits have been growing, including in the Greek subsidiaries. The remaining payment restrictions were lifted in April 2015. Total deposits in Cyprus increased by about EUR 1.5bn in the year up to end-August 2016. In the first half of 2016 the Greek subsidiaries had recovered all the liquidity shed in 2015, i.e. more than EUR 600m. By depositor

types, the highest annual growth rates were recorded for Cypriot NFCs and households from the rest of the world (Graph 2.7).

Graph 2.7: Deposits developments



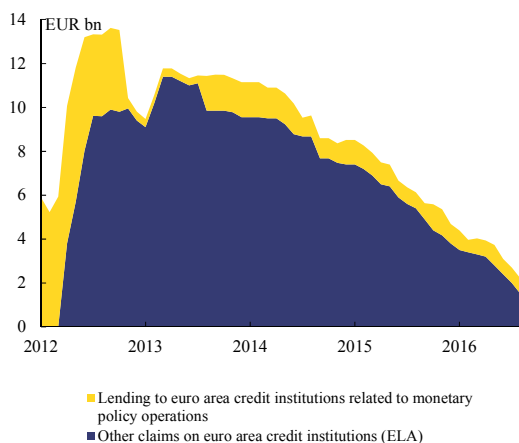
Source: Central Bank of Cyprus

**The reliance on central bank funding has been further reduced.** Following the exit from the economic adjustment programme in March 2016, Cyprus government bonds lost their eligibility as collateral for Eurosystem monetary policy operations. Indeed, as Cyprus is rated below investment-grade by credit rating agencies, the participation to a programme was a condition for the Eurosystem eligibility of Cypriot sovereign debt. No material negative impact on central bank funding was observed as Cypriot banks had prepared liquidity buffers in anticipation of this event. The reduction in the reliance on central bank funding was mainly achieved thanks to both the broadening of the deposit base and the successful downsizing of the bank assets. As of

August 2016, total reliance on central bank funding by Cypriot banks stood at EUR 2.2 billion down from EUR 4.7bn at end-2015 (Graph 2.8). The reliance on ELA more than halved to EUR 1.5bn over the same period. Bank of Cyprus still accounts for the lion's share of ELA funding with EUR 1.3bn as of September 2016, down from a peak of EUR 11.4bn in March 2013.

**Banks' profitability is challenged by decreasing net interest income and further provisioning of NPLs.** Banks recorded a loss (before tax) of EUR 374m in 2015, as the net profit before provisions and impairment decreased by 12.5% to EUR 1.4bn, while provisions increased by 21.4% to EUR 1.7bn. In the first half of 2016, banks recorded a profit before tax of EUR 272m. The decline in provisioning charge of about EUR 370m offset the lower net interest income. Overall, the banks' capacity to generate profits remains under pressure in a context of very low and negative interest rates and further balance sheet deleveraging. While higher provisions would be welcome, they would have a negative short-term impact on bank profits both directly and indirectly via the recording of accrued interest on the non-provisioned part of NPLs.

Graph 2.8: Borrowing from the Eurosystem



Source: Central Bank of Cyprus

**The very high level of NPLs remains a concern, but risk provisioning has improved.** As of June 2016, NPLs on local operations of both banks and cooperative institutions stood at 58.3% of credit facilities to non-financial corporations (NFCs) and

56.3% of loans to households (Table 2.1). While the NPL ratio for households remained almost flat, the NPL ratio for NFCs inched up by about 2pps from December 2015 to June 2016. This was due to the fact that although NPLs declined in absolute terms by EUR 1.3bn for NFCs in the first half of 2016, the gross amount of loans decreased significantly by about EUR 3.2bn over the same period. In the case of households, both the reduction of NPLs and of the total loan portfolio were much lower at around EUR 0.4bn and EUR 0.7bn during H1 2016. This illustrates a much more dynamic restructuring of loans for NFCs. It is also an outcome of the banks' increased resort to debt for asset swaps, in particular for company loans, which allow them to overcome inherent inefficiencies in the judiciary sector and in the use of collaterals. Taking resolute action in using the new tools made available by the foreclosure and insolvency frameworks may have a significant impact on the reduction of NPLs via improved payment discipline. The SSM's Supervisory Review and Evaluation Process (SREP) exercise of end-2015 led to an increase in the coverage of NPLs by accumulated provisions for impairments from about 33% to 37%. The coverage rate remains somewhat lower than the average of banks across Europe, mostly due to policies for haircuts to collateral valuation, assumptions about time to recovery and a high level of collateralisation of loans. Higher provisioning levels coupled with strong supervisory action should provide strong incentives for banks to deal more effectively with the large stock of NPLs.

**Both banks and cooperative institutions have stepped up their loan restructuring efforts, and first positive results in terms of performing restructured loans are emerging.** The share of restructured loans has increased notably since the last review mission in November 2015. In June 2016, compared to a year before, the amount of restructured loans (performing and non-performing) increased to 36.8% of total loans for NFCs and 26.4% for households from 31.9% for NFCs and 25.1% respectively. This better performance in the case of restructured loans for NFCs can be explained by the fact that the newly created or strengthened arrears management units focused their efforts on the larger legacy bad assets. Most importantly, the share of performing restructured loans to total loans has increased for NFCs from 7.9% in June 2015 to 9.1% in June

2016, whereas the same ratio for households has dropped from 8.6% to 6.7% over the same period. This would suggest that relatively more restructurings are conducted in the case of NFCs and that they are also beginning to bring about the expected positive impact on the quality of assets. To further speed up the debt restructuring, targets were set for loan restructurings (Box 2.1).

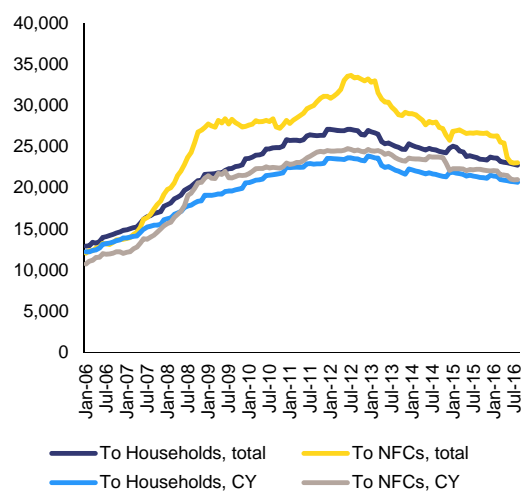
#### **Banks have maintained sound capital positions.**

The Common Equity Tier 1 (CET1) capital ratio of all banks stood at 15.7% in June 2016, about 0.5 percentage point higher than a year before. This improvement follows the SREP exercise and the assessment of provisioning practices and policies carried out at the end of 2015, which highlighted the need for stronger capital buffers and provisioning levels. This notably led the Cooperative Group (Coops) to benefit from a capital injection of public money of EUR 175m 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. Indeed, this would strengthen their capital generation capacity and allow them to reduce the need for further provisioning of losses on delinquent borrowers.

#### **Banks' deleveraging continues while new lending is picking up.**

The gross stock of loans to resident households and NFCs contracted respectively by -3% and -6% y-o-y as of August 2016 (Graph 2.9). This contraction mainly results from the growing use of debt-to-asset swaps and debt write-offs by banks in order to restructure their non-performing exposures, and to some extent from the repayment of performing loans. The capitalisation of interest might be understating the downsizing of loan exposure since it appears in the statistics as an increase in loans outstanding. The pace of new bank lending to local residents has picked up in proportional terms from about EUR 1.5bn in 2015 to EUR 890m in the first half of 2016. However, the total domestic lending activity of the banks was still declining by about 8% y-o-y as of August 2016 due to the fast contraction in loans to other financial intermediaries and the government.

Graph 2.9: Loan developments, EURbn

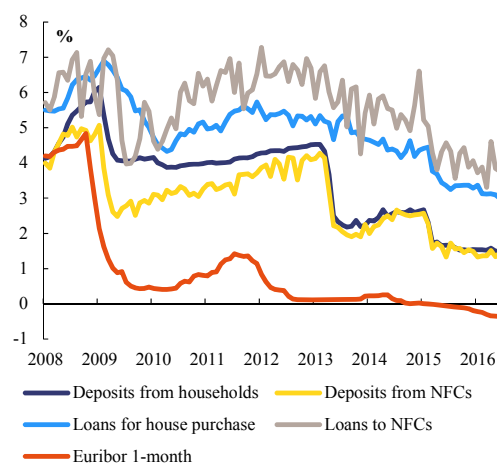


Source: Central Bank of Cyprus

#### **The net interest margin has narrowed, notably due to regulatory actions.**

Following an increase in interest rates during 2014 (Graph 2.10), the Central Bank narrowed the maximum authorised spread between Euribor and the deposit interest rates in 2015. This led to a relatively sharper decline of lending rates than deposit rates, weakening the net interest margin, which remains however above the average of euro area peers. This contributes to putting additional pressure on banks' profitability.

Graph 2.10: Interest rates developments



Source: Central Bank of Cyprus

### Box 2.1: Non-performing loans: targets and achievements

**The banking sector is still confronted with an excessively high NPL ratio, which stood at close to 56.3% of total loans for non-financial corporations and households at end-August 2016.** At the same time, accelerated loan restructuring efforts and the more supportive economic environment have led to a decline in the outstanding stock of non-performing loans (NPLs). In particular, the amount of NPLs declined in absolute terms by around EUR 2bn in the first eight months of 2016.

**The banks and the authorities have put forward several measures and legal initiatives aiming at reducing the large backlog of NPLs.** The banks have proceeded with creating dedicated internal arrears management units and strengthening related internal processes. The foreclosure and insolvency frameworks, as well as legislation for dealing with the title deeds and property rights and facilitating the sale of loans all improve the framework conditions for handling the NPL problem. Furthermore, legislation for loan securitisation is also under preparation. Also, the Central Bank of Cyprus (CBC) has established an arrears management framework, has issued a code of conduct for the banks and set targets on key performance indicators (KPIs). The CBC has more recently set targets for restructuring of loans presenting arrears over 90 days and handling of loans with arrears less than 90 days.

**Targets for four indicators were set to the whole loan portfolio, with quarterly reporting requirements.** The four indicators are:

- (1) "Proposed sustainable solutions" as a percentage of the loans presenting arrears over 90 days (non-cumulative);
- (2) "Concluded sustainable solutions" as a percentage of the loans presenting arrears over 90 days (non-cumulative);
- (3) "Terms-being-met" - loans that have been restructured and present arrears of less than 8 days as a percentage of the total loans which have been restructured (cumulative since 1 January 2014);
- (4) "Early-arrears cure rate" - share of loans that presented arrears between 30 and 90 days at the beginning of the quarter but by the end of the quarter do not present any arrears (due to pro-active measures by the bank).

