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Cyprus, Spring 2018

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2018

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Institutional Paper 083

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The cut-off date for the data and policy developments included in this report is 15/05/2018. This report is complemented by an Addendum.

ABBREVIATIONS

ALMPs: Active labour market policies

AWG: Ageing Working Group

CBC: Central Bank of Cyprus

CCB: Cooperative Central Bank

CET1: Common Equity Tier 1

CIT: Corporate Income Tax

COLA: Cost of Living Allowance

CSE: Cyprus Stock Exchange

CSRs: Country specific recommendations

CyTA: Cyprus Telecommunications Authority

DB: Draft Budget

DBP: Draft Budgetary Plan

DSA: Debt Sustainability Analysis

DTA: Deferred Tax Assets

EAC: Electricity Authority of Cyprus

EC: European Commission

ECB: European Central Bank

EDP: Excessive Deficit Procedure

EEZ: Exclusive Economic Zone

EIOPA: European Insurance and Occupational Pensions Authority

ELA: Emergency Liquidity Assistance

EPC: Economic Policy Committee

ESA2010: European System of Accounts 2010

ESF: European Social Fund

ESI: Economic Sentiment Indicator

ESM: European Stability Mechanism

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

FDP: Field Development Plan

FRBSL: Fiscal Responsibility and Budget System Law

GDP: Gross Domestic Product

GMI: Guaranteed Minimum Income

GVA: Gross value added

HICP: Harmonised Index of Consumer Prices

IAS 39: International Accounting Standard 39

IDR: In-depth review

IFRS 9: International Financial Reporting Standard 9

IMF: International Monetary Fund

LTD: loan-to-deposit (ratio)

LNG: Liquefied Natural Gas

MIP: Macroeconomic Imbalance Procedure

MTO: Medium-term objective

NEET: Not in education, employment or training

NFC: Non-Financial Corporations

NHS: National Health System

NPL: Non-performing loans

OECD: Organisation for Economic Co-operation and Development

PDMO: Public Debt Management Office

PES: Public Employment Services

PIT: Personal Income Tax

PPM: Post-programme monitoring

PPPs: Public-private partnerships

PPS: Post-programme surveillance

PSPP: Public sector purchase programme

RoA: Return on assets

RoE: Return on equity

SB: Structural balance

SGP: Stability and Growth Pact

SMEs: Small and medium-sized enterprises

SOEs: State-owned enterprises

SRB: Single Resolution Board

SREP: Supervisory Review and Evaluation Process

SSM: Single Supervisory Mechanism

SWF: Sovereign Wealth Fund

TSOCy: Transmission System Operator of Cyprus

VAT: Value-added tax

VET: Vocational and Educational Training

EXECUTIVE SUMMARY

This report presents the findings of the fourth post-programme surveillance (PPS) mission of European Commission staff, in liaison with staff from the European Central Bank (ECB), which took place in Cyprus from 19 to 23 March 2018, completing the assessment with the developments of the economy up to the cut-off date. An Addendum is included at the end of the report providing a brief overview of the recent developments in the banking sector, namely the sale of the second largest bank in the country (Cyprus Cooperative Bank, CCB). The mission was coordinated with the International Monetary Fund's (IMF) post-program monitoring (PPM) mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System. The next PPS mission will take place in autumn 2018.

Reducing the still high stock of non-performing loans (NPLs) should remain a high priority, as they weigh heavily on the profitability and the overall soundness of the banking sector. While NPLs are declining, the levels continue to be high, — close to 44% of gross loans at the end of 2017, down from 47 % a year before. The main drivers for the decline in 2017 were cured restructured loans, write-offs and cash repayments. However, loan restructuring is becoming more challenging as the pool of NPLs for which negotiation is an option is dwindling. Following supervisory pressure by way of general and bank specific guidance, in 2017, the provisioning of NPLs has accelerated and together with shrinking interest margins, has led to losses for the banking sector as a whole. This eroded the banks' capital buffers by around 1 percentage point in 2017 (to Common Equity Tier 1 (CET1) ratio of 14.9 %), which was still above the EU average (CET1 of around 13 %). Deposits were stable in general in 2017, but displayed some variability over time and across banks. Outside the banking sector, no progress was made on integrating the insurance and pension fund supervisor.

As part of a more comprehensive strategy to deal with NPLs, additional efforts are needed to increase the implementation and use of the new insolvency and foreclosure tools and more generally, to strengthen the payment culture. The limited use of insolvency and foreclosure frameworks hampers the deleveraging process and faster reduction of NPLs. The authorities are preparing a package of targeted legal amendments to accelerate NPL resolution. This includes increasing the effectiveness and efficiency of the insolvency and foreclosure frameworks as well as the sale of loans law, though the work has not been finalised yet. The authorities aim to promote these amendments alongside a proposal of a government subsidy scheme addressed to vulnerable groups. It will be important that the design of this scheme follows international best practices and strengthens the payment culture in the country. It is also important that other policy measures considered by the authorities are also assessed in that light. The authorities have also started to identify the main deficiencies in the implementation of the insolvency and foreclosure frameworks as part of broader project, but the progress remains slow. The secondary market for NPLs is showing some positive signs, although the level of activity is quite small compared to the stock of NPLs. All of the main three domestic banks have recently set up arrangements with external servicers to facilitate the workout of NPLs, which may also speed up the progress in secondary market sales.

The macroeconomic situation and outlook remain very positive although the risks to the outlook have increased. After real growth of 3.9% in 2017, 3.6% is forecast for 2018 and 3.3% for 2019, fuelled by foreign-funded investment and solid private consumption. The current account deficit widened to 6.7% in 2017, as imports increased markedly, outpacing the growth of exports. The widening of the current account deficit is expected to persist reflecting the strong economic performance and the high import content of investment and consumption. Job creation gathered momentum. As a result, unemployment fell to below 10 % and is expected to continue falling, while labour market slack kept a lid on wage pressures. Inflation remains low and is set to stay subdued. However, recent developments in the financial sector have widened downside risks to the outlook.

Fiscal performance has also been remarkably strong, although the latest developments have increased downside risks to the outlook, warranting a continuation of prudent fiscal policy. Fiscal performance once again outperformed projections in 2017, mainly driven by buoyant tax revenues.

Expenditure increased at a slower pace than revenues. The general government is expected to continue to post sizeable budgetary surpluses in 2018 and 2019. The forecast is subject to uncertainties mainly in relation to the financial sector developments, in particular on the budgetary impact of the government's transaction related to the CCB. Additional risks to the fiscal outlook relate to the fiscal impact of healthcare reform and the public payroll growth trend once the collective agreement expires. After falling significantly in 2017 to 97.5% of GDP, public debt is expected to rise to 105.7 % of GDP in 2018, mainly due to the authorities' intervention in the banking sector, namely the issuance of government bonds, the proceeds of which were deposited with the CCB. However, given the one-off nature of the CCB transaction and the assumed continuation of high primary surpluses as well as favourable debt dynamics mostly due to strong GDP growth, public debt is projected to steadily decline after that. Nevertheless, a continuous prudent budgetary policy remains essential, especially in view of increased downside risks; it is crucial to ensure that temporary revenue windfalls do not give rise to permanent increases in expenditure and to safeguard fiscal sustainability in line with the requirements of the Stability and Growth Pact.

Renewed structural reform commitment by all national stakeholders is key to maintain growth over the medium term and safeguard fiscal sustainability. A swift completion of the justice system reform is needed given its significant impact on the functioning of the economy and its strong link to the reduction of NPLs, including the establishment of a commercial court, the update of the civil procedure rules and the adoption of legislation on improving claim enforcement. Moreover, the completion of the reform of the public administration would enhance the efficiency of the public sector and support fiscal sustainability. The mission also encouraged the authorities and other stakeholders to step up progress in other essential areas, including the implementation of the national healthcare system in a fiscally-sustainable way, the ongoing reform of the electricity market, and the establishment of an efficient title deeds issuance and transfer system. Moreover, the mission underlined the importance of continuing efforts to enhance the economy`s growth potential, through improving the business environment and attracting further growth-enhancing investment, as well as prioritising key measures included in the action plan for growth.

Risks to Cyprus' capacity to service its ESM debt have increased compared to the previous PPS report. After a significant improvement in 2017, borrowing conditions for Cyprus have deteriorated somewhat in recent months, driven by factors related to vulnerabilities in its banking sector and uncertainties related to the ongoing sale of the CCB, and its potential repercussions on the financing conditions for Cyprus. However, current medium-term fiscal and debt servicing financing needs under the baseline scenario are moderate, in particular due to Cyprus' past active debt management operations, which reduced Cyprus' annual gross financing needs in coming years (2018-2021). Continued fiscal discipline, forceful reduction of NPLs and progress on growth-enhancing structural reforms will therefore play a vital part in consolidating and further improving investor confidence.

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1. INTRODUCTION

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

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the fourth post-programme surveillance (PPS) mission to Cyprus between 19 and 23 March 2018. The mission was coordinated with IMF's post program monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country having received financial assistance([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions, if necessary and where appropriate.

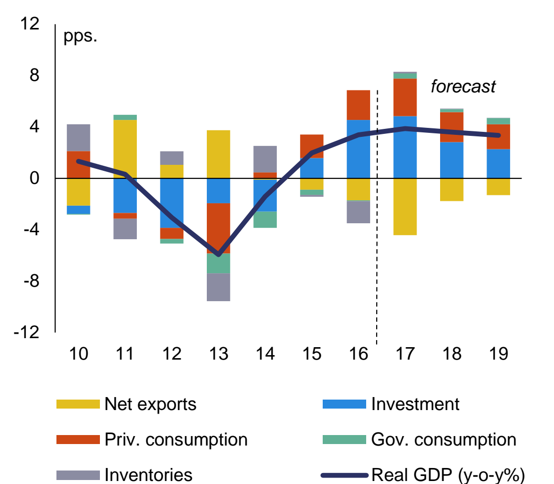
([1]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid.

2. MACROECONOMIC OUTLOOK

The cyclical upswing made further headway in 2017, with real GDP growing by a remarkable 3.9 %. This was the highest growth rate since the 2013 crisis and makes Cyprus one of the fastest growing economies in the euro area, for the second year in a row. Growth was driven by investment, consumption and exports of services. The labour market continued to recover at a fast pace. Tourism, professional services and construction on the supply side were the main sectors that helped to accelerate growth.

Growth is expected to remain strong in 2018 and 2019, albeit easing somewhat. Early indicators of economic activity in Cyprus continue to point to a strong start to the year. For the year as a whole and in 2019, growth is expected to be driven by investment and private consumption, with public consumption also making a positive contribution, although to a much lesser degree. Net exports are expected to be negative in the coming years, yet are not expected to be a substantial drag on growth.

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



Source: European Commission

Investment has become the main driver for growth. In 2017, investment surged again, recording a 28 % annual increase. In volume terms, it reached levels close to those seen in the boom years (2005-2011), while investment to GDP ratio has more than fully caught up with the EA average of 20 %. The rapid rise in investment was heavily influenced by the equipment category, which is driven by ship acquisitions or registrations. The tourism boom has greatly increased the demand for accommodation and other tourism infrastructure, to which supply continues to respond. Recovering local demand for housing and particularly the citizenship scheme ([2]), which encourages foreigners to acquire property in Cyprus, has stimulated the construction of dwellings. Some investment is taking place in other sectors, including education and energy, although the bulk is related to construction. Investment in R&D, innovation and other productivity-enhancing fields holds a relatively small share. The current composition of investment hence raises questions on the longer term impact on growth. At the same time, the risk of a new boom and bust cycle in construction cannot be fully excluded, warranting a close monitoring of developments in the sector.

The investment outlook is positive. Several foreign-funded, large-scale projects, focused on tourism infrastructure (marinas, hotels and other accommodation), are already being built or are about to be start. The largest among these is the biggest casino in Europe, whose construction is envisaged to start later in 2018 and continue for 3 years. The gradual revival in new bank lending is expected to boost investment further. Business confidence was on the rise in the first quarter of 2018. Brexit might be an opportunity for Cyprus to attract companies from the UK. This could possibly create an additional investment stimulus in the short to medium term.

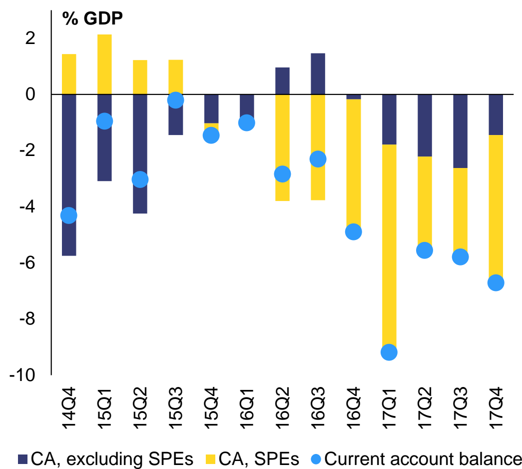
Consumption has accelerated and is expected to remain strong. In 2017, private consumption rose by 4.2 % in real terms and public consumption increased by 2.7 %. Rapidly expanding employment and low inflation boosted the real disposable income of Cypriot households, creating positive expectations and boosting consumption. Consumer sentiment rose further in the first quarter of 2018, improving across all its subcategories: expectations on the financial situation, employment, savings and the general economic situation. Consumption is expected to be solid in 2018 and beyond, although improved loan repayment discipline following a change to the

([2]) It requires to acquire a residence with a minimum value of EUR 0.5 million or to invest a minimum EUR 2 billion in other assets.

insolvency and foreclosure frameworks could limit it somewhat.

The current account deficit is widening. For 2017, it deteriorated to 6.7 % of GDP, as imports increased markedly, outpacing the healthy growth of exports. Net trade in services continued to generate ever larger surpluses, driven mainly by the services related to tourism but also telecommunications and auxiliary financial services. Meanwhile, the trade deficit in goods has been rising markedly, with exports further contracting and imports increasing substantially. For the latter, the acquisition and registration of ships via Special Purpose Entities (SPEs) has played a prominent role. In 2017, the current account deficit in Cyprus, excluding SPE activities, would have been much smaller, at 1.5 % of GDP. The current account is expected to worsen again in 2018 and 2019 as the buoyant economy with strong consumption and investment is likely to be accompanied by strong import growth and more ships being registered. This is projected to be partially offset by increasing exports of services. On the export of tourism services, the first quarter of 2018 (low season) was promising, with tourist arrivals up by nearly 20 %.

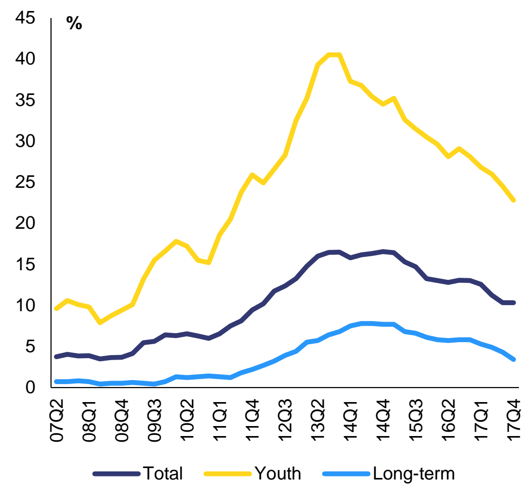
Graph 2.2: **Current account developments, SPEs and non-SPEs**



Based on running total of 4 quarters.
Source: Central Bank of Cyprus

The labour market is performing strongly. Rapid employment growth in most sectors of the economy has reduced unemployment in early 2018 to below 10 %. All sectors except agriculture saw a substantial increase in employment in 2017, with employment in construction accelerating in the last quarter. The reported intentions of employers in the main sectors (construction, manufacturing, retail sales and services) point to a continuation of this trend in 2018. Youth unemployment, which is still very high, is expected to fall thanks to activation measures, the general improvement in the labour market and new openings offered by the temporary casino.

Graph 2.3: **Unemployment rate**



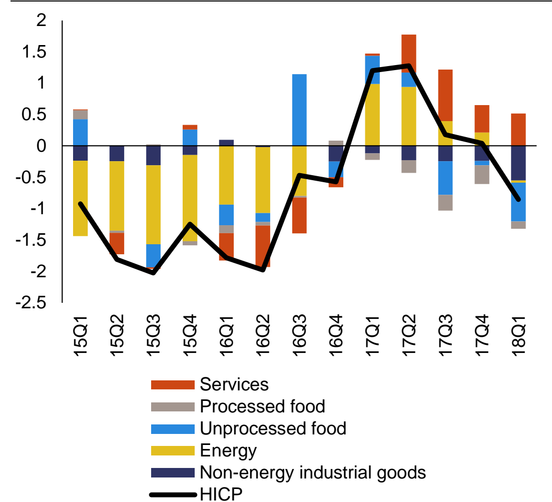
Source: Eurostat

Wage pressures remain weak. Due to slack in the labour market, wage pressures continue to be weak. Wage rises overall were generally low, though much more pronounced in the public sector, where the wage indexation mechanism has kicked in and promotions that took place in 2012-2016 have started to be remunerated.

Inflation turned out lower than expected and is projected to remain low. Following a very weak 2017, inflation in the first quarter of 2018 dipped into negative territory. This was a rather broad pattern. Prices of non-energy goods fell as new import markets opened and competition increased, which was more pronounced during the sales season. Unprocessed food prices also declined mainly due to a significant fall in vegetable prices, while processed food became cheaper on the back of heightened competition among supermarkets. Energy prices fell slightly. The only category to buck this trend was services, where prices picked up from February onwards as the tourism season

resumed. While the fall in prices in the first few months of 2018 is regarded mostly as a temporary phenomenon, inflation is expected to be below 1 % in 2018 and only slightly higher afterwards amid remaining slack in the labour market.

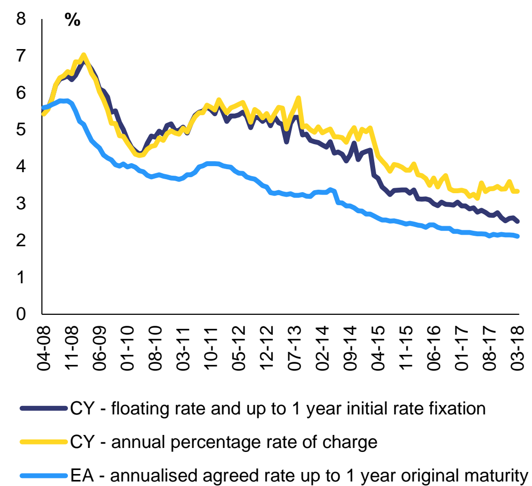
Graph 2.4: **HICP inflation and contributions**



Source: Eurostat

The residential real estate market is gradually recovering. Residential property sales were up by double-digit percentages in 2017, boosted by a number of government incentives. Residential property prices have risen moderately, up 2.4 % in 2017 (Eurostat). Bank lending for buying real estate has also improved slightly, which could help stimulate local demand. Some mortgages, reportedly, are granted with a loan-to-value ratio of around 70 %. Mortgage rates have fallen considerably and are at historical lows; nevertheless, while the nominal interest rate keeps falling, the annual percentage interest rate, which better reflects the full cost of credit (i.e. it comprises an interest rate component and a component of other related charges, such as the cost of inquiries, administration, preparation of documents, guarantees, etc.), has stabilised.

Graph 2.5: Interest rates on mortgages



Source: Central Bank of Cyprus, European Central Bank

The real estate supply side is responding to increasing demand although substantial inefficiencies remain. Construction activity has considerably picked up in 2017 and the number of building permits issued continued to increase. However, real estate developers report extremely difficult and lengthy procedures (7 years on average) to obtain permits for a large project. A very lengthy timespan between the initiation of the projects and their execution prevents the supply side from responding swiftly and creates inertia. The creation of a "single window", the electronic submission of documents and the setting of time limits for completing procedures necessary to issue a permit are urgently needed. The Ministry of Interior is taking some steps to improve the situation, including preparation of legislative acts (see Section 5.2 immovable property rights). The attitude of banks towards financing real estate construction has become slightly more positive, with some projects starting to obtain credit; however, this remains very limited and the main sources of financing are still the pre-sales and profits.

The balance of risk to the economic outlook of Cyprus has widened compared to the previous PPS report. The financial sector, which is unprofitable and burdened by non-performing loans (NPLs), remains the major downside risk. Tourism faces both downside and upside risks: the reopening of neighbouring markets, notably Turkey, increases competition, especially for some segments of tourists, while marketing efforts, increased air transport and accommodation capacity brighten the sector's prospects. At the same time, stronger investment or faster implementation of projects than currently envisaged, including advancements in gas exploration, are the upside risks to the outlook in the short to medium term.