Indicators	2015		2016	
	June achieved	September target	December achieved	March target
(1) Proposed solutions (%) (non-cumulative)	6.1	9.4	6.2	12.5
(2) Concluded solutions (%) (non-cumulative)	4.7	7.4	6.6	11.7
(3) Terms-being-met (%) (cumulative since Jan 2014)	65.8	66.5	69.8	72.9
(4) Early-arrears cured (%) (non-cumulative)	28.1	27.8	32.2	40

Source: Central bank of Cyprus

**The targeting system confirmed the positive trends in proposing and carrying-out new sustainable restructurings.** In the last quarter of 2015, banks exceeded their targets on both indicators and showed a significantly improved performance. At the same time, banks underperformed against their targets of cured restructurings and cured early arrears. While indicator (3) is somewhat difficult to interpret because it depends on the quality of the restructurings offered, the early cure rate suggests that banks are taking a pro-active approach in preventing early arrears from generating NPLs. This bodes well for the future evolution of the level of NPLs, in particular as the achieved early cure rate is significantly higher than the ones reported in the previous quarters. The high share of "Terms-being-met" (cumulated cured restructurings) stands in contrast with the low share of total performing restructured loans (relative to the non-performing ones) in the aggregate portfolio of the banks. This suggests that some of the past restructurings may not be sustainable. As a result of the performance observed during Q4 2015, banks have revised slightly their targets for Q1 and Q2 2016. The supervisory involvement in the target setting process represents a strong incentive for the appropriate calibration of the targets and meeting them by the banks.

**The CBC committed to gradually extend the horizon of the targets to four quarters during 2016.** CBC will also put in place a framework to analyse the estimated path of system-wide loan restructuring and recovery based on the actual and targeted restructuring performance of banks. In addition, the CBC will study the scope for an extension of the targeting framework to cover troubled assets resolution in addition to existing loan restructuring targets.

## 3. POLICY ISSUES

### 3.1. FINANCIAL SECTOR

#### 3.1.1. Regulation and supervision in the bank and non-bank sectors

**The authorities have deepened the implementation of the reforms to the supervisory and regulatory frameworks initiated during the programme.** Most notably, a number of important regulations on loan origination and on provisioning have become fully operational and are now contributing to an improved risk management by commercial and cooperative banks. Incentives have been created, including through legal amendments, for the creation of a secondary market for bank loans. Key legal instruments, notably the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive (DGSD) have been transposed into national legislation. The credit register, in addition to becoming more efficient, has become a useful tool for banks' loan origination. The supervision of the coops has been fully integrated into the Central Bank of Cyprus (CBC) and is carried out on a level-playing field in relation to the commercial institutions. CBC's additional staffing needs have been addressed.

**In addition to these achievements, the Cypriot authorities have engaged into several initiatives to further improve the supervisory and regulatory framework.** Most importantly, the loan origination directive was simplified, in line with comments and suggestions received from the banks. The pre-contractual phase of a loan agreement, and more specifically the reflexion time for the potential borrower, was shortened. The revamped directive also clarifies that financial leases and syndicated loans are outside of its scope. In order to stimulate a secondary market for loans, the authorities still pursue the legal initiative for a bill on securitisation. Final comments by the concerned stakeholders are still awaited, hoping to submit a legal text to the Parliament by the end of the year. However, given the latest experience with the bill on the sale of loans, it remains to be seen to what extent the securitisation bill will have a material impact. It appears that no loan below EUR 1mn has been sold so far, which may be explained by the burdensome licensing requirements placed on potential purchasers of

those assets. Lack of servicers and poor liquidity in the estate market may also play an important role. The Central Bank reported that, despite a few requests, no application was filed for obtaining the necessary licence. It is not to be excluded that the provisions of the securitisation law will remain equally inactive. Thus, the effective functioning of a secondary market for bank loans remains one of the main challenges for the Cypriot financial sector.

**The authorities are continuing to improve the credit register and the electronic registrar of companies.** The credit register of commercial banks' borrowers will be fully integrated with the register of the cooperative banks. In addition, the managing company is being required to develop a scoring system for better appreciation of households' risks. The CBC continues reflecting on how to integrate the credit register's data in its economic research and is exploring how to submit more granular data to the ECB AnaCredit database, starting from 2018. The registrar of companies has been updated and submission of financial statements and other data has been made electronic.

**The regulation and supervision of insurance companies and pension funds is to be integrated into a single supervisor.** A working group was set up in 2015, including representatives of the two current supervisors, the Ministry of Finance and experts from EIOPA. This working group aims to establish the legal, financial and operational options for achieving this supervisory integration. 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 in October 2015. While the supervisory integration is not yet effective, much progress has been achieved in the diagnosis of the sector (See Box 3.1). A technical project management team was set up in September 2016 with a view to implement the integration of the regulation and supervision of the sector in line with the recommendations contained in the October 2015 report.

### *Box 3.1: Pension and insurance sectors: structure and supervision*

**During the economic adjustment programme, the authorities committed to review the options for improving the quality, independence, governance and administrative capacity of the non-banking supervision.** The authorities referred to EIOPA for expert advice in this area. The analytical work carried out by EIOPA was summed up in a report, submitted to the authorities on 30 October 2015, which contained a detailed description of the market based on data up to end-2014, an assessment of its supervisory structure, as well as a list of specific recommendations. This box provides a summary of this report.

**The insurance sector comprises 32 entities with total assets of about EUR 3.8bn at end-2014, the two thirds of which approximately cover the life insurance responsibility.** The sector is characterised by high concentration with the top 5 undertakings in the life and non-life segments controlling respectively 85% and 48% of the market. For 2014, life insurance attracted total premiums of EUR 361m, while the non-life segment generated business for EUR 530mn. About one fifth of the policies are written abroad. The overall business has decreased by 4% relative to 2013, with a stronger contraction in the life segment. Despite the aggregate profit of EUR 15m for 2014, the life segment posted a loss of EUR 19m.

About two thirds of the life segment consists in unit-linked policies with their assets primarily invested in investment funds (54%), property (7%), equity (7%) and group loans and participations (7%). The assets of the non-linked policies are mostly invested in private bonds (34%), investment funds (22%), government bonds (20%) and property (5%). The structure of assets in both cases raises the question of the liquidity of the assets and requires a look-through approach for the proper appreciation of counterparty and market risks, the significant reliance on debt instruments in the case of non-linked policies calls for a duration study in order to fully gauge the risks of a possible maturity mismatch.

The non-life insurance segment is dominated by motor insurance (38% of total business in 2014), followed by fire insurance (30%) and accident and health coverage (27%). The main line of business, i.e. motor insurance, is not perceived as profitable,

due to strong competitive pressure for market shares and high costs, mainly driven by high distribution fees. The assets covering the technical provisions of the non-life segment are concentrated in reinsurance share (34%), deposits (26%), other debts (11%), group loans and participations (6%) and property (6%). In the current low interest environment, this investment structure raises some concerns about the capacity of the segment to generate capital internally and thus to build up its capital reserves.

**The insurance undertakings are supervised by the Insurance Companies and Control Services (ICCS), which is organised as a Directorate within the Ministry of Finance.** In total, the ICCS is staffed with 16.5 full-time employees and relies on the general IT and human resources support of the Ministry of Finance. Internal actuarial resources are lacking, also due to a non-attractive wage structure relative to the market-determined wages for actuaries. As a result of this, the ICCS is subcontracting actuarial services from a UK firm. The ICCS has not developed its own legal expertise as it relies on the office of the Attorney General. A comprehensive reform is necessary in order to ensure the operational and legal independence of the insurance supervisor. This would help prevent the materialisation of major risks associated to inadequate supervision.

**The second pillar (occupational) pension industry in Cyprus comprises two kinds of pension schemes: defined-contribution schemes (provident funds) and defined-benefits or hybrid schemes (pension funds).** The provident funds are mainly sponsored by the private sector companies, whereas the pension funds are mainly sponsored by the broader public sector organisations. As of October 2015, there were 2,056 registered provident funds, 56% of which were under dissolution, primarily due to the economic crisis. The majority of provident funds are small, i.e. below ten members, while there are about hundred provident funds with over 100 members. As of end 2014, the top twenty-one provident funds, for which data is available, included 42,743 members and held assets for about EUR 1.2bn. Bank deposits and government bonds represent respectively 46% and 24% of the top twenty-one provident funds' assets.

*(Continued on the next page)*

*Box (continued)*

**The pension market is highly concentrated: the main pension fund has a 48% market share, while the top two provident funds control 60% of their market.** By law, members of provident funds are allowed to receive their entitlements upon termination of employment and not when the retirement age is reached. The law does not have any provisions regulating the transfer of funds from one provident fund to another. There are 6 registered pension funds and 75 pension funds under registration, which are in the majority small funds below 10 members. The two largest pension funds are the ones of the semi-government organisations Cyprus Electricity Authority and Cyprus Telecommunications Authority. All pension funds belong to one of the following three categories: semi-government organisations and councils, municipality sector and community sector. As of end 2014, the top five pension funds, out of the total number of 71, included 7,880 members and held assets for about EUR 800m. Banks deposits, shares and loans to members represented respectively 61%, 15% and 11% of the top five pension funds' assets. According to the rules of operation of each pension fund, the benefits are guaranteed by the Sponsoring Undertaking which is fully under the control of the central government.

**Providence and pension funds in Cyprus are supervised by the Registrar for Occupational Retirement Benefit Funds (RORBF).** The RORBF is set up within the Directorate for Social Insurance Services, which is part of the Ministry of Labour, Welfare and Social Insurance. It has ten staff members, some of which are seconded from other ministries. For legal, operational, and human resources matters, the RORBF is heavily relying on the general support of the Ministry of Labour.

**In light of the current state of play, it appears that the current supervisory structure is not adequate for ensuring the stability of the non-negligible sector of non-bank financial intermediaries.** The report by EIOPA identifies all the risks related to maintaining the status quo, and makes a number of recommendations for improving the supervisory landscape. It is proposed that the statute of the new single authority should be determined by an autonomous piece of legislation. To increase its independence and transparency, a Board structure is suggested, including financial independence. The report leaves open the question whether the Board structure implies necessarily a full independence from any existing administrative entity, such as the Ministry of Finance for instance. A specific organisational structure, with own supporting IT and other services, totalling around fifty staff members, is outlined and provides for the employment and continuous training of highly qualified personnel, including eight actuaries.

### 3.1.2. Restructuring of the banking sector

**Both Bank of Cyprus and the Cooperative Group have made notable progress with the implementation of their restructuring plans.**

Both institutions managed to strengthen their positions with respect to funding and efficiency. Thanks to significant private liquidity inflows, Bank of Cyprus reduced its reliance on ELA at an impressive pace, and loan-to-deposit ratios have evolved very positively. Efficiency gains have been achieved through optimisation of branches, cost reduction and divestment of foreign and legacy assets. Bank of Cyprus improved its arrears' management, and has restructured already about sixty percent of its non-performing exposures.

**Despite the progress achieved, further restructuring efforts and eventually a return to sustainable viability seem increasingly challenging for the Cooperative Group.**

A key milestone was reached with the operational transfer of the individual cooperative banks' assets to the Central Cooperative Bank. However, the Group is struggling to improve its net interest margin, which stands at about 100 basis points below the average of the sector in Cyprus. Due to the slow implementation of its restructuring plan, the Group only managed to restructure about one fifth of its NPLs. The finalisation of the centralisation process is necessary to support the pro-active management of NPLs. Future steps towards compliance with the revised restructuring plan include the optimisation of the branch network and the public listing of the shares. The latter is likely to occur in September 2018 at the earliest, accompanied by an appropriate capital increase to ensure ten percent of the shares are floating freely. However, increasing political interference puts into question the ability of the management of the Group to continue to adhere to agreed targets and deadlines included in the restructuring plan. All in all, the restructuring plan of the Coops needs to be implemented more forcefully in order to *inter alia* meet the deadlines for the listing and privatisation of the credit institution.

**The risk stemming from the subsidiaries of Greek banks appears fully contained.** The four Greek subsidiaries managed to recover the deposit base lost in the first half of 2015. Exposure to Greece has remained flat and is contained thanks

to over-collateralisation by parent funding. With the commitment to complete the sales of the Piraeus and NBG subsidiaries, as per the restructuring plans of the parent institutions, exposure to Greece will be further mitigated. As far as Eurobank is concerned, it stands out with a low NPL ratio of 6% thanks to its late arrival in the market in 2008 and cash collateralised lending practices.

**The resolution process of legacy Laiki is taking much longer than initially foreseen.**

An advisor was hired for the disposal of foreign assets and this workstream appears to be progressing. Foreign banks are set to be appointed as external consultants for the management of the stake in Bank of Cyprus. The finalisation of the appointment is, however, pending on some administrative hurdles, as well as legacy Laiki's creditors' attempts to regain control over Laiki's assets from the Resolution Fund. While creditors' stronger involvement in the management of legacy Laiki would not, per se, be contradictory with the resolution process, it could nevertheless slow it down or even attempt to revert it. The latter would lead to re-licensing the institution as a bank, which could negatively impact the public finances and other banks through a re-activation of the Deposit Guarantee Scheme (DGS). In order to prevent such risks, the authorities are committed to finalise the resolution process as initially intended.

**The resolution of FBME is progressing, albeit at a slow pace.**

FBME Cyprus is a branch of a Tanzanian bank which has been cut off from international inter-bank transactions on money-laundering suspicions. Following the revocation of its banking licence by the Central Bank of Cyprus, its liquidation could start effectively only after the appointment of a liquidator by the court, expected for end October 2016. The pay-out of the EUR 140m of eligible insured deposits has started already, and claims for only close to EUR 30m had been received as of end-September 2016. Thus, it can be expected that less than the overall eligible deposits will be effectively reimbursed. Once the liquidation process starts formally, the DGS will be able to recover these amounts out of the branch's estate, which includes a deposit at the CBC for EUR 130m. Thus, no impact on the public finances or the industry is expected.



### 3.1.3. Future challenges for the financial sector policy

**The main challenge remains the improvement of banks' asset quality, which is a prerequisite for banks' active contribution to the funding of the economy.** Banks have strengthened their active arrears management. In addition, the improved economic growth has also played a role and the number of mutually beneficial restructuring solutions has increased. However, some institutional bottlenecks are still present and could become an obstacle to the successful and sustainable improvement of banks' asset quality. Most notably, the judiciary system reform would allow for swifter conflict resolution in the event of commercial disputes. There are signs that banks are trying to avoid recourse to the judiciary system and agree with the debtors on bilateral out-of-court debt-for-asset swaps. Such solutions, to be sustainable, require at a minimum the mobilisation of extensive resources specialised in real estate management and the respect of strict risk exposure limits to avoid the concentration of real estate market risk. The long-term viability and effective operation of banks in their traditional role could otherwise be impeded.

**The low interest rate environment weighs on profitability and could lead to excessive risk taking by banks.** So far, Cypriot banks have managed to keep their interest rate margins above the EU average. At the same time, banks in Cyprus benefit from ample excess liquidity, due to improved confidence thanks to high capital buffers and the expansionary monetary stance in the euro area. However, excess liquidity may also turn into a curse. In cases where excess liquidity is negatively affecting profitability, banks may have an incentive to search for higher yields both home and abroad. Higher profits come with higher risks that, if miscalculated, could ignite the same boom-bust cycle through which Cypriot banks went through.

### 3.1.4. Legal framework for private debt restructuring

**The use of the new corporate and personal insolvency processes is low, but is expected to increase.** 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.

**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 acquired basic resources (staff, IT), it needs to be strengthened in order to properly carry out its tasks. It has made significant efforts to publicise the new insolvency framework.

Table 3.1: **Insolvency framework applications as of end August 2016**

Personal Insolvency Arrangements (PIA) (debt repayment plans)			
Applications to ISCyp	Applications to Court for protection certificate	Court-issued protection certificates	Approved PIAs
32	4	3	0
Debt Relief Order (debt forgiveness process for up to €25k)			
Applications to ISCyp	Applications processed to date	Referred to the District Court for final approval	Court issued DROs
910	155	40	7
Examinership (corporate debt restructuring)			
Applications to Court for temporary protection from creditors	Withdrawn by applicant	Before the Court	
2	1	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. This review has not commenced, primarily due to a lack of policy coordination between the Ministries involved. The Ministry of Energy, Commerce, Industry and Tourism (MECIT) will assume lead responsibility for all insolvency policy. This may facilitate the start of the review.

**The revised foreclosure legislation is now in full legal effect but is only sparsely used.** The first foreclosure auctions took place quite late, in June 2016 and proved rather unsuccessful as the majority did not attract satisfactory bids. Only few residential properties have been the subject of notice for auction, and only about 40 foreclosure cases were being pursued by banks as of October

2016. Compared to the outstanding total amount of NPLs (EUR 27.3bn or 160 % of GDP), those where the underlying collateral is to be auctioned represent only about EUR 100m. This confirms that banks have so far used the foreclosure tool as a way to improve the payment discipline of borrowers via a signalling effect rather than as a primary way to collect outstanding debts.

**The legal procedures are being modernised 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 are expected to be submitted to the House of Representatives in autumn 2016.

**The reform of the system of title deeds transfers has been 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 but more steps are needed to have a new system of swift, safe and automatic transfers of titles. Out of the 11,000 applications received as of end August 2016, nearly 4,000 title deeds were issued which led to approximately 800 transfers of titles. This progress may be considered as positive, and actions taken by the Department of Land and Surveys have been very supportive, including website information, training, and an instruction manual sent to all relevant staff. However, despite the promising start and efforts, results are not as positive as hoped, due to several legal actions taken by banks claiming that the legacy law is unconstitutional.

**Substantial effort is 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. The Ministry of Finance is continuing 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.**

The Ministry of Interior has made some progress, with the completion of a comprehensive report on the streamlining of issuance procedures in 2015. The Council of Ministers also approved measures to assist the issuance and, thus, the transfer of title deeds where relatively minor breaches of planning conditions have occurred.

### 3.2. FISCAL POLICY

**The Commission autumn forecast estimates the general government deficit at 0.3% of GDP for 2016.**

A deterioration of the primary balance is expected from September to December 2016, mostly due to a significant reduction of the immovable property tax receipts and the implementation of new location rules regarding VAT for e-commerce services. This would bring the primary balance to 2.3% at the end of 2016 and the headline balance to 0.3%.

**The Commission autumn forecasts projects that fiscal policy will be pro-cyclical in 2017<sup>(5)</sup>, leading to a deterioration of the primary balance to 2.0% of GDP.**

In 2017 the authorities are expected to abolish the immovable property tax paid to the central government, while other measures are also expected to have a negative impact on revenue, such as the implementation of the new location rules regarding VAT for e-commerce services, and the expiry of the special payroll contribution levied in response to the crisis. The partial switch to professional soldiers is also set to contribute to the rise in expenditure, with a full-year effect in 2017. Overall, the 2017 primary balance is expected to be substantially lower than the target set during the programme for the outer years (3% in 2017, 3-4% in 2018). This points to a relaxation of fiscal discipline.

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<sup>(5)</sup> See Commission opinion on Cyprus 2017 Draft Budgetary Plan ([http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/dbp/2016/cy\\_2016-11-16\\_co\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/cy_2016-11-16_co_en.pdf)) and the relevant Staff Working Document ([http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/dbp/2016/cy\\_2016-11-16\\_swd\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/cy_2016-11-16_swd_en.pdf))

**In 2018, the Commission expects the primary balance to increase, underpinned by continued economic growth.** The primary balance is expected to recover to 2.5% of GDP in 2018, as economic activity and the labour market continue to improve, driving tax revenues up and containing social expenditure. Cyprus' ability to achieve a headline surplus in the outer years, as committed during the programme, remains however vulnerable to a rise in the interest bill. This calls for the continuation of a prudent fiscal policy.

**According to the Commission autumn forecast, public debt would decline to 100.6% of GDP in 2018. (see Annex2).** This is slightly better than envisaged in the 2016 Spring Forecast, mainly due to better nominal GDP growth and a 1.4pps downward revision to the public debt ratio in 2015. The debt path remains sensitive to macroeconomic and fiscal shocks and speaks in favour of maintaining an appropriately high primary surplus. A continuously prudent implementation of fiscal policy in 2016-18 could improve outcomes compared to projections.

**Fiscal risks remain significant.** Downside risks relate mainly to the large, albeit slowly declining, exposure to contingent liabilities (financial sector, SOEs) and potentially adverse macroeconomic and fiscal developments. The latter includes the mounting pressures to implement fiscal relaxation measures, especially in the context of the electoral cycle. On the upside, privatisation proceeds may help reduce sovereign debt at a faster pace, though the more difficult political environment and resistance from vested interests has considerably slowed the privatisation process.

### 3.3. FISCAL-STRUCTURAL REFORMS

#### 3.3.1. Public Financial Management and Budgetary Framework

**Some progress has been made concerning the implementation of the fiscal framework and public investment management.** The House of Representatives adopted the secondary legislation for the Fiscal Responsibility and Budgetary Framework Law (FRBFL). This legislation was necessary to lay 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 training programmes and acquiring proper IT management systems.