Table 2.1: Main features of macroeconomic forecast - European Commission Spring 2018 forecast

		2016		2014	2015	2016	2017	2018	2019
		Curr. prices (EUR m)	% of GDP	Annual percentage change					
GDP		18.2	100	-1.4	2.0	3.4	3.9	3.6	3.3
Private consumption		12.6	69.0	0.7	2.6	3.3	4.2	3.4	2.9
Public consumption		2.7	15.0	-7.2	-2.6	-0.4	2.7	1.5	3.3
Gross fixed capital formation		3.2	17.4	-17.5	13.6	35.0	27.8	13.4	9.8
Exports (goods and services)		11.8	64.7	4.2	5.8	4.0	3.4	2.3	1.9
Imports (goods and services)		11.9	65.5	4.6	7.4	6.8	10.1	4.8	3.7
GNI (GDP deflator)		17.9	98.4	-0.4	6.6	1.1	3.5	3.6	3.4
Contribution to growth:	Domestic demand			-3.3	3.0	6.8	8.2	5.4	4.7
	Inventories			2.1	-0.1	-1.7	0.1	0.0	0.0
	Net exports			-0.1	-0.9	-1.7	-4.4	-1.8	-1.3
Employment				-1.8	1.5	3.3	3.4	2.8	2.8
Unemployment (1)				16.1	15.0	13.0	11.1	9.0	7.1
Compensation per employee				-3.6	-1.2	-0.7	0.7	1.4	2.0
Unit labour costs, whole economy				-4.0	-1.7	-0.8	0.2	0.6	1.4
Real unit labour costs				-2.4	-0.5	-0.1	-1.3	-0.9	-0.3
GDP deflator				-1.6	-1.2	-0.7	1.5	1.5	1.7
Harmonised index of consumer prices				-0.3	-1.5	-1.2	0.7	0.7	1.2
Terms of trade				0.5	-0.5	0.1	1.5	0.7	0.5
Trade balance (goods and services) (2)				0.4	0.1	-0.1	-0.8	-1.0	-1.2
Current account balance (3)				-4.4	-1.4	-4.9	-8.1	-9.0	-9.7

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

3. FINANCIAL SECTOR ISSUES

3.1. BANKING SECTOR PERFORMANCE

Overall situation

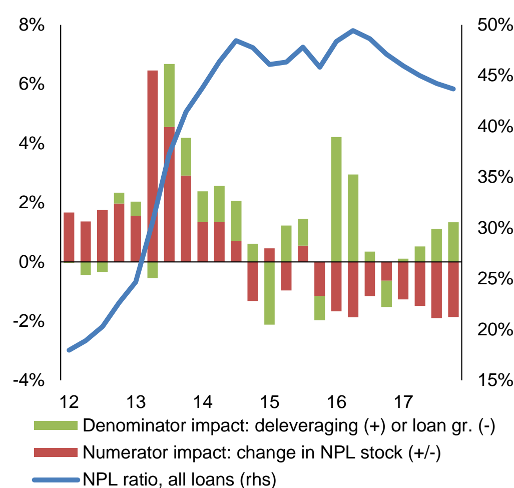
The banking sector remains fragile due to its large, albeit declining, stock of non-performing loans (NPLs) and negative profitability. Progress has been made on reducing NPLs, in terms of both volume and as a share of total loans, but they remain a significant challenge to financial stability. This has prompted the authorities to seek comprehensive solutions to accelerate bank restructuring and balance-sheet clean-up (see Section 3.2). Banks continued to post losses in 2017 due to low interest rates, on-going balance-sheet clean-up and a further building-up of provisions, partly in response to supervisory pressure. Deposits were almost flat in the banking sector in 2017, although with divergent trends among banks. Overall, banks maintain large liquidity buffers, which also weigh heavily on their profitability.

In the spring of 2018, there were significant developments concerning the Cyprus Cooperative Bank (CCB), the second largest bank in the country. The bank is publicly owned and has an NPL ratio of close to 60 %. On 19 March the government initiated the sale of the bank ([3]). On 3 April, Cyprus issued government bonds with a total value of EUR 2.35 billion that were bought by the CCB. The funds raised through this transaction and a small cash addition from the government's cash buffer (EUR 0.15 billion) were deposited on the same day at the CCB totalling EUR 2.5 billion. The situation was still evolving at the time of the mission and writing this report.

Asset quality

The high NPL ratio despite the strong economic recovery suggests structural problems in the financial sector which so far had not been adequately tackled. NPLs stock has declined, but the NPL ratio ([4]) continues to remain very high. At end-2017, NPLs in local operations of banks declined to around 44 % of all loans from close to 47 % a year before (see Table 3.1) ([5]). The decline in the stock of NPLs in 2017 has been above the average trend since the end of 2015 (see Graph 3.1). However, as total loans continue to decline, progress on reducing the NPL ratio is being somewhat moderated due to this denominator effect. Overall, the large stock of NPLs underlines the importance of further reforms aimed at improving the payment discipline.

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



Source: Central Bank of Cyprus

Loan restructuring has slowed. The total stock of restructured loans (including both performing and non-performing) has declined, both in absolute terms (to EUR 11.8 billion in December 2017, from EUR 13.4 billion a year before) and as a share of total loans, falling from 27.7 % to 26.6 %. The share of restructured loans to NPLs, including debt-to-asset swaps, increased slightly to 43.5 % in

([3]) http://www.ccb.coop/userfiles/93df4f45-33a6-4e45-9c09-c01795656b98/news-19032018-en.pdf

([4]) The NPL ratios referred to in this report are based on the Central Bank of Cyprus' data and definition. Thus, they differ from the ratios referred to in the 2018 Cyprus Country Report, which is based on the ECB data. In particular, exposures of banks to central banks and credit institutions and the overseas operations (branches and subsidiaries situated abroad) of the Cyprus based banking groups are not taken into account in the CBC aggregate NPL ratios.

([5]) Data for January 2018 show that the NPL stock and ratios have increased on a month-on-month basis. NPLs in local operations of banks increased to around 46 % of all loans. This development is thought to be mostly driven by the introduction of the IFRS 9 standards on 1 January 2018. A more detailed assessment will be provided in the next PPS report when further observations and bank-specific data become available.

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

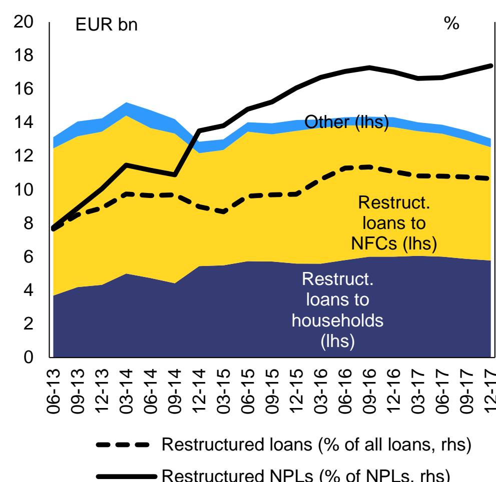
	2012	2013	2014	2015	2016				2017			
	Dec	Dec	Dec	Dec	Mar	June	Sep	Dec	Mar	June	Sep	Dec
NPLs*, all loans (EUR billions)	15.6	26.0	27.3	26.7	25.7	24.7	24.1	23.8	23.2	22.4	21.5	20.6
NPLs*, all loans (% of total)	22.6	41.5	47.8	45.8	48.4	49.4	48.6	47.2	46.0	45.0	44.2	43.7
NPLs*, loans to NFCs (% of total)	..	..	58.0	56.0	55.1	58.3	56.9	56.4	54.4	52.5	51.0	50.2
Restructered non-performing (% of tot	..	12.5	23.3	25.9	26.3	27.7	26.9	25.7	23.7	22.9	22.5	..
Restructured performing (% of total)	..	12.2	5.3	7.5	7.8	9.1	9.1	9.4	9.9	10.6	9.9	n.a.
NPLs*, loans to households (% of total)	..	43.3	52.7	56.2	56.4	56.3	56.6	55.9	55.7	55.7	54.6	53.9
Restructered non-performing (% of tot	..	6.7	13.9	18.0	19.0	19.7	20.3	20.0	20.0	20.1	19.9	n.a.
Restructured performing (% of total)	..	10.4	8.9	6.7	6.2	6.7	7.2	7.7	8.1	8.1	8.2	n.a.
Coverage rate (Impairments / NPLs)*	47.9	37.7	32.9	37.8	37.1	37.9	38.6	41.7	42.7	46.7	46.9	46.6
Cost-to-income ratio	55.6	53.4	40.4	44.1	54.2	52.4	52.3	52.5	51.3	48.4	48.7	53.6
Net interest margin	2.3	2.4	2.9	2.8	2.8	2.7	2.6	2.6	2.4	2.4	2.4	2.3
Common Equity Tier 1 ratio	..	..	14.2	15.6	15.3	15.7	16.0	15.9	15.8	14.9	15.0	14.9
Return on assets	-3.4	-4.3	-0.6	-0.6	0.6	0.6	0.5	-0.3	-0.1	-1.9	-1.3	-1.1

The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis.
*The local NPL definition was used until the end of 2014. From 2015, the EU NPL definition was used, as defined in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278. Figures exclude exposures to central banks and credit institutions.
Source: Central Bank of Cyprus

September 2017, up from 42.6 % at the end of 2016 due to a larger reduction in NPLs than restructured loans (see Graph 3.2).

The slowdown in loan restructuring is largely due to the increasing share of loans for which no negotiation option exists. According to the Central Bank of Cyprus (CBC) aggregate data, more than half of the fixed-rate NPL stock is classified under the 'terminated accounts' category, where legal recourse is seen as the only option. (6) One potential explanatory factor for the unwillingness of these borrowers to renegotiate the terms of their loans is the dismal foreclosure activity. This leads to a very large stock of NPLs with no or very little prospect of workout. There is also considerable political and social pressure on banks not to make use of foreclosures, especially for primary residences, to avoid households losing their homes.