#### 3.3.2. State-Owned Enterprises

**The implementation of the privatisation plan is facing significant delays.** The privatisation policy aims to improve economic efficiency, attract investment in Cyprus and reduce public debt. There are significant delays in implementing the privatisation plan, with the notable exception of the concession of Limassol port's commercial services awarded in April 2016. The delays are mostly due to the difficulty of fostering political consensus in Parliament around an ambitious privatisation agenda, but also due to coordination issues within the administration.

**The privatisation process of Cyprus Telecommunications Authority (CyTA) has been put on halt.** Faced with strong political opposition, the Government withdrew in May 2016 its legislative proposal for the privatisation of CyTA. The draft laws 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. Following the withdrawal of the draft laws, the House of Representatives adopted a bill freezing the privatisation process of CyTA until end-2017. This bill has not been enacted and is under review by the Supreme Court due to constitutionality concerns. Alternative arrangements towards the privatisation of CyTA are currently being explored by the Government.

**Progress with the privatisation of other assets is hampered by coordination issues within the public administration.** The privatisation of land assets has not been centralised, contrary to the advisers' recommendation. Line ministries will therefore proceed with the sale of their respective assets, while lacking the expertise to do so and

without the possibility to take advantage of the economies of scale. The privatisation process of the National Lottery and of the Troodos residences is also facing delays, mainly due to cumbersome legal vetting processes.

**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.

### 3.3.3. Revenue Administration

**The integration of the main functions of the tax administration is proceeding slower than expected.** Major progress towards the single taxpayer registration is being made, however the integration of the debt collection function is facing delays. There is evidence of insufficient human resources in the tax administration, leading notably to imbalances in the regional coverage.

### 3.3.4. Public Administration Reforms

**The horizontal reform of public administration could be a landmark achievement, but has still not been approved by the House of Representatives.** The parliamentary discussions have been delayed since August 2015 due to political opposition and some constitutionality issues. The public administration reforms are key to ensuring public finance sustainability over the medium- and long-term. The draft laws provide for a new mechanism safeguarding the fiscal sustainability of the wage bill, including both the compensation and the number of public employees. They also modernise the appraisal system through written exams and interviews, and improve the promotion system by opening promotion posts to all qualified candidates and by linking further merit and promotion. They also

make the public administration more flexible and resilient by incentivising staff mobility and enhancing staff redeployment rules. The legal proposals, after adoption, should be implemented in 2017.

**The reform of line ministries has started following the completion of the reviews.** Implementation of the reform plans is expected to take place in conjunction with the horizontal reforms. The process has already started in the ministries of agriculture and education and it will be soon followed in the ministries of foreign affairs, defence as well as justice and public order.

**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 is key as it affects the delivery of local public services. This could improve the issuance of title deeds. The issuance of building permits and certificates could be made more efficient. The reform could also improve Public Finance Management since it foresees the implementation of a common accounting and reporting framework for all local government.

### 3.3.5. Reform of the Welfare System

**The authorities have reached an important milestone with the implementation of the Guaranteed Minimum Income Scheme (GMI).** Cyprus has put in place an effective electronic management system comprising a comprehensive database where all applications are recorded and information can be cross-checked from different sources, including population registries, the land registry, car registrations, social security records, and banks. On the basis of all information recorded and the parameters defined in the legislation, the system automatically accepts or rejects applications. Appeals are subsequently considered by the system if supported by relevant information. All payments are also processed automatically through the system, and different reports and certifications can be produced. It is now possible to track different types of benefits paid to a 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 end of September 2016, there were 27,226 GMI beneficiaries in the system, with only about 7,000 beneficiaries from the previous public assistance system, consisting of cases which deserve special attention, waiting to be assessed for possible transfer into the new GMI system. There were 571 new applications per month on average in 2016. The coordination with public employment services (PES) for the activation of GMI beneficiaries has been improved. The PES, however, 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.

**The cost of GMI remains within its original estimates.** The fiscal cost of GMI amounted to around EUR 223m in 2015, below the original estimate of EUR 255m, despite the relaxation of certain eligibility criteria contained in the amendments to the GMI legislation adopted by the House of Representatives in July 2015. Expenditure in 2016 is estimated to stay on the same trend because the gains from the economic recovery will be offset by commitments towards existing social care beneficiaries which have not yet started to be paid.

**Changes in the legislation on disability benefits have been delayed but there is progress with implementing the system for 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.

### 3.3.6. Healthcare

**The National Health System (NHS) is expected to be established from 2019, which is welcome**

**after long delays in this important area.** There is currently no universal health care in Cyprus. 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. Any budgetary shortfall is expected to be covered by financial buffers that will be built up over time. The proposed reform would have a significant impact on lowering the out-of-pocket costs for healthcare from over 50% to below 15% of overall health costs. So far the timeline for NHS implementation envisage 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 awarded through public tender.

**The authorities have also adopted the hospital autonomisation bill and submitted it to the House of Representatives.** The bill foresees putting all public hospitals under the authority of an independent 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 leave little room for preparing public hospitals for competition with private hospitals. As part of the parliamentary discussions, a detailed roadmap with clear milestones for the implementation of hospital autonomisation should be prepared.

**The restructuring of primary healthcare centres is scheduled to start by end-2016.** The restructuring entails clustering small healthcare facilities, extending opening hours, standardising procedures and improving synergies and coordination with community care centres. The authorities aim at completing the restructuring by end-2017.

### 3.3.7. Immovable property tax

**The abolition of the immovable property tax (IPT) undermines revenue efficiency.** The authorities decided to reduce IPT in 2016 and to fully eliminate it by 2017. This goes against their programme commitment to reform the IPT, which was originally intended to improve the quality of

the public revenues. Property taxation is among the least distortionary taxes, therefore contributing to a more growth-friendly revenue structure. Additionally, the authorities have so far not identified any compensatory measures to mitigate the fiscal impact of the abolition of IPT.

### 3.4. STRUCTURAL REFORMS

#### 3.4.1. Labour Market

**Tripartite negotiations on indexation to inflation of the cost of living allowance (COLA) in the private sector were initiated in beginning of October 2016 and should be concluded by the year end.** Wage indexation in the private sector remains suspended until end-2016. If reinstated now as it was applied in the past, it will imply a reduction in wages, as inflation in 2016 has been negative. Both employers and employees agree that the system should be reformed but disagree on the parameters of the new system. To avoid tensions in January 2017, negotiations would need to be concluded before the automatic reinstatement of wage indexation and should ensure that wages evolve in line with productivity growth.

**In the construction sector, discussions continue for legislating the automatic extension of certain elements of the collective agreement.** There has been an agreement on the need to legislate certain provisions of collective agreements, including wage floors, working hours, and provident fund contributions. However, the exact details still need to be agreed. 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 €1,645-€1,905 a month depending on the skill level.

**A package of active labour market policies (ALMPs) has been adopted for the period 2015-2017.** These policies are expected to be regularly monitored and evaluated. 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 and persons with disabilities. Additional programmes are set to be launched in October 2016, focusing on GMI recipients. However, calls for applications have only been launched for a very limited number of listed programs, while others are held back due to legal difficulties. It is not clear therefore what has been the impact of ALMPs on the activation of the unemployed in Cyprus. This can only be assessed when the monitoring and evaluation system will be in place. 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.** The launching of the tender for the recruitment of additional staff needs to proceed as soon as possible and the authorities have not yet shared a comprehensive plan 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. The job placement rate for PES is very low (currently below 1%, although the statistics may underestimate the impact as there are ceilings for referrals by PES to a single company and candidates are sometimes advised to contact the firm directly). An online matching system is currently under consideration.

**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.

#### 3.4.2. Energy

**The Cypriot authorities are still discussing 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. 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.** The third licensing round launched in March 2016 aims to grant exploration licenses for blocks 6, 8 and 10 of the EEZ. Six applications have been received, by eight companies (ExxonMobil, Qatar Petroleum, Statoil, Eni, Total, Capricorn Oil, Delek Drilling and Avner Exploration). The authorities aim to sign the exploration licenses by January 2017. In addition, the licenses for blocks 2, 3, 9 and 11 (ENI/KOGAS and Total) have been renewed for two years until 2018. The exploration is expected to resume in the first half of 2017.

**The natural gas company DEFA is studying the best options for importing liquefied natural gas (LNG) to Cyprus.** The authorities still aim to import LNG before 2020 and have commissioned a study to identify the most appropriate import solution, as well as the necessary implementation steps.

**The Cypriot authorities are planning to set up a Sovereign Wealth Fund (SWF) but the adoption of the necessary legislation is facing some delays.** The SWF bill, which lays out the governance structure of the SWF, had not yet been adopted as of October 2016. The draft legislation defining inflow and outflow rules of the SWF has been submitted to the House of Representatives, but its adoption is linked to that of the SWF bill.

**The timeline for the ownership unbundling of the Electricity Authority of Cyprus (EAC) has been significantly pushed back.** The Government committed in January 2016 to proceed with the ownership unbundling of network activities from commercial activities (See box 3.2). 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 end-2018.

**Insufficient progress is being made towards improving the transparency and efficiency of the Cypriot energy market.** In addition to the

accumulation of delays regarding the ownership unbundling of EAC, the approval of the new electricity trade and settlement rules (TSR) is also proving very slow. An approval of the rules could be envisaged by end-2016, but there is a risk of slow implementation by the Transmission System Operator due to the latter's limited capacity.

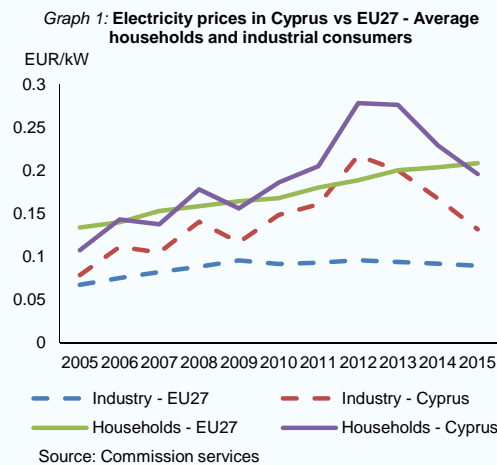
#### 3.4.3. Housing Market and Immovable Property Regulation

**The housing market is bottoming out.** House sales during the first 8 months of 2016 have increased by about 30% compared to the same period in 2015 but the level of sales remains below the historical average. For properties sold to Cypriot residents, prices remain very depressed as transactions are mostly cash transactions and buyers are also more aware of the problems in obtaining title deeds. These transactions also include debt-to-asset swaps between borrowers and banks. In the foreign segment of the market, the profile of buyers has changed, and buyers are now predominantly from Russia, Asia, and the Middle East. These buyers do not generally seek to obtain credit locally and pay mostly in cash. Prices for this market segment are markedly higher. The British demand, previously dominant, remains depressed.