Graph 3.2: **Loan restructuring developments**

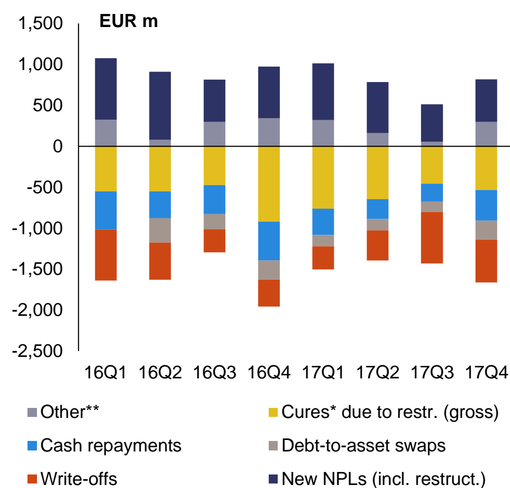


The figures were adjusted to take into account debt-to-asset swaps, which are recognised as restructured NPLs.
Source: Central Bank of Cyprus

The restructuring solutions are still a concern, but are less worrisome. The curing of restructured loans and its impact of reducing NPLs, after declining in early 2017, has stabilised in the last quarter (see Graph 3.3). The aggregate default rate on loans that were last restructured over the last 18 months rose to 11.8 % at the end of 2017, up from 5.8 % a year before (see Graph 3.4). However, this was mainly due to a reduction of NPLs (the denominator effect) rather than an increasing stock of defaulted loans.

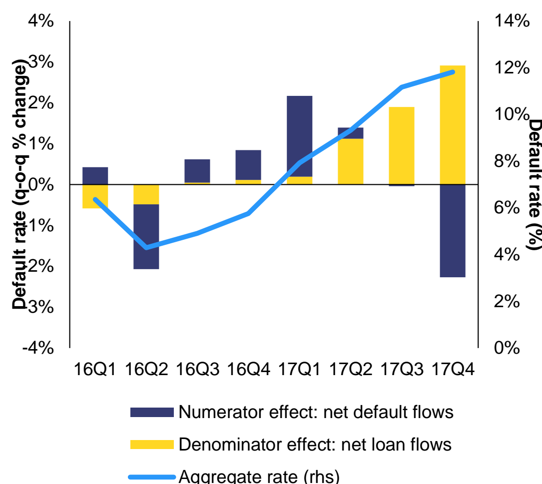
(6) According to the Cypriot loan classification rules, a loan is moved to the terminated category when no negotiation possibilities exist.

Graph 3.3: **Quarterly NPL flows**



The figures are only for loans with fixed maturities, excluding revolving loan facilities such as overdrafts.
* Cured loans cover restructured NPLs that transition into performing status.
** Other includes NPL inflows on credit cards and overdrafts, interest accruals, unwinding of interest, and valuation changes due to currency fluctuations as well as error items.
Source: Central Bank of Cyprus

Graph 3.4: **Default rate on loans restructured within the last 18 months**



The data only covers fixed-term loans and up to 11 local credit institutions, representing over 90 % of domestic lending. For loans subject to multiple restructuring, latest restructuring date is taken into account. A loan remains classified as restructured, even if it fulfils the usual exit criteria (i.e. a probationary period of 24 months or more). The default rate therefore increases if a restructured loan is (i) repaid, de-recognised (i.e. written-off), or re-classified into "terminated" status (denominator effect); or (ii) goes into default by becoming more than 90 days past-due, (numerator effect).
Source: Central Bank of Cyprus

Owing to supervisory pressure, notably through the Single Supervisory Mechanism's Supervisory Review and Evaluation Processes (SREP), the provisioning coverage of NPLs increased to 46.6 % at the end of 2017 (up from 41.7 % a year before). The coverage level of Cypriot banks is now in line with the EU average of 44 % and should be closer to reflecting the market value of real estate collateral. In 2017, the SSM and the national supervisor, the CBC, required additional provisioning buffers to be built, partly to prepare for the gradual introduction of the International Financial Reporting Standard 9 (IFRS 9), which addresses the impairment of financial instruments. Banks with sizeable legacy issues and those that rely heavily on loan restructuring have taken on board additional provisioning charges, some of which are reflected in their 2017 financial results. The strong underlying economic conditions and current capital positions have served as offsetting factors. Nevertheless, further provisioning is expected as banks continue to clean up their balance sheets and the introduction of the IFRS-9.

Banking sector profitability

Bank profitability has been mostly negative for 6 years in a row. In 2017, it fell significantly due to a larger provisioning effort and a further decline in net interest income. For the locally active credit institutions, a net loss before tax of around EUR 650 million was recorded in 2017. Net interest income declined by around 13 % year-on-year (y-o-y) to EUR 1.2 billion. By contrast, total operating expenses declined only marginally, by 3 % to EUR 960 million. As a result, total operating profit declined by around 17 % y-o-y. In addition, a significant increase in provisions of around 70 % y-o-y to EUR 1.3 billion tipped the financial results into deeply negative territory in 2017. Overall, the banks' capacity to generate profits is challenged by the dwindling interest margins and workout of the extremely high volume of NPLs.

Bank profitability remains under pressure amid the need for further provisioning. Increased provisioning reduces profits directly, but also indirectly by reducing the non-provisioned part of NPLs on which banks accrue interest income. As banks register accrued interest income on non-provisioned NPLs, under-provisioning allows them

to register profits without corresponding cash inflow and to bolster their net interest margin. As a result, a sharp increase in provisions in 2017 negatively impacted the banks' net interest income. By continuing to work out a large amount of NPLs, banks remain subject to considerable pressure on their financial results.

One way of improving profitability is to increase the efficiency of banks by reducing their operating expenses. While all three of the largest banks made good progress in reducing their number of branches and employees since the crisis, several indicators point to the fact that they are still oversised. The amount of customers and assets per branch or employee in Cyprus remains significantly lower than the euro area average. This is also impacted by the larger deleveraging that took place in Cyprus. In addition, due to the decrease in income, the cost-to-income ratio fell by 1 percentage point to 53.6 % in 2017. As a result, there is still room to rationalise the capacity and operations of Cypriot banks by increasing the use of ICT technologies and online products, down-sizing units that operate below cost recovery, and diversifying the range of services they offer in order to attract new business.

Capitalisation, liquidity and lending

The Common Equity Tier 1 (CET1) capital ratio of all banks declined to 14.9 % in December 2017, down from 15.9 % a year before due to recurrent losses. The overall solvency ratio decreased by 0.5 percentage point to 16.3 % over the same period. While the CET1 ratio is still higher than the EU average of around 13 %, this reflects the large uncertainty associated with the high ratio of impaired loans. The acceleration of NPL workout has started to take a toll on the banks' capital buffers. The banks that are more advanced in terms of balance-sheet clean-up have seen their CET 1 ratio fall well below the sector's average. If banks continue to increase their provisioning levels and register losses, maintaining current capitalisation is likely to prove challenging. Some of the largest banks are therefore planning to issue additional Tier 1 or Tier 2 capital in order to strengthen their capital buffers as a prerequisite for a successful implementation of their NPL reduction targets.

The CBC designated six credit institutions as Other Systemically Important Institutions (O-SIIs) ([7]). The imposed capital buffers to be phased in over 2019-2022 are: 0.5 % for Alpha Bank and Eurobank, 1 % for Hellenic Bank and the CCB, 1.5 % for RCB and 2 % for Bank of Cyprus. The countercyclical capital buffer requirement is still 0 % ([8]).

Due to the requirement side on the minimum requirement for own funds and eligible liabilities (MREL) banks will need to raise additional funds in the coming years. Cypriot banks lack of non-deposit funding, therefore they will need to raise additional eligible funds, such as non-preferred senior bonds, to meet the MREL requirements. This may be more difficult for Cypriot banks due to profitability challenges and weak asset quality positions. However, they will have a long transition period to adjust.

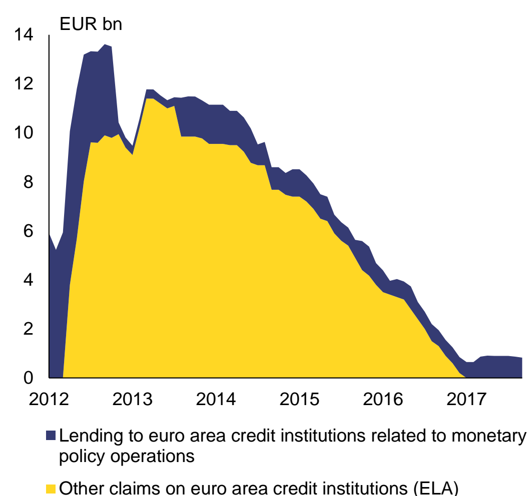
Banks reliance on central bank funding stabilised and deposits declined at the beginning of 2018. Banks reliance on central bank funding stood at around EUR 0.9 billion in early 2018 (see Graph 3.5). Deposits from residents continued to increase in 2017, especially from corporates, whereas deposits from non-residents declined (see Graph 3.6), leading to overall almost flat deposit base in 2017. Deposits, however, declined significantly in the first quarter of 2018. In particular, the CCB recorded sizeable deposit outflows linked to doubts about the viability of its restructuring process. More recently, outflows have eased, but remain volatile.

Deleveraging of the banks' balance sheets has bottomed out. Total consolidated assets of the banking sector increased marginally by 0.6 % y-o-y in 2017 due to higher cash, deposits and assets available for sale, while the stock of loans continued to contract. The contraction of the gross stock of loans for domestic residents stood at almost 7 % y-o-y as of February 2018.

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

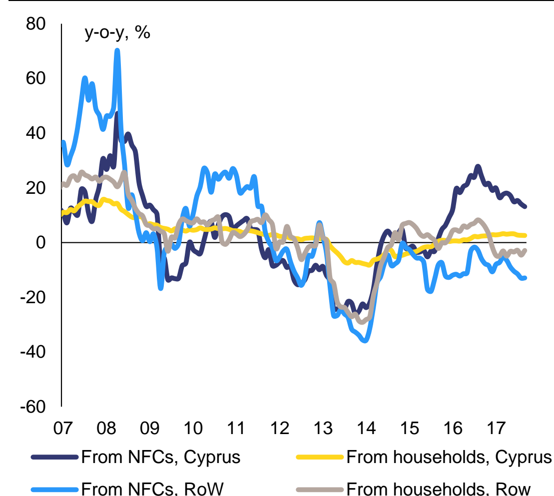
([8]) The CBC also introduced borrower-based measures in 2013, which were streamlined in March 2016, with total debt servicing and the loan-to-value ratio capped.

Graph 3.5: **Borrowing from the Eurosystem**



Source: Central Bank of Cyprus

Graph 3.6: **Deposits developments**



Source: Central Bank of Cyprus

Interest rates on both deposits and loans declined further, albeit at a slower pace. In February 2015, the CBC narrowed the maximum spread between Libor and the deposit interest rates that banks can offer from 300 to 200 basis points (bps). This resulted in a sharp decline in deposits and, in particular, in lending rates, which increased pressure on the banks' net interest income. In 2017, interest rates continued to fall, albeit at a slower pace. Loan interest rates declined further by 25 bps on longer-term mortgages and by 40 bps for longer-term NFC loans from the end of 2016 to the end of 2017 (see Graph 3.6). At the beginning of 2018, the fall in loan interest rates for NFC loans continued, although it stalled for mortgage loans.

Restructuring and resolution of banks

The CCB continues to suffer from a high stock of NPLs. Despite improving economic conditions on the island and progress by local peers, the volume of NPLs has declined only slightly. The latest development was mostly due to a one-off write-off in the second half of 2017, which also led to de-recognition losses. The NPL ratio has declined marginally from 60% at end-2016 to 59% in September 2017. The chief factor in explaining this development has been the poor quality of the restructuring solutions.

Although the CCB has made significant steps to achieve operational requirements set forth in its restructuring plan, it has so far not succeeded in meeting its privatisation objectives. Following two capitalisation injections totalling to EUR 1.7 billion in 2014 and 2015, the Cypriot government has a 77% direct ownership of the CCB, while the Recapitalisation Fund ([9]) holds almost all of the remaining stakes. According to its restructuring plan, the CCB has to be gradually privatised within the period September 2018 to March 2020. ([10]) The Cypriot government announced in early summer of 2017 its intention to distribute freely the relevant amount of shares to clients of the group. The plan was abandoned following discussions with the European Commission. In late August 2017, the Cypriot government stated that it aims to fulfil the privatisation requirement by selling the bank to a strategic investor and to bring fresh capital to the bank. As already mentioned at the beginning of this chapter, in March 2018 the government initiated the sale of the CCB and then in April made a significant financial transaction

([9]) To finance the second capital injection of EUR 175 million in 2015, the Cypriot government provided a loan to the Recapitalization Fund. The loan will be repaid through a special levy on bank deposits.

([10]) More specifically, CCB has to list 25% of its total shares by September 2018, followed by two additional listing of at least 25% of total shares within 9 and 18 months of the initial sale. As an alternative to listings, the corresponding stakes can be sold to known international or domestic financial institutions as well as renowned institutional investors active in the financial services industry with private offering.

with the bank. Developments related to CCB were still ongoing at the time of writing.

Bank of Cyprus, the largest systemic bank in Cyprus, has made notable progress in implementing its restructuring plan. According to the bank's 2017 results, the stock of NPLs was reduced by EUR 2.01 billion, or around 20 % in 2017. This adds to the steady progress that the bank has made in reducing its NPL stock over the past 2 years. Most of the reduction was possible due to write offs' (€978m or 48.5% of total reduction). The curing of restructured loans, representing 47 % of the net NPL reduction in 2017. The rest of the reduction was due to write-offs and foreclosures (mainly consensual). While the bank made some headway in selling foreclosed assets in 2017, the overall sales figures remain relatively low. The relatively high direct exposure of the bank to real estate due to the use of debt-to-asset or equity swaps is an ongoing concern. The slower pace of deleveraging combined with the reduction in NPL stock brought the NPL ratio to 47 % at the end of 2017, down from 55 % the year before. Meanwhile, the bank's CET1 ratio fell substantially to 12.7 % (transitional), mostly due to an additional provisioning of EUR 590 million in the first half of 2017 following interactions with the SSM. This additional provisioning brought the bank's NPL coverage ratio to 48 %, up from 41 % the year before. It has also helped reduce the bank's net loans-to-deposit ratio, which came to 82 % at the end of 2017, down from 95 % the year before.

The resolution of Laiki reached its final phase. The banking licence of Laiki's Russian subsidiary was revoked in 2015, while the Ukrainian, Serbian, and Romanian subsidiaries were sold in 2016 and 2017. After a long delay and various proceedings, a deal was struck with the Malta's National Development and Social Fund in March 2018 to buy Laiki's stake in Malta's Lombard Bank. The sale of Laiki's shares in its Greek subsidiary is expected to be finalised in July 2018. The Cypriot resolution authority sold half of Laiki's Bank of Cyprus shares in May 2017 and will sell the remaining shares when market conditions improve.

The liquidation of FBME Bank is underway, but may be delayed due to international legal challenges. The Cypriot Deposit Guarantee Scheme has started making payments, although only 1 600 claims had been received by April 2018 out of a potential 6 500 claims. The scheme has paid EUR 67 million so far. However, the overall liquidation process has been halted as a Tanzanian senior bond-holder claims that liquidation should take place in Tanzania.

3.2. BROADER FINANCIAL SECTOR DEVELOPMENTS

A decisive and durable reduction in NPLs requires strengthening Cyprus's payment culture. The authorities are currently contemplating a more comprehensive strategy to address the high NPL stock in the banking sector. Work on a number of initiatives has been brought forward in the past few months and should be pursued as a matter of priority. It will be key that any new measures initiated by the government contribute to strengthen the payment discipline and are in line with international best practices.

The authorities are working on a package of legal amendments to accelerate NPL resolution. This includes increasing the effectiveness and efficiency of the insolvency and foreclosure framework as well as the sale of loans law. The targeted amendments build on input from various stakeholders, including the Cypriot banking association and aim at removing impediments identified in the application of these frameworks. The proposals are awaiting approval by the Council of Ministers, the aim being to submit them to the House of Representatives by June 2018. The authorities aim to propose these amendments alongside the proposal for the measure addressed to vulnerable groups, i.e. the system-wide government subsidy scheme for NPLs secured with primary residences below a certain value, subject to certain income and property criteria. While details of this scheme have not yet been decided, it is important to design it in a way that does not provide wrong incentives for debtors and banks or undermines fiscal sustainability.

Use of the insolvency and foreclosure frameworks in place remains limited and thus their efficiency has not yet been fully tested. Foreclosure auctions under the current legislation started in June 2016, but have proved rather unsuccessful as the majority did not attract satisfactory bids. The sale of foreclosed assets

remains poor, with the total book value of sold assets representing less than 0.05 % of NPLs in the second half of 2017. On implementation of the insolvency framework, the main bottleneck is the lack of interest (i.e. lack of applications) among eligible borrowers. To promote the framework, the authorities engaged with stakeholders to explain various parts of the 2015 insolvency reform and made an effort to raise general awareness. An interactive web tool was also set up to help debtors to create a restructuring plan of their own. Despite this, demand for the insolvency tools remains low. Debt relief orders (for relief from small unsecured debts, up to EUR 25 000) (DROs) proved to be more popular than personal repayment plans (PRPs), with 1 381 and 114 applications [11] respectively by the end of April 2018. PRP applications only took off in 2016 and almost doubled in 2017. The backlog of untreated applications by borrowers for DROs and PRPs is mainly generated by the Insolvency Service, since the Courts treated majority of the cases submitted to them. The number of applications for corporate debt restructuring is also very low.

Work is ongoing to improve the effectiveness and efficiency of the Insolvency Service and to strengthen the regulatory framework for insolvency practitioners, although progress is slow. An independent review of the operations of the Insolvency Service has been finalised, resulting in an action plan lasting 3 years. The action plan has yet to be approved by the Council of Ministers. The project to improve the regulatory framework for insolvency practitioners in the areas of training, supervision and discipline with the technical assistance of the European Bank for Reconstruction and Development has started, and is expected to be finalised by around the end of 2019. As well as preparing the legal amendments to the three frameworks mentioned, there is a parallel work stream in which a working group involving the CBC and relevant ministries, supervised by a recently established ministerial committee, assesses implementation of the insolvency and foreclosure frameworks, and which is expected to give a political steer. So far, the working group did not yet make any significant progress as it has only reviewed implementation of the DROs.

On new legal initiatives, the revised draft securitisation law is currently being vetted for the second time by the Attorney General. One amendment that has been incorporated relates to the application of set-offs[12] in the event of liquidation, for which the borrower is given more flexibility. Moreover, the draft law, much like the foreclosure and loan sales framework, requires the originator to notify the borrower prior to the inclusion of his or her loan in the securitisation pool. The ECB has issued its opinion of the draft law in early April 2018, highlighting a number of concerns, including approval power granted to the CBC and the requirement of notification to the borrowers, collateral providers and guarantors, well in advance in the event of a transfer or a sale.

There are positive developments in the secondary market for NPL sales. Although the newly created framework for a secondary market for NPLs is still not used enough, Hellenic Bank, Cyprus' third-largest lender, sold EUR 145 million of its NPLs (some 6 % of its NPL stock) to Norway's B2Holdings ASA in January 2018. All major banks have now engaged in arrangements with external service providers for workout of their NPLs. The increased use of loan servicers may serve as a first step towards more widespread loan sales. The government has also shown an increasing willingness to amend the foreclosure and insolvency procedures to facilitate collateral recovery, which may improve secondary market valuations and facilitate sales.

The quality of financial information available on borrowers is limited, which is being addressed to some extent. As agreed in the 2017 National Reform Programme, the authorities are improving the credit registry by broadening the information that is collected and made available as well as expanding the set of reporting counterparties. The scope and quality of the financial information available for credit risk assessment has been relatively limited but is in the process of being improved by integrating the

(11) Source: http://www.mcit.gov.cy/mcit/insolvency.nsf/All/4502C8E1D60C5CC0C2257F6100390460?OpenDocument.

(12) A set-off is where amounts are set off against each other to arrive at a single amount payable arising out of a series of mutual dealings between two parties.

island's second largest lender the CCB into the credit register. The creation of a credit scoring system for physical persons has been commissioned, although no precise implementation timeline has been announced yet. The credit registry needs further improvements regarding data quality, access and management, in line with international best practices.