**Stakeholders are pushing for reforms to stimulate the market.** Property developers are urging the authorities to speed up and improve the reform of the system for issuance and transfer of title deeds in a way that gives more responsibilities to architects and engineers and streamlines the role of the local authorities. They also urge the authorities to streamline the process for issuing building permits, which in Cyprus takes more than two years and is distorting business decisions.

**Box 3.2: Unbundling the Electricity Authority of Cyprus**

**The electricity market in Cyprus presents a series of structural deficiencies, which call for a comprehensive reform.** Electricity prices are amongst the highest of the European Union, notably due to the heavy reliance on imported fossil fuels in energy mix (92.7% of electricity generation in 2014). Although the recent drop in oil prices has been reflected in end-user prices (see graph 1), the reliance on fossil fuels goes against Cyprus' commitments towards EU 2020 targets regarding carbon emissions and energy efficiency. The dependence on imported fossil fuels is exacerbated by Cyprus being a small, isolated electricity market: the electricity grid is not connected to neighbouring countries and represents a very small share of the EU's electricity consumption (0.1% in 2014). The modernisation of Cyprus' electricity sector, which could lead to lower costs and prices and higher energy efficiency, would have a positive impact on potential growth. Furthermore, higher energy efficiency would contribute significantly to improving the external balance.



**Second, the Electricity Authority of Cyprus (EAC), as the sole player in the market, has a de facto monopoly.** EAC is a state authority in charge of all four activities of the electricity market: generation of power, transmission and distribution through the electricity grid, and supply to the end consumers. Although competition was opened in 2014, there are only a few independent power producers (IPP), which are obliged to sell their production (7.3% of electricity generation in 2014) to EAC through a feed-in tariff. Currently, EAC's generation capacity exceeds the country's estimated

needs (145.5% of the expected maximum demand), due to excessive investment activity in the past, and to the steep decline in electricity demand as a result of the economic crisis. EAC is the sole supplier of electricity in Cyprus.

**To address these deficiencies, the Cypriot authorities are committed to an effective and efficient unbundling of EAC.** This commitment to unbundling was made during the programme, and should be in line with the provisions of the Third Energy package directive<sup>1</sup> ensuring an "effective and efficient" unbundling. The authorities chose more precisely to undertake the ownership unbundling of EAC, in which the network functions (ie transmission and distribution) are separated from the commercial functions (ie generation and supply) in a different entity, with stringent requirements regarding separation of control. This would imply the effective division of EAC in different companies, which seems to be more suitable for the particular characteristics of the Cypriot market. This would reduce EAC's power to fully control the market and facilitate the effective regulation of the market by the energy regulator Cyprus Electricity Regulatory Authority (CERA). It would not necessitate a change of ownership of EAC's assets, but would facilitate privatisation in the long run.

**The unbundling of EAC aims to allow effective competition, appropriate regulation and economic efficiency.** The separation of network operations from competitive activities is key to promoting the development of competition in the electricity market. If properly done, it can prevent anticompetitive behaviours such as cross-subsidisation between competitive and monopolistic activities, selective disclosure of information to market participants, or discriminatory access to the electricity grid. By promoting competition, and provided that a well regulated market structure is in place, unbundling can be a decisive factor towards ensuring lower energy prices for end-consumers.

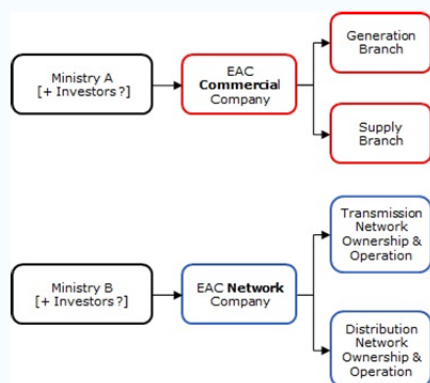
<sup>1</sup> Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC

*(Continued on the next page)*



Box (continued)

Figure 1: An example of ownership unbundling



Source: Commission services

**Unbundling EAC could also unlock investment opportunities and bolster security of supply.** By severing its link with the incumbent generator, unbundling provides the network operator with clear incentives to promote investments that would diversify its pool of clients towards independent power generators. Full ownership unbundling also renders the network operator more accountable for the performance of the network. By guaranteeing non-discriminatory access to the grid, unbundling also attracts new investors in the generation and supply businesses, which may be less concerned about potential unfair treatment by the incumbent operator. This could allow the introduction of more recent and efficient generation technologies and management practices.

**The first stage of EAC unbundling is ongoing, with the functional and accounting separation of EAC's network and commercial activities.** EAC's unbundling is expected to go in parallel with both the implementation of a new market structure, and the introduction of natural gas in electricity generation.

#### 3.4.4. Justice System Reform

**The Cyprus justice system is one of the least efficient in Europe.** According to data collected through the European Justice Scoreboard (REF), 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 investments 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, but a more comprehensive strategy is necessary.** 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 plans to create a commercial court by early 2018. These positive steps should lead to a comprehensive strategy for the reform of the judicial system, involving the Supreme Court and the ministries of Finance and Justice.

#### 3.4.5. Action Plan for Growth

**Implementation of the Action Plan for Growth continues, albeit at a slow pace and with delays in some areas.** While none of the work streams are completed, the Action Plan for Growth now includes a new work stream to revamp the existing competitiveness board. In addition, some delays were observed, notably on the finalisation of the study forming the base for a new tourism sector growth strategy and the introduction of new framework for facilitating strategic investment. A recent study, commissioned by the Presidency's reform unit, has identified the main factors weighing on export performance. The next steps include implementing actions addressing the identified shortcomings.

### 3.5. PROGRESS ON POLICY MEASURES WITH A VIEW TO ADDRESS MACROECONOMIC IMBALANCES

**In April 2016, Cyprus was identified as experiencing excessive macroeconomic imbalances in the context of the MIP.** The identified imbalances mainly relate to the large private, government, and external debt. Important vulnerabilities were also identified in the financial sector, burdened with a non-performing loans ratio close to 50%. The Country-Specific Recommendations under the European semester provided policy guidance for policy follow-up. This section overviews the state of play as regards progress with policy implementation to address imbalances. In order to avoid an overlap of surveillance processes, it does not provide an assessment of fiscal targets.

**The 2016 Country-Specific Recommendations aim to address the excessive macroeconomic imbalances identified under the MIP.** CSR 1 recommends maintaining the fiscal position at the medium-term objective (MTO), ie a balanced position in structural terms. It further recommends implementing fiscal structural measures that would strengthen the sustainability of public finance and contribute to reducing public debt. CSR 2 calls for the implementation of appropriate tools to help decrease the high private sector debt, while CSR 3 calls for measures to reduce the level of non-performing loans. CSR 4 promotes measures to encourage investment and raise potential growth, while CSR 5 addresses the issue of the effectiveness of public employment services and active labour market policies.

**No new measures were taken to accelerate the reduction of private sector debt, while the use of the new insolvency and foreclosure frameworks appears limited.** The recent economic conditions have not supported passive deleveraging. Despite better economic outlook, given the extensive deleveraging pressure, policy measures are required to facilitate active deleveraging. The modernisation of the insolvency framework in 2015 was intended to provide an efficient path for the resolution of unviable debts. However, so far the recourse to insolvency procedures has remained marginal due to a mix of factors: slow build-up of the insolvency service operational capacity, inadequate Rules of Court, and

reluctance to engage in lengthy proceedings (see section 3.1.4). The new foreclosure legislation allows banks to sell the collateral underlying non-performing loans. There have been so far only few foreclosure auctions due to slow build-up of operational capacity (auction houses), lack of implementation track record and growing willingness by debtors to reach voluntary restructuring agreements (see section 3.1.4). Active deleveraging also depends on the possibility to dispose of underlying assets. The currently dysfunctional title deeds issuance and transfer system is deterring potential investors and thus, weighing on the liquidity of the property market. Although some measures were taken to streamline the issuance of title deeds for new properties, no new measure was announced to provide for a sustainable system of transfer of title deeds (see section 3.1.4)

**The reduction of the stock of NPLs mainly stems from loan restructuring efforts by banks, the improved economic environment, and the implementation of measures already in place.** The reforms undertaken by the authorities during the programme (see section 3.1) are starting to bear fruit and result in a reduction of the NPL stock. Their implementation is being monitored by the authorities. Loan restructuring efforts, on the back of a more favourable economic environment, are contributing to reduce the stock of NPLs. On the one hand, the potential recourse to modernised insolvency and foreclosure procedures seems to provide key incentives for borrowers to accept restructuring terms offered by banks. On the other hand, banks have improved their expertise and appear to provide more sustainable restructuring solutions. The authorities intend to improve risk assessment in the banking system, notably through the implementation of the new loan origination directive, which requires cash-flow based lending instead of collateralised lending. The quality of financial information available for credit risk assessment is also being improved through the integration of a single credit register, the creation of a credit scoring system for physical persons, and the modernisation of the companies registrar. The creation of a secondary market for loans is intended to provide banks with ways to actively deleverage and attract specialised investors. However, the new framework provided by the sale of loans legislation has so far not led to any transactions. The authorities announced their

intention to adopt a legislative framework for loan securitisation by end-2016, in order to facilitate the creation of a secondary market for the sale of loans.

**In a context of fiscal relaxation, key fiscal-structural measures have yet to be adopted in order to strengthen the long term sustainability of public finance.** Cyprus took measures which, if not compensated, are expected to weaken its budgetary position. The abolition of the immovable property tax may support the housing market but narrows the tax base and reduces the fiscal space; the shift to professional soldiers is an efficient measure in the long-run but with important short-term costs, while the non-prorogation of the solidarity payroll levy might reduce labour costs but also public revenue. In this context, the adoption of adequate fiscal-structural measures is crucial. The secondary legislation necessary to implement the Fiscal Responsibility and Budget System law was adopted in October 2016 (see section 3.3.1). However, significant measures are still pending adoption, some since mid-2015. One of these measures is the draft law for a binding mechanism containing the growth rate of the compensation of public employees. In addition, key modernisation measures for the public administration (overhaul of recruitment, assessment, promotion and mobility), state-owned entities and local governments are also pending. These measures would significantly contribute to ensuring the long term sustainability of public finance, and thus facilitate the reduction of public debt.