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

4. BUDGETARY OUTLOOK AND FISCAL POLICY STANCE

4.1. FISCAL PERFORMANCE

Fiscal performance was remarkably strong in 2017, once again exceeding expectations. The general government balance achieved a surplus of 1.8 % of GDP, up from 0.3 % of GDP the year before. The primary surplus increased to 5.0 % of GDP, ([13]) up from 3.6 % of GDP in 2016, and is now one of the highest in the EU. This is a remarkable turnaround compared to a headline deficit of 5.1 % of GDP when the economic adjustment programme started in 2013. Revenue collection in 2017 was buoyant and increased by 8.2 %, while expenditure increased at a much slower pace, by 4.3 %. The fiscal outturn in 2017 was also better than expected in the Draft Budgetary Plan for 2018 and the Commission's Autumn 2017 Economic Forecast (i.e. up by 0.8 percentage points and 0.7 percentage points of GDP for the headline surplus respectively).

Increased general government revenue receipts in 2017 were underpinned by the strong economic recovery and ongoing improvements in the labour market. Tax receipts on production and imports increased significantly (VAT receipts rose by 15.9 %). In addition, tax revenues on income and wealth also shot up despite the negative impact of abolishing the temporary tax on wages of private sector employees and the immovable property tax (i.e. corporate tax and income tax revenues increased by 10.3 % and 11.4 % respectively). Moreover, social contributions increased by a similar amount (up 10.5 %).

General government expenditure increased in 2017, albeit below the authorities' projections in the Draft Budgetary Plan for 2018. The increase was mainly due to a rise in investment (up 12.3 %), followed by increases in intermediate consumption (up 11.9 %; partly due to one-offs related to energy-related expenditures and for desalinated water), compensation of employees (up 4.0 %; including the hiring of additional personnel for security forces and the abolition of the temporary tax on wages of public sector employees) and social transfers (up 2.1 %; mainly due to payments for old age pensions). However, expenditure in 2017 was somewhat lower than projected in the Draft Budgetary Plan for 2018. Most savings resulted from lower-than-budgeted expenditure execution on social transfers (i.e. lower-than-projected Guaranteed Minimum Income contributions and unemployment benefits), and subsidies (i.e. front-loading of agricultural subsidies in December 2016).

Public debt fell significantly in 2017, dropping below 100 % for the first time since 2013, to 97.5 % of GDP. Cyprus has accelerated its public debt reduction thanks to high nominal GDP growth, a sizeable general government primary surplus (5.0 % of GDP) and active debt management operations. The latter involved repaying part of the debt from the accumulated cash balances. In particular, the government repaid part of the debt owed to the CBC (amounting to EUR 615 million or 3.2 % of GDP) in November 2017. For other active debt management operations in 2017, including early repayment of a part of the IMF loan, see Section 6 of Cyprus' Post-Programme Surveillance Report of autumn 2017 ([14]).

4.2. FISCAL OUTLOOK

Fiscal performance for 2018 is expected to maintain sizeable budgetary surpluses. According to the Commission's spring forecast, the general government headline and primary surpluses are projected to remain high at around 2.0 % of GDP and 5.0 % of GDP respectively in 2018, both well above the euro area average and among the highest in the EU. This is mainly due to the positive macroeconomic outlook, which is driven by domestic demand, strong tourism and the improving labour market. In 2019, both headline and primary balances are expected to increase

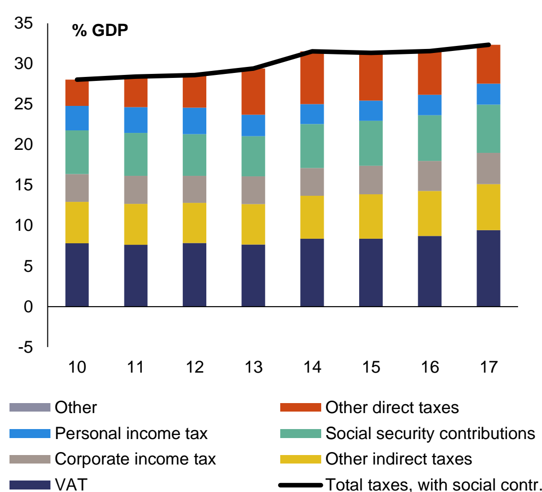
([13]) Based on data reported to Eurostat in spring 2018, see April 2018 EDP notification. Discussions between Eurostat and the Statistical Service of Cyprus (Cystat) are ongoing regarding the recording of interest expenditure and intermediate consumption. Possible future changes to the recording of those expenditure items would not have an impact on the general government balance, but they would affect the primary balance and interest expenditure.

([14]) European Commission (2017), Post-Programme Surveillance Report – Cyprus (autumn 2017), European Economy, Institutional Paper No 067, Publications Office of the European Union, Luxembourg.

further to around 2.2 % of GDP and 5.1 % of GDP respectively, mainly on account of an increase in social security contributions. The Commission forecast is based on a no-policy change assumption and is therefore consistent with previous policy orientations. It also takes into account new measures that are sufficiently detailed and have been announced by the authorities. According to the 2018 Stability Programme submitted by the Cypriot authorities, the headline and primary balances are projected to reach 1.7 % of GDP and 4.5 % of GDP respectively in 2018, and 1.7 % of GDP and 4.7 % of GDP respectively in 2019. The authorities underpin the improving fiscal position going forward with enhanced economic growth. Based on the authorities' projections, the structural balance is expected to somewhat deteriorate to 0.2 % of GDP over 2018-2020, followed by an increase to 0.5 % of GDP in 2021.

However, this strong revenue performance may not last. The shares of VAT and income taxes (i.e. corporate income tax and personal income tax) in terms of GDP have increased in recent years. In 2017, around three quarters of the observed increase in total tax revenues was down to VAT and income taxes. However, corporate income tax is an inherently volatile source of revenue subject to relocation decisions by (large) companies, while the sizeable VAT receipts in 2017 largely benefitted from the buoyant construction sector and, to a lesser extent, from wholesale and retail trade. It is therefore important to understand the underlying drivers of corporate income tax and VAT receipts as well as the extent to which they are driven by cyclical developments. As mentioned in the 2018 Country Report for Cyprus([15]), the Commission's analysis points to significant tax buoyancy effects for corporate income tax and VAT in Cyprus, leading to revenue windfalls in 2017. Prudent fiscal policy would avoid risks associated with using the additional temporary revenue generated by tax buoyancy effects to finance increases in long-term expenditure.

Graph 4.1: **Tax revenue contributions**



Source: Ministry of Finance and European Commission

Fiscal risks remain tilted to the downside and have considerably increased. The forecast is subject to uncertainties mainly in relation to the financial sector developments, including the budgetary impact of the CCB related transaction. The high proportion of NPLs in the financial sector also represents a contingent risk for Cyprus. Furthermore, there are fiscal risks associated with public payroll growth. Compensation of employees may suffer upward pressure, which may have significant budgetary implications and potential spill-over effects in the private sector. A permanent mechanism that regulates the growth of the public sector wage bill would avoid any potential fiscal slippage and ensure the sustainability and predictability of public finances. Another major risk is linked to the fiscal impact of healthcare reform, which might create additional budgetary pressures. The study on the fiscal and economic impact of the reform is not expected before the third quarter of 2018, while the potential cost overruns in establishing the financial and operational autonomy of public hospitals are still being assessed. Moreover, the government recently agreed to introduce pay rises for health-care professionals, effective from 2019. There are also uncertainties regarding the outcome of court cases on the constitutionality of the public sector wage and benefit cuts during the crisis; rulings in favour of claimants could significantly impact public finances.

([15]) See also 2018 Country Report for Cyprus, pages 26-28. https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-cyprus-en.pdf

Taking into account the government's transaction with the CCB in April, public debt is projected to increase from 97.5 % in 2017 to 105.7 % of GDP in 2018, but would steadily decline after that. The increase in 2018 is mainly due to the issuance of a series of government bonds on 3 April 2018 (worth EUR 2.35 billion), the proceeds of which were deposited with the CCB. Based on the no-policy change assumption, the deposit is not expected to be withdrawn by the end of the forecast horizon. The implications of banking support for the State's balance sheet are particularly relevant in the Cypriot context where the size of the banking sector relative to that of the public sector is large. The transaction represents a shift upwards in Cyprus's public debt. In the absence of further government support for the banking sector, public debt is projected to decrease again to below 100 % in 2019 owing to the projected high primary surplus of 5.1 % of GDP and favourable debt dynamics mostly due to strong real GDP growth (see also Section 6 and Annex 1 for an analysis of debt sustainability, including the impact of the government's transaction with the CCB of 3 April 2018).

The House of Representatives has resumed discussions on creating a sovereign wealth fund. The draft law, which sets out the conditions for collecting, managing and using future resources from hydrocarbon exploitation and stipulates that the government will be able to use part of the revenue to reduce government debt, is set to be adopted in mid-2018. This fund is key to strengthening the long-term sustainability of public finances and to ensure the sustainable use of revenue generated by exploiting hydrocarbon reserves.

6. STRUCTURAL ISSUES

The favourable economic environment offers the new government in place an opportunity to proceed swiftly with much needed structural reforms. Since early 2017, there has been a noticeable slowdown in structural reforms. The mission stressed that renewed structural reform commitment by all national stakeholders is needed. It also encouraged all stakeholders to step-up the reform momentum in key areas, which are necessary to unlock the potential growth and safeguard fiscal sustainability, given the country's ongoing important economic vulnerabilities.

6.1. FISCAL STRUCTURAL REFORMS

Public financial management and budgetary framework

Considerable progress has been made on implementing the fiscal framework, although further efforts are needed on the appraisal of public investment projects. Secondary legislation for the Fiscal Responsibility and Budgetary Framework Law has been fully operational since January 2018. The administrative capacity of the key institutions involved in assessing public investment projects is being further improved. In particular, guidelines and templates have been finalised, several training courses are ongoing and a software management system is being acquired. However, the selection process for including projects in the budget needs to be assessed and further enhanced based on the pilot of the new project selection process of the 2017-2019 budget. The establishment of a unit responsible for public-private partnerships within the Ministry of Transport is still under discussion.