**The situation in the labour market has improved, but important challenges remain.**

The unemployment has markedly decreased since end-2014. Unemployment rate remains high, however, particularly so for youth and long-term unemployed. Active labour market policies have been launched, but their scope remains limited (see section 3.4.1). A monitoring and evaluation system is warranted to assess the impact of these policies. There is a need for a comprehensive reform plan to improve the operational capacity of public employment services.

**The authorities are taking incremental measures to improve potential growth.**

Improvements to the business environment are being gradually identified and addressed through

the implementation of the Action Plan for Growth. This notably comprises measures to streamline administrative procedures for businesses, allow the electronic filing of accounts for companies, facilitate strategic investments, promote the growth of exports, and identify a national strategy for the tourism sector. The implementation of the privatisation plan is lagging behind the original schedule, as only the commercialisation of the port of Limassol has been completed so far (see section 3.3.2). As a first step towards a broader reform of the justice system, a feasibility study towards the creation of a commercial court has been announced.

**Overall, few new measures were taken or announced by Cyprus in 2016 to address its excessive macro-economic imbalances.**

Cyprus has not yet adopted the key reforms that would contribute to ensure the sustainability of public finances (i.e. horizontal public administration reform, public sector wage bill mechanism). Legislation to create a reliable system of issuance and transfer of title deeds remains necessary to help reduce private debt. The review of the insolvency and foreclosure framework would also contribute to that objective, and could help to accelerate the reduction of non-performing loans. The functioning of the labour market could be improved by more active labour market policies targeted towards young and long term unemployed and by a comprehensive reform of the public employment services. A more vigorous implementation of the Action Plan for Growth is warranted to attract investment and raise potential growth.

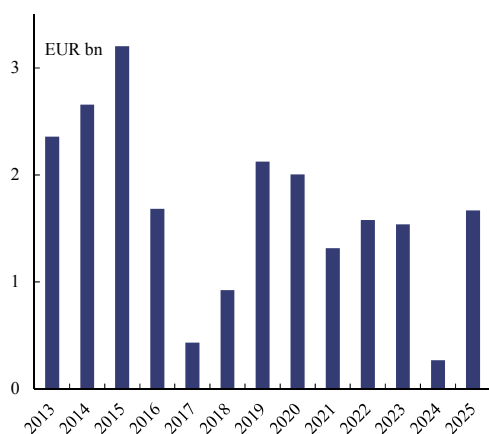


## 4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

**Cyprus successfully tapped international markets three times in the first nine months of 2016.** Following domestic issuances of EUR 150m and EUR 75m in January 2016, Cyprus issued a seven-year Eurobond of EUR 1.0bn in July 2016. This was the fourth international issuance since entering the bailout programme in 2013. The main objectives of these transactions were to diversify the funding sources, develop the yield curve, and improve the debt profile. The 7-year 3.75% EUR 1bn bond was priced at the lowest coupon rate achieved by Cyprus for a euro benchmark bond.

**Low financing needs in the first months of 2016 allowed Cyprus to smoothen the maturity profile.** Proceeds from the market issuances allowed Cyprus to redeem debt maturing in 2019 and 2020, where financing needs remain high (Graph 4.1). 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 4.1: Medium and long-term debt amortisation



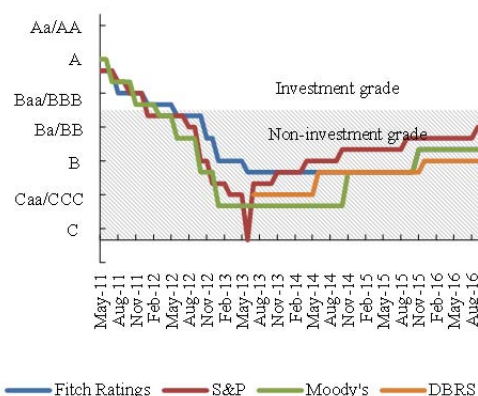
Source: Public debt management office, Cyprus.

**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 3-month T-bill primary market fell gradually, reaching 0.47% in the latest auction in October 2016. The steady decrease in T-Bill yields was also facilitated by regular T-bill auctions. By mid-October 2016, the outstanding T-Bill stock stood at EUR 320m, somewhat below

the target of EUR 400m enshrined in the Medium Term Debt Strategy. Yields on longer term debt displayed similar developments, reaching 3.80% at the 7-year bond issuance in July 2016.

**Cyprus' sovereign credit rating has continued to rise.** Over the past year, the four major rating agencies upgraded Cyprus' sovereign rating. However, the most favourable rating, by Standard & Poors (S&P), remains two notches below investment grade at 'BB' (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 debt could hold back further upgrades.

Graph 4.2: Sovereign long-term ratings, Cyprus



Source: Bloomberg and DBRS.

**The sovereign's financing situation remains comfortable.** Based on the updated macro and fiscal projections, total debt redemptions and fiscal needs until end-2017 are contained and lower than the existing cash buffer. Over the last quarter of 2016 total debt redemptions are estimated at around EUR 0.1bn. In 2017, debt redemptions and fiscal needs are estimated at EUR 0.4bn and EUR 0.1bn, respectively.

**Risks for Cyprus' capacity to service its debt to the European Stability Mechanism remain low in the short-term.** However, medium-term financing needs, particular in 2019 and 2020 remain high. Furthermore, medium-term debt

dynamics are sensitive to macroeconomic shocks, vulnerabilities in the financial system, the fiscal performance, and the continuation of the market access on favourable terms.

(Continued on the next page)

<b>MIP objective: Reduce private sector debt</b>			
<b>Private indebtedness</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p><b>Expected in 2016:</b> amendments to the Civil Procedure Law will be submitted to the House of Representatives.</p> <p><b>Expected in 2017:</b> review of the new insolvency framework.</p> <p><b>Expected in 2017:</b> establishment of the Insolvency Service as an independent entity.</p> <p><b>Expected in 2017:</b> Adoption of new Rules of Court for Corporate insolvency.</p>	<p><b>October 2016:</b> Adoption of new Rules of Court for personal insolvency.</p>	<p><b>June 2016:</b> The necessary infrastructure for the operation of the foreclosure framework has been put in place (e.g. auctions houses)</p>	<p><b>CSR 2:</b> "By June 2017, eliminate impediments to the full implementation of the insolvency and foreclosure frameworks and ensure adequate resources for the Insolvency Service (...)"</p>
<b>Housing market</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p><b>Expected in 2017:</b> Draft legislation on a new system for the transfer of title deeds.</p>		<p><b>2016:</b> Administrative simplification measures (planning and building permits) taken to facilitate the issuance of title deeds</p>	<p>CSR 2: "By June 2017,(...) ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights (...)"</p>

(Continued on the next page)

<b>MIP objective: Reduce non-performing loans</b>			
<b>Financial services</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p><b>Expected by end-2016:</b> To stimulate the development of a secondary market for loans, the authorities intend to adopt a legislative framework for the securitisation of loans</p> <p><b>Expected in 2017:</b> To improve the assessment of credit risk, the credit register of commercial banks will develop a credit scoring system for physical persons.</p>		<p><b>2016:</b> The credit register for commercial banks is being integrated with the credit register of the cooperative banks so as to provide more comprehensive information on borrowers.</p> <p>The legislative framework on the sale of loans was implemented but has not resulted in any transaction.</p>	<p><b>CSR 3:</b> Take measures to ensure a decline in non-performing loans (...). Increase the range of information available for creditors to make the credit registry fully operational.</p>
<b>MIP objective: Reduce General Government debt</b>			
<b>Fiscal policy and fiscal governance</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>



(Continued on the next page)

<p><b>Expected by end-2016:</b> legislation creating a mechanism containing the growth of the compensation of public sector employees as a share of GDP.</p>	<p><b>October 2016:</b> The secondary legislation for the Fiscal Responsibility and Budget System law was adopted.</p>		<p><b>CSR 1: (...)</b> By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public sector employees. (...) By the end of 2016, adopt the secondary legislation to complete the new budgetary framework.</p>
<b>Public administration</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
<p><b>Expected by end-2016:</b> legislation modernising the recruitment, assessment, promotion and mobility within the public administration.</p> <p><b>Expected by end-2016:</b> legislation for the reform of local governments.</p> <p><b>Expected in 2017:</b> legislation overhauling the monitoring and governance of State-owned enterprises.</p> <p><b>Expected in 2017:</b> Creation of a permanent contact centre for public services and of an online portal for e-services</p>			<p><b>CSR 1:</b> By the end of 2016, adopt the horizontal reform of the public administration and the law on the governance of state-owned entities, and implement the reform of local governments.</p>
<b>MIP objective: Increase potential growth</b>			
<b>Improve the business environment and external sustainability</b>			

(Continued on the next page)

<p><b>By end-2016:</b> Study towards the creation of a specialised commercial court should be commissioned.</p> <p><b>By end-2016:</b> Publication of a national competitiveness report.</p> <p><b>By end-2016:</b> Publication of a National Tourism Strategy and action plan.</p> <p><b>By 2017:</b> New procedural and legal framework for strategic investments</p>	<p><b>April 2016:</b> The commercialisation of the Limassol port operations was approved.</p> <p><b>April 2016:</b> New law on public procurement and related matters transposing directive 2014/24/EU</p>	<p><b>2016:</b> Simplifications and improvement of existing legislative framework for businesses (e.g. Tax Department, Company's Registrar, Social Insurance Services)</p>	<p><b>CSR 4:</b> Remove impediments to investment by implementing the Action Plan for Growth, pursuing the privatisation plan and strengthening the national regulatory authorities.</p>
<b>Access to Finance</b>			
<p><b>In 2017:</b> ex-ante assessment for the development of financial instruments under ESIF</p> <p><b>In 2017:</b> Tax incentives for investing in innovative SMEs</p>			<p><b>CSR 4:</b> Take measures to increase access to finance for small and medium-sized enterprises.</p>
<b>MIP objective: Reduce unemployment</b>			
<b>Labour Market</b>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>

<p><b>By end 2016:</b> launch of the tender for the reinforcement of PES</p> <p><b>By end 2016:</b> action plan fiche for the enhancement of PES</p> <p><b>By mid-2017:</b> ALMPs monitoring and evaluation tool</p>		<p><b>In 2016:</b> launch of targeted measures to tackle youth and long-term unemployment.</p>	<p>CSR (5)-2016: "Enhance (...) provision to the long-term unemployed; improve outreach to the non-registered unemployed (...)"</p>
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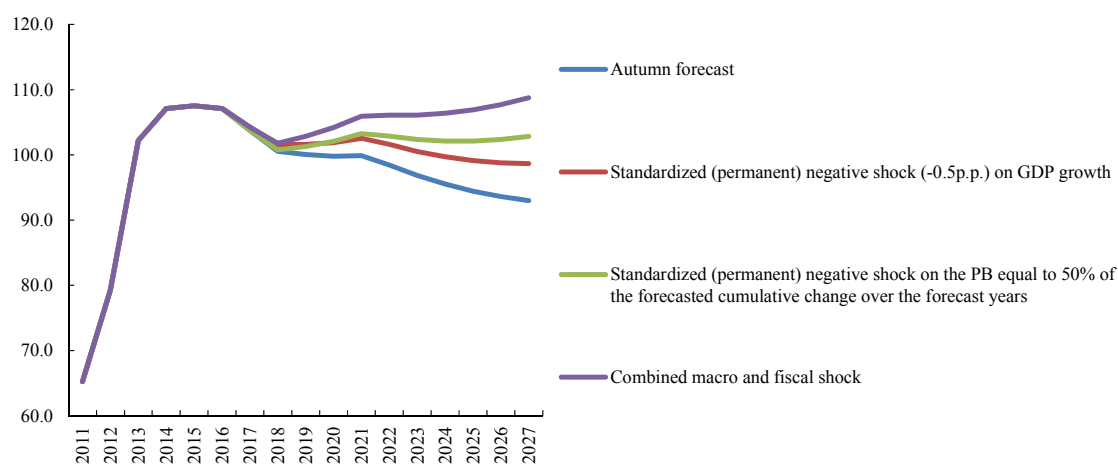
## ANNEX 2

### Debt Sustainability Analysis

**Following a peak of 108% of GDP in 2015, public debt is expected to decline steadily to 93% of GDP in 2026.** The starting point for the baseline debt projection is the Commission's 2016 Autumn Forecast. After 2018, the debt projection is based on technical assumptions ensuring cross-country consistency among Member States, including: (i) the structural primary fiscal balance remains unchanged at a surplus of 0.8% of GDP as from 2018 under the no-fiscal policy change assumption, (ii) inflation converges linearly to 2.0% by 2021 (year of output gap closure) and remains at that level 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 (level of around 1.5%); and (v) ageing costs develop according to the Commission and EPC's 2015 Ageing Report.

**The evolution of the debt trajectory continues to be sensitive to the macroeconomic and fiscal performance.** Reducing (Increasing) real GDP growth by one standard deviation over the horizon would trigger an upward (downward) revision of the debt trajectory, leading to a stabilisation in the debt ratio. Assuming an additional effect of a lower (higher) real GDP growth on the primary balance would partly reverse the decline observed in the initial years. Overall, the economic recovery remains favourable for the evolution of the debt trajectory but needs to be accompanied by continued fiscal discipline.

Graph A2.1: Debt trajectories (in % of GDP)



Source: European Commission.

**The high stock of public debt still poses risks to medium-term debt sustainability, leaving limited room for further fiscal relaxation.** The S1 medium-term sustainability indicator is 2.9% of GDP, mostly on account of sizable debt requirements. That is, a cumulative improvement in the structural primary balance of 2.9% of GDP over five years (from 2019 to 2023) is needed to reach the debt reference value of 60% of GDP by 2030. Amongst other factors, this structural primary balance improvement chiefly stems from the high debt requirement (or the additional adjustment due to the initial distance from the debt target, estimated at 3.1% of GDP) given the current high level of government debt. The required adjustment is significantly higher than estimated in the 2016 Spring Forecast. This stems mainly from a worse initial budgetary position, reflecting the fiscal relaxation in 2016. The initial budgetary balance contributes neutrally to the S1 indicator, suggesting that the fiscal space for relaxation has been exhausted in 2016.

**In the longer term, risks are less pronounced.** The S2 long-term sustainability indicator is -0.7% of GDP, mainly due to favourable projected costs of ageing. As with the S1 indicator, the S2 deterioration compared to the 2016 Spring Forecast is due to a less favourable initial budgetary position, which partly offsets the more favourable projected costs of ageing.

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

	Cyprus	
	No-policy-change scenario	Spring 2016
<b>S2*</b>	-0.7	-1.8
<i>of which :</i>		
Initial budgetary position (IBP)	-0.1	-1.0
Long-term cost of ageing (CoA)	-0.7	-0.8
<i>of which:</i>		
pensions	0.2	0.2
healthcare	0.2	0.2
long-term care	0.2	0.2
others	-1.3	-1.3
<b>S1**</b>	2.9	1.7
<i>of which:</i>		
Initial budgetary position (IBP)	-0.2	-1.4
Cost of delaying adjustment	0.5	0.3
Debt requirement (DR)	3.1	3.3
Long-term cost of ageing (CoA)	-0.4	-0.5
<b>S0 (risk for fiscal stress)***</b>		:
<i>Fiscal subindex</i>		:
<i>Financial-competitiveness subindex</i>		:
<b>Debt as % of GDP (2015)</b>		107.5
<b>Age-related expenditure as % of GDP (2015)</b>		20.6

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

\*\* The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 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.

\*\*\* 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 3

### European Commission macroeconomic and fiscal projections (2016 Autumn Forecast)

Table A3.1: Selected economic indicators

	2012	2013	2014	2015	2016	2017	2018
<b>Real economy</b>							
	<i>(percent change)</i>						
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	2.9	2.6	2.1
Total consumption expenditure	-1.6	-6.4	-1.1	1.4	1.9	1.6	1.4
Private consumption expenditure	-1.3	-5.9	0.7	1.9	2.4	1.8	1.5
Government consumption expenditure	-2.3	-8.2	-7.9	-0.6	-0.1	0.9	0.9
Gross fixed capital formation	-20.5	-12.9	-17.5	12.0	9.1	8.3	6.4
Exports of goods and services	-2.7	1.9	4.2	-0.3	5.5	4.6	3.9
Imports of goods and services	-4.5	-4.9	4.6	2.1	5.7	4.7	3.6
<b>Contribution to growth</b>							
	<i>(percentage points)</i>						
Domestic demand (excl. inventories)	-5.2	-7.4	-3.4	2.6	2.9	2.5	2.1
Foreign trade	1.1	3.7	-0.1	-1.4	-0.1	0.0	0.2
Changes in inventories	1.1	-2.2	2.1	0.3	0.0	0.0	0.0
<b>Inflation</b>							
	<i>(percent change)</i>						
GDP deflator	1.9	-1.0	-1.5	-1.3	-1.1	0.3	1.2
HICP	3.1	0.4	-0.3	-1.5	-1.1	0.7	1.3
<b>Labour market</b>							
	<i>(percent change, unless otherwise stated)</i>						
Unemployment rate (% of labour force)	Refresh	15.9	16.2	15.0	12.5	11.1	10.0
Employment	-3.2	-5.9	-1.9	0.8	1.8	1.6	1.5
Compensation per employee	1.5	-5.4	-3.6	-0.5	1.2	1.5	1.9
Labour productivity	0.0	0.0	0.4	0.9	1.0	0.9	0.8
Unit labour costs	1.5	-5.4	-4.0	-1.5	0.3	0.5	1.1
<b>Public finance*</b>							
	<i>(percent of GDP)</i>						
General government balance	-5.8	-4.9	-8.8	-1.1	-0.3	-0.4	0.0
Total revenue	36.0	36.4	39.4	39.0	38.2	37.7	37.7
Total expenditure	41.9	41.3	48.2	40.1	38.5	38.1	37.8
General government primary balance	-2.9	-1.8	-6.0	1.7	2.3	2.0	2.5
Gross debt	79.3	102.2	107.1	107.5	107.1	103.7	100.6
<b>Balance of payments (to be updated)</b>							
	<i>(percent of GDP)</i>						
Current external balance	-5.9	-4.9	-4.4	-3.0	-2.8	-3.3	-3.4
Ext. bal. of goods and services	-1.5	1.8	2.1	0.3	0.6	0.1	0.1
Exports goods and services	53.5	58.7	62.2	61.2	62.9	64.6	65.6
Imports goods and services	55.0	56.9	60.1	60.9	62.3	64.4	65.6
Balance of services	16.6	18.0	18.1	18.3	20.3	21.3	21.6
Balance of goods	-18.0	-16.2	-16.0	-18.0	-19.7	-21.2	-21.6
Balance of primary income	-3.0	-4.6	-3.7	-0.4	-0.4	-0.4	-0.4
Balance of secondary income	-1.4	-2.1	-2.8	-3.0	-3.0	-3.0	-3.0
<b>Memorandum item</b>							
	<i>(EUR bn)</i>						
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.

Source: Commission services.

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

<i>percent change unless otherwise stated</i>	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	-1.3	-5.9	0.7	1.9	2.4	1.8	1.5
2. Government consumption expenditure	-2.3	-8.2	-7.9	-0.6	-0.1	0.9	0.9
3. Gross fixed capital formation	-20.5	-12.9	-17.5	12.0	9.1	8.3	6.4
4. Domestic demand excl. inventories	-5.0	-7.4	-3.4	2.7	2.9	2.6	2.1
5. Changes in inventories (contr. to growth)	1.1	-2.2	2.1	0.3	0.0	0.0	0.0
6. Domestic demand incl. inventories	-4.0	-9.4	-1.4	2.9	2.9	2.6	2.1
7. Exports of goods and services	-2.7	1.9	4.2	-0.3	5.5	4.6	3.9
7a. - of which goods	-0.2	-12.5	2.1	-12.3	2.0	2.8	3.3
7b. - of which services	-3.7	7.8	4.9	3.9	6.6	5.1	4.0
8. Final demand	-3.5	-5.5	0.7	1.7	3.9	3.4	2.8
9. Imports of goods and services	-4.5	-4.9	4.6	2.1	5.7	4.7	3.6
9a. - of which goods	-7.9	-15.3	5.1	3.0	10.0	6.2	4.0
9b. - of which services	1.4	11.4	3.9	1.1	0.9	2.8	3.0
10. GDP at market prices	-3.2	-6.0	-1.5	1.7	2.8	2.5	2.3
<i>(Contribution to change in GDP)</i>							
11. Final domestic demand	-5.2	-7.4	-3.4	2.6	2.9	2.5	2.1
12. Changes in inventories	1.1	-2.2	2.1	0.3	0.0	0.0	0.0
13. Net exports	1.1	3.7	-0.1	-1.4	-0.1	0.0	0.2

Source: Commission services.