State-owned enterprises

Only individual privatisation projects remain active after the privatisation unit was dismantled and the legal framework for privatisation was abolished. After the House of Representatives rejected budgetary appropriations earmarked for privatisation projects in the 2017 budget, the government effectively dismantled its privatisation unit and cancelled decrees to privatise the Cyprus Telecommunications Authority (CyTA) and the Cyprus Stock Exchange. In February 2018, the Supreme Court upheld the law adopted by the House of Representatives to abolish the legal framework for privatisation. As a result, only individual privatisation projects are still active, with the House of Representatives closely scrutinising any progress made on these files. These developments represent a reverse of one of the key reform commitments made under the programme. Nevertheless, progress on the individual privatisation projects could attract further foreign investment in Cyprus, reduce the state's exposure to contingent liabilities from public companies and improve the economic governance and performance of state-owned enterprises (SOEs).

To improve the efficiency of SOEs, steps could be taken in three areas. Following the withdrawal of the government's legislative proposal to privatise CyTA in May 2016 due to strong political opposition, the government now proposes the corporatisation of this company. The government submitted a draft bill to the House of Representatives in November 2017, in which it remains the majority shareholder and a strategic investor is in charge of managing CyTA. An agreement was also reached to sell CyTA Hellas, the Greek subsidiary of CyTA. The bill for licensing the activities of the National Lottery to a private investor was submitted to the House of Representatives, with an investor expected to be selected in 2018. The privatisation processes of the Larnaca port and the Troodos residences are underway, with both subject to tender procedures in 2018. By contrast, no notable progress has been made on the privatisation of other assets, in particular the Cyprus Stock Exchange. As the experience with the privatisation of the Limassol port shows, smaller scale privatisation projects can also yield important efficiency gains in key strategic sectors of the Cypriot economy.

The law on SOE corporate governance is at a standstill. The law, which aims to improve the corporate governance of SOEs, was submitted to the House of Representatives in 2015, and no progress has been made since then. Even though the law applies to companies not intended for privatisation, it has nevertheless been associated by stakeholders with being part of the wider privatisation strategy and therefore garners significant opposition.

Revenue administration

Slow progress is being made on reforms in the area of revenue administration. Measures to step up the fight against tax evasion are underway, which aim to target those taxpayers with the biggest impact on public revenue collection. However, progress on implementing the integrated tax administration system is slow. The tender procedure for a new tax IT system is expected to be completed by the end of 2018, although full deployment of the new system is expected to take several years. In the meantime, the current online system is being upgraded to improve tax administration (e.g. e-payments). Stakeholders are currently being consulted on some of the chapters of the Tax Procedure Code, with these expected to be adopted in 2018 or early 2019.

Public administration reforms

Renewed commitment to completing the horizontal reform of public administration is needed. It consists of six pieces of legislation that aim to modernise public administration and enhance its productivity. Legislation on mobility between public administration and SOEs and among SOEs was enacted in May 2017 and is expected to improve the flexibility of public administration on resource allocation. Following their rejection by the House of Representatives, the draft laws on modernisation of the evaluation procedures for recruitment and promotion, introduction of a new staff appraisal system and the functioning of the Public Service Commission were amended. The government intends to re-submit them for adoption in mid-2018 after discussing and reaching consensus with the relevant stakeholders.

The introduction of a permanent mechanism to safeguard the fiscal sustainability of the wage bill faces opposition. The draft law introducing a permanent mechanism to contain increases to the public sector payroll to the developments in fiscal conditions and nominal GDP growth was rejected by the House of Representatives in December 2016 and the government does not intend to re-submit it for adoption. The draft law provisions were introduced be means of a collective agreement between the government and the union of civil servants, which expires at the end of 2018. The new government plans to start negotiations with public sector unions in 2019 to renew the agreement. However, a legislative mechanism is still needed to provide for the long-term predictability of the evolution of the public sector wages.

Local government reform has stalled. The draft law was submitted to the House of Representatives in 2015 and no progress has been made since then. The reform is intended to streamline and improve local public services, in particular waste and water management. It is expected to accelerate the issuance of certificates necessary to issue and transfer title deeds, which face significant backlogs (see Section 5.2 Immovable property rights). The reform also intends to establish a common accounting and financial reporting framework for all local governments, which could improve the public finance management.

Reform of the welfare system

The costs of the Guaranteed Minimum Income (GMI) scheme is set to decline, reflecting the decreasing number of beneficiaries. The implementation of targeted active labour market policies and the improved situation of the labour market on the back of economic recovery led to a decrease in the number of the GMI recipients. In March 2018 there were about 45 000 beneficiaries of GMI declining from 47 000 in September 2017, and 46 000 in December 2017. GMI costs is therefore expected to fall to EUR 220 million in 2018, as compared to around EUR 250 million in 2016 and 2017.

Preliminary analysis of social indicators shows that GMI has a positive impact on reducing poverty. A study of the GMI scheme's impact on poverty is expected at the end of 2018 based on the 2016 EU Statistics on Income and Living Conditions (SILC) data. In the meantime, the preliminary figures on the at-risk of poverty indicator, the poverty gap and the impact of social benefits on poverty reduction for 2016, (27.7% down from 28.9% in 2015) suggest that the introduction of the GMI scheme had a large positive impact on reducing poverty.

Healthcare reform

Implementation of the long-standing healthcare reform is gaining momentum. In June 2017, the House of Representatives adopted the legislation to establish a universal healthcare system in Cyprus by 2020 (National Health System NHS). This was an important achievement, signalling compliance with a long-standing programme commitment and recurrent country-specific recommendation as part of the European Semester. The government has reaffirmed its commitment to proceeding with full implementation of the NHS. Progress on key implementation milestones is being made, in particular on implementing the IT system and reforming primary healthcare. Furthermore, the negotiations between the authorities and the representatives of medical professionals are ongoing in a constructive way. The outcome of the negotiations will have an impact in particular on the participation rate of private sector health professionals in the NHS. Progress is also being made on the financial and operational autonomisation of hospitals, which is set to be completed by June 2020.

Implementation of the new healthcare system is expected to significantly lower the out-of-pocket medical costs currently incurred by the population, although efforts to safeguard fiscal sustainability need to continue. Out-of-pocket medical costs currently account for more than half of the total healthcare expenditure. The reform is expected to reduce these costs to 15%, with a positive impact on the household disposable income. However, the fiscal costs of the reform is still unknown —the results of the study on the hospitals' costs, which could help identify possible costs overruns, will only be available in mid-2018. Furthermore, the results of the study, commissioned by the Ministry of Finance, on how the reform impacts the economy, including identifying potential fiscal risks are only expected at the end of 2018. Implementation of the reform, in particular autonomisation of public hospitals, entails significant investment needs, including human capital, health technology, and a new IT system. In this respect, it is important to strengthen safeguards against possible costs overruns and implement this major reform in a fiscally sustainable way.

6.2. STRUCTURAL REFORMS

Justice system reform

Preparations for comprehensive reform of the justice system continue, with some progress expected in 2018. The gradual implementation of the reform is expected to be, to a great extent, finalised in 2020, with preparations gaining momentum, in particular thanks to technical assistance provided by the European Commission (Structural Reform Support Service). The law establishing an administrative court to deal with asylum seekers has been submitted to the House of Representatives and it is expected to be adopted by mid-2018. The law establishing a commercial court, which will handle cases of over EUR 2 million is under legal vetting and should be submitted to the House of Representatives by mid-2018. This court is expected to make the system more efficient, in particular for cases related to the non-performing loans (NPLs), which is much needed in order to allow banks to proceed swiftly with cleaning up their balance sheets. These two courts will also help reduce the large backlog of cases accumulated over the years due to the inefficiencies of the judicial system. In addition, the training school for judges is also due to be fully operational by the end of 2018. While the transition to an IT system is still a long way off, preparations are advancing. Amendments to the civil procedure rules are still at an initial stage.

An independent review of court operations has been finalised. A study on court operations, which was commissioned by the Structural Reform Support Service, was presented in March 2018. It makes a series of recommendations, including creating a task force to clear the large backlog of cases, making changes to the management structure of the courts, improving the efficiency of case management and more effective judicial time management. The recommendations will be reviewed by the Cypriot authorities. Reform of the judicial system is deemed necessary given its strong link to issue of the NPLs and the enforcement of contracts as well as the business environment and investment conditions. Successful implementation of the reform requires more staff in the Supreme Court office dealing with the reform initiatives and a close cooperation between the Supreme Court and the Ministries of Finance and Justice.

Energy

Recent gas exploration results reconfirmed the promising geological characteristics of the Cyprus' Exclusive Economic Zone (EEZ). Following a successful exploration licensing procedure in 2017 with well-known companies (ExxonMobil, Qatar Petroleum, Eni and Total), drillings in the Cyprus' EEZ were stepped up in the second half of 2017, in particular the one of ENI in Block 6 Offshore Cyprus at the end of 2017. This last exploration reconfirmed very promising gas reserves in Cyprus' EEZ. More exploratory drillings by Eni in Block 3, which is closer to Cyprus' coast, were blocked by Turkish ships. This military incident created uncertainty and highlighted once again the complex geopolitical situation. In March 2018, President Anastasiades informed the European Council about the incident, which called on Turkey to cease these actions and respect the sovereign rights of Cyprus to explore and exploit its natural resources in accordance with EU and international law([16]). On a positive note, Exxon is advancing with the necessary environmental studies, and is expected to start drilling in mid-2018.

The Cypriot authorities are continuing with negotiations to monetise potential reserves of gas at the Aphrodite field and confirmed their intention to take part in the EastMed Pipeline Project. The development and production plan for the Aphrodite field is still being discussed by the Cypriot authorities and the Aphrodite consortium. On the prospects of gas supply to the EU from Eastern Mediterranean sources, Cyprus — along with Israel, Italy and Greece — signed a Memorandum of Understanding to confirm their intention to cooperate in developing and implementing the EastMed Pipeline Project (2 000 km long pipeline to channel offshore reserves from the Eastern Mediterranean to Greece and Italy. An intergovernmental agreement is expected to be signed in 2018.

The plan on importing liquefied natural gas (LNG) to Cyprus is being implemented. The two tenders - one to supply LNG by way of a long-term contract and the other to build the infrastructure to distribute LNG over the energy network - are about to be launched. The project received funding of around EUR 100 million from the Connecting Europe Facility, which amounts to around 40 % of the total costs.