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

<i>percent change unless otherwise stated</i>	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	1.1	-5.9	0.2	0.2	1.0	2.3	2.8
2. Government consumption expenditure	-3.2	-12.4	-12.2	-1.2	0.1	2.6	2.5
3. Gross fixed capital formation	-21.1	-12.7	-19.9	14.4	6.0	9.9	8.8
4. Domestic demand excl. inventories	-3.8	-8.1	-4.9	1.6	1.5	3.4	3.7
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	1.5	3.3	3.6
7. Exports of goods and services	-0.3	2.1	2.7	-1.2	4.5	5.6	5.3
7a. - of which goods	0.4	-10.7	3.5	-11.6	1.3	4.0	5.3
7b. - of which services	-0.5	7.4	2.4	2.4	5.4	6.1	5.2
8. Final demand	-1.9	-5.8	-1.0	0.9	2.6	4.2	4.3
9. Imports of goods and services	-2.9	-3.7	2.5	1.6	4.1	6.4	5.4
9a. - of which goods	-6.5	-13.7	-0.6	0.5	7.1	7.7	5.5
9b. - of which services	3.4	12.1	6.2	2.9	0.7	4.8	5.3
10. Gross national income at market prices	-4.3	-8.5	-2.1	3.9	1.7	2.9	3.5
11. Gross value added at basis prices	-1.5	-6.7	-4.4	0.7	1.7	2.9	3.6
12. Gross domestic product at market prices	-1.3	-6.9	-3.0	0.4	1.7	2.9	3.6

Source: Commission services.

Table A3.4: Implicit deflators

<i>percent change</i>	2012	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	2.4	0.0	-0.5	-1.7	-1.4	0.5	1.3
2. Government consumption expenditure	-0.9	-4.6	-4.6	-0.7	0.2	1.6	1.7
3. Gross fixed capital formation	-0.7	0.2	-2.9	2.1	-2.9	1.5	2.3
4. Domestic demand incl. inventories	1.3	-0.6	-1.9	-0.7	-1.4	0.8	1.5
5. Exports of goods and services	2.5	0.2	-1.5	-0.9	-1.0	0.9	1.3
6. Final demand	2.5	0.2	-1.5	-0.9	-1.0	0.9	1.3
7. Imports of goods and services	1.7	1.3	-2.0	-0.5	-1.5	1.6	1.7
8. Gross domestic product at market prices	1.9	-1.0	-1.5	-1.3	-1.1	0.3	1.2
HICP	3.1	0.4	-0.3	-1.5	-1.1	0.7	1.3

Source: Commission services.



Table A3.5: Labour market and costs

<i>Percent change unless otherwise stated</i>	2012	2013	2014	2015	2016	2017	2018
1. Labour productivity	0.0	0.0	0.4	0.9	1.0	0.9	0.8
2. Compensation per employee	1.5	-5.4	-3.6	-0.5	1.2	1.5	1.9
3. Unit labour costs	1.5	-5.4	-4.0	-1.5	0.3	0.5	1.1
4. Total population	1.5	-0.2	-1.1	-0.6	-0.3	0.2	0.4
5. Population of working age (15-64 years)	1.5	-0.8	-2.1	-0.2	-0.2	-0.2	-0.3
6. Employment	-3.2	-5.9	-1.9	0.8	1.8	1.6	1.5
7. Unemployment rate (1)	11.9	15.9	16.2	15.0	12.5	11.1	10.0

(1) Eurostat definition, % of labour force.

Source: Commission services.

Table A3.6: External balance

<i>EUR bn unless otherwise stated</i>	2012	2013	2014	2015	2016	2017	2018
1. Exports of goods (fob)	3.0	2.7	2.8	2.5	2.5	2.6	2.8
2. Imports of goods (fob)	6.6	5.7	5.6	5.6	6.1	6.5	6.9
3. Trade balance (goods, fob/fob) (1-2)	-3.5	-2.9	-2.8	-3.2	-3.5	-3.9	-4.1
<i>3.1 p.m. (3) as % of GDP</i>	-18.0	-16.2	-16.0	-18.0	-19.7	-21.2	-21.6
4. Exports of services	7.4	7.9	8.1	8.3	8.8	9.3	9.8
5. Imports of services	4.2	4.7	4.9	5.1	5.1	5.4	5.7
6. Service balance (4-5)	3.2	3.3	3.2	3.2	3.6	3.9	4.1
<i>6.1 p.m. 6 as % of GDP</i>	16.6	18.0	18.1	18.3	20.3	21.3	21.6
7. External balance of goods and services (3+6)	-0.3	0.3	0.4	0.1	0.1	0.0	0.0
<i>7.1 p.m. 7 as % of GDP</i>	-1.5	1.8	2.1	0.3	0.6	0.1	0.1
8. Balance of primary and secondary incomes	-0.9	-1.2	-1.1	-0.6	-0.6	-0.6	-0.7
<i>8.1 - of which, balance of primary income</i>	-0.6	-0.8	-0.6	-0.1	-0.1	-0.1	-0.1
<i>8.2 - of which, balance of secondary income</i>	-0.3	-0.4	-0.5	-0.5	-0.5	-0.6	-0.6
<i>8.3 p.m. 8 as % of GDP</i>	-4.5	-6.7	-6.4	-3.3	-3.4	-3.4	-3.4
9. Current external balance (7+8)	-1.2	-0.9	-0.8	-0.5	-0.5	-0.6	-0.6
<i>9.1 p.m. 9 as % of GDP</i>	-5.9	-4.9	-4.4	-3.0	-2.8	-3.3	-3.4
10. Net capital transactions	0.0	0.3	-0.1	0.0	0.1	0.1	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-1.1	-0.6	-0.9	-0.5	-0.4	-0.5	-0.6
<i>11.1 p.m. 11 as % of GDP</i>	-5.8	-3.5	-5.1	-2.7	-2.5	-2.9	-3.1

Source: Commission services.

Table A3.7: 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	2,625	2,657	2,728
Taxes on income and wealth	1,905	1,853	1,775	1,719	1,763	1,752	1,858
Social contributions	1,510	1,362	1,445	1,483	1,514	1,546	1,607
Other current resources	891	900	1,107	1,069	956	998	1,014
<b>Total current revenue</b>	<b>7,008</b>	<b>6,590</b>	<b>6,919</b>	<b>6,873</b>	<b>6,858</b>	<b>6,954</b>	<b>7,208</b>
Capital transfers received	11	6	5	11	4	4	4
<b>Total government revenue</b>	<b>7,019</b>	<b>6,596</b>	<b>6,924</b>	<b>6,883</b>	<b>6,862</b>	<b>6,957</b>	<b>7,212</b>
Compensation of employees	2,825	2,573	2,299	2,225	2,236	2,319	2,396
Intermediate consumption	811	744	655	692	622	622	629
Social transfers	2,580	2,484	2,469	2,468	2,568	2,612	2,661
Interest payments (1)	566	563	497	495	465	454	487
Subsidies	95	95	80	72	77	77	78
Other current expenditure	526	403	395	463	466	446	454
<b>Total current expenditure</b>	<b>7,394</b>	<b>6,857</b>	<b>6,392</b>	<b>6,410</b>	<b>6,430</b>	<b>6,525</b>	<b>6,700</b>
Total capital expenditure (2)	746	624	2,071	665	479	504	511
<b>Total expenditure</b>	<b>8,149</b>	<b>7,486</b>	<b>8,467</b>	<b>7,080</b>	<b>6,914</b>	<b>7,034</b>	<b>7,215</b>
General government balance	-1,130	-891	-1,543	-196	-52	-77	-4
General government primary balance	-564	-328	-1,046	299	413	377	483
	% of GDP						
Taxes on production and imports	13.9	13.7	14.8	14.7	14.6	14.4	14.3
Taxes on income and wealth	9.8	10.2	10.1	9.7	9.8	9.5	9.7
Social contributions	7.8	7.5	8.2	8.4	8.4	8.4	8.4
Other current resources	4.6	5.0	6.3	6.1	5.3	5.4	5.3
<b>Total current revenue</b>	<b>36.0</b>	<b>36.4</b>	<b>39.4</b>	<b>39.0</b>	<b>38.2</b>	<b>37.7</b>	<b>37.7</b>
Capital transfers received	0.1	0.0	0.0	0.1	0.0	0.0	0.0
<b>Total government revenue</b>	<b>36.1</b>	<b>36.4</b>	<b>39.4</b>	<b>39.0</b>	<b>38.3</b>	<b>37.7</b>	<b>37.7</b>
Compensation of employees	14.5	14.2	13.1	12.6	12.5	12.6	12.5
Intermediate consumption	4.2	4.1	3.7	3.9	3.5	3.4	3.3
Social transfers	13.3	13.7	14.1	14.0	14.3	14.2	13.9
Interest payments (1)	2.9	3.1	2.8	2.8	2.6	2.5	2.5
Subsidies	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Other current expenditure	2.7	2.2	2.3	2.6	2.6	2.4	2.4
<b>Total current expenditure</b>	<b>38.0</b>	<b>37.8</b>	<b>36.4</b>	<b>36.3</b>	<b>35.8</b>	<b>35.4</b>	<b>35.1</b>
Total capital expenditure (2)	3.8	3.4	11.8	3.8	2.7	2.7	2.7
<b>Total expenditure</b>	<b>41.9</b>	<b>41.3</b>	<b>48.2</b>	<b>40.1</b>	<b>38.5</b>	<b>38.1</b>	<b>37.8</b>
General government balance	-5.8	-4.9	-8.8	-1.1	-0.3	-0.4	0.0
General government primary balance	-2.9	-1.8	-6.0	1.7	2.3	2.0	2.5
<b>Nominal GDP</b>	<b>19.5</b>	<b>18.1</b>	<b>17.6</b>	<b>17.6</b>	<b>17.9</b>	<b>18.5</b>	<b>19.1</b>

Fiscal accounts

\* 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.

(2) 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: Commission services

Table A3.8: Debt developments

	2012	2013	2014	2015	2016	2017	2018
Gross debt (% of GDP)	79.3	102.2	107.1	107.5	107.1	103.7	100.6
Real GDP growth (% change)	-1.3	-4.2	-2.6	0.1	1.5	1.5	2.6
Nominal GDP (EUR bn)	19.5	18.1	17.6	17.6	17.9	18.5	19.1
General government balance (% of GDP)	-5.8	-4.9	-8.8	-1.1	-0.3	-0.4	0.0
Change in gross debt ratio (pps change)	14.0	22.9	4.9	0.4	-0.4	-3.4	-3.2
	Contribution to the change in stock						
Primary balance	2.9	1.8	6.0	-1.7	-2.3	-2.0	-2.5
Snow-ball effect	3.1	9.3	6.0	2.4	0.8	-0.5	-1.0
of which							
Interest expenditure	2.9	3.1	2.8	2.8	2.6	2.5	2.5
Real growth effect	1.6	5.1	1.6	-1.8	-2.9	-2.7	-2.3
Inflation effect	-1.4	1.2	1.6	1.4	1.1	-0.3	-1.3
Stock-flow adjustments	7.2	12.1	-7.1	-0.3	1.1	-0.8	0.4

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

Source: Commission services



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