The Cypriot authorities are committed to opening the electricity market as of July 2019. The three-stage review of the implementation of the functional unbundling is advancing; the first review has been completed, the second is currently under way and the third is expected by the end of 2018. Accounting unbundling is also advancing with Separated Regulatory Accounts being prepared for the years 2015 and 2016. If functional and accounting unbundling are successful and provided that political backing by all stakeholders continues, full ownership unbundling is expected as of 1 July 2019. In the meantime, an important stepping stone towards increasing competition in the electricity market is the fact that a new electricity supplier has been licensed — F. E. First Electric Supply Ltd — who will interact with producers and consumers based on bilateral contracts. It is the first time an electricity supplier other than the Electricity Authority of Cyprus is allowed to enter in the market. Two additional licences are expected to be granted soon.

Immovable property rights

Progress is slow on reducing the backlog of transfers and issuance of title deeds. The backlog of unissued titles fell to around 26 000 in March 2018, down from 28 000 in September 2017. The authorities believe that the main reason for the delay lies with local governments and their reluctance to issue the necessary certificates. This is due in particular to small infrastructure projects, where the developers did not complete the required works and the local government needs to complete them and bear the costs before the certificates can be issued. Pending local government reform is expected to address these difficulties. Limited progress has also been made on legacy cases e.g. the transfer of title deeds to their final buyers for sales registered before 2015. Some 4 000 out of 15 600 transfer applications have been completed, with quicker resolution expected. The constitutionality of the trapped buyers' law is still subject to a decision by the Supreme Court. A new law that could remedy the situation is at the Legal

([16]) http://www.consilium.europa.eu/en/press/press-releases/2018/03/23/european-council-conclusions-22-march-2018/

Service for vetting and is being discussed with the stakeholders. The reform, which would streamline and shorten the long and cumbersome procedures for issuing building and spatial planning permits, is still under preparation with technical assistance from the Commission (see Section 2 on the impact of the real estate supply side).

Action Plan for Growth

Implementation of the National Strategy for Tourism is underway. Following consultation with stakeholders, the strategy was adopted by the Council of Ministers and has entered the implementation phase. However, the setting up of the Deputy Ministry for Tourism has been delayed in the House of Representatives, with no timeline announced.

The framework for strategic investments is pending adoption by the House of Representatives. Preparation of a key element of the Action Plan for Growth — setting up of a fast-track mechanism for strategic investments — was completed, with the House of Representatives expected to adopt it. Efforts are under way to make it easier for small and medium-sized enterprises (SMEs) to access finance, including two projects under the European Fund for Strategic Investments (EFSI SME window). Implementation of e-government projects is gaining momentum.

Labour market structural issues

Public employment services (PES) are not yet well equipped, although some measures (PES peer support, IT platform) are being taken. The recruitment of 30 extra employment counsellors has been further delayed and is now expected to take place in May 2018.

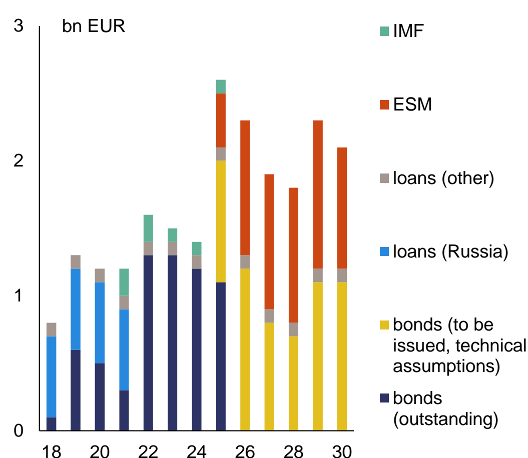
The assessment of the effectiveness of active labour market policies (ALMPs) has started since the beginning of 2018. ALMPs include measures targeting young people under the National Action Plan for Youth Employment as well as measures targeting other vulnerable groups, such as the long-term unemployed, persons with disabilities, but also GMI recipients. The new ALMPs monitoring and evaluation system has been in place since the beginning of 2018, but still needs some time to deliver results. In addition, a study is expected to be launched by the University of Cyprus on the effectiveness of ALMPs.

Collective agreements have been renewed or are in place for most sectors of the economy. In the construction sector, discussions are still ongoing on legislating certain provisions of collective agreements, including wage floors, working hours and provident fund contributions in an effort to set minimum standards for the construction industry. The main reason for this action is to have a comprehensive coverage as the trade union membership rate in this sector has fallen to below 50 %, and the extension of an agreement reached between minority unions might not be representative of the needs of the entire sector. In the financial sector, the collective agreement for the Bank of Cyprus, the largest bank in the country, is still being negotiated to better link wages to profit and performance.

7. SOVEREIGN FINANCING AND ABILITY TO REPAY

Sovereign financing situation remains comfortable in the baseline scenario, although significant risks related to the financial sector have recently come to the front. As a result of active debt management in recent years, there will be no more debt amortisation peaks in the medium term. In 2018-2021, the annual debt principal repayments will not exceed EUR 1.4 bn or 7 % of GDP (see Graph 7.1). In addition, total debt redemptions and fiscal needs will be contained in the medium term owing to the long maturity of ESM loans and projected government surpluses. Excluding Treasury bills (T-bills), financing needs for 2018 are estimated at around EUR 0.5 billion (consisting of EUR 0.9 billion of debt redemption needs, which are partly offset by EUR 0.4 billion of revenue from the projected headline surplus). As the CCB sale was still evolving at the time of writing, there are major uncertainties regarding potential financial sector financing needs in relation to the sale. Excluding these potential additional needs up to mid-2019, the financing needs are lower than the cash buffer, even after excluding the funds deposited with the CCB of EUR 0.9 billion available in April 2018.

Graph 7.1: **Medium and long-term debt amortisation**



Source: Ministry of Finance —- Public debt management office and own calculations

While Cyprus maintained access to international capital markets at favourable rates in 2017, uncertainties have increased for 2018 linked to the ongoing sale of the CCB. In June 2017, when the previous international bond issuance took place, Cyprus issued a seven-year Eurobond of EUR 0.85 billion (4.4 % of GDP) with a yield of 2.8 %. The issuance was almost five times oversubscribed. So far in 2018, the government has raised funds through the transaction involving a private placement with the CCB in April. This transaction comprised the issuance of 9 domestic government bonds for a total nominal amount of EUR 2.35 billion, with maturities of 15-20 years and yields of 2.45-3.05 % ([17]), the proceeds of which and a small cash addition from the government's cash buffer (EUR 0.15 billion) were deposited with the CCB. According to Cyprus' Annual Financing Programme 2018 ([18]) and the 2018 Stability Programme, Cyprus also plans to issue an international bond of around EUR 1 billion later in 2018, subject to market developments and the actual financing needs of the sovereign.

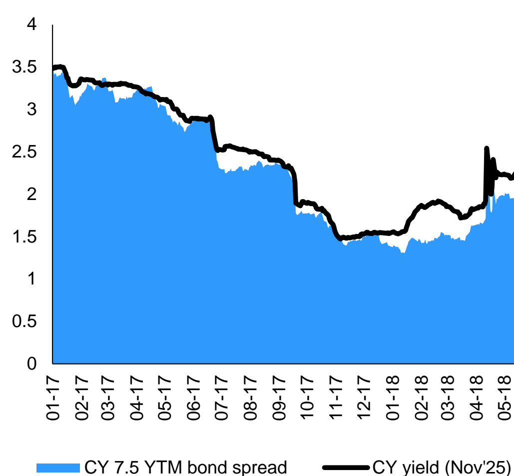
After a significant improvement in 2017, Cyprus' sovereign bond yield has deteriorated somewhat following the recent CCB developments. Cyprus' 7 ½ year sovereign bond yield declined substantially in 2017, to 1.5 % in December 2017, and then increased with peaks in February and April, amounting to around 2.3 % in the middle of May 2018. The spread to the German sovereign bond had a similar decline in 2017 and stayed broadly at that level before increasing somewhat since the second half of March 2018 (see Graph 7.2). The deterioration in Cyprus' sovereign bond yield in 2018 mainly reflects country-specific factors, likely related to the recent developments in relation to the banking sector and in particular the CCB. The most recent spike in the yield may be down to a Fitch report of 13 April 2018 stating that banks in Cyprus (as well as in some other EU countries) may need to build up further reserves, given the riskier market characteristics. The yield somewhat fell again after the rating upgrade by Fitch that followed.

([17]) The government bonds include a unilateral call option for an early buyback of all or any part of the bonds from any holder at nominal value. See also for further information: http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/All/01EC129A8453C1D4C225826B002D5117/$file/Announcement%20bond%20issuance%20through%20private%20placement.pdf.

([18]) Source: http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/All/E633CAF2CA92B6AFC22581FD003753A7/$file/Announcement%20for%20AFP%202018%20EN.pdf?OpenElement.

However, it is worth noting that the Cyprus sovereign bond market is relatively small, which tends to exacerbate volatility in yields. At the shorter end of Cyprus' yield curve, the yield for three-month T-bills on the primary market remained negative. In February 2018, the outstanding T-bill stock stood at EUR 300 million, within the target range set out in the Medium Term Debt Strategy (1-4 % of total debt).

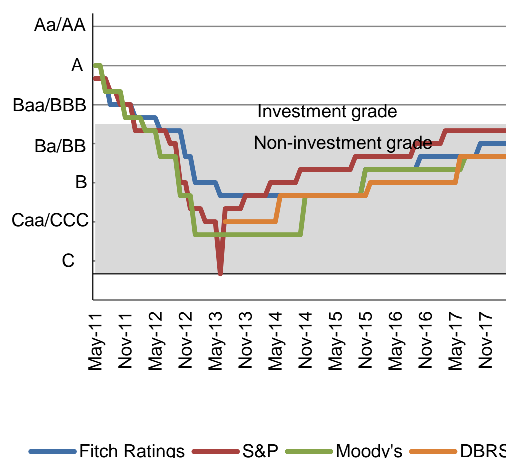
Graph 7.2: **Cyprus sovereign bond yield and spread vs. German sovereign bond**



Source: Bloomberg and own calculations.

Cyprus' sovereign credit rating was recently upgraded by Fitch, although it remains below investment grade. On 20 April 2018, Fitch upgraded Cyprus by one notch to 'BB+' from 'BB', keeping its outlook positive, due to the country's strong cyclical economic recovery and prudent fiscal policy. This upgrade occurred around 2 weeks after the government's transaction with the CCB. In March 2018, Standard & Poor's kept Cyprus' sovereign credit rating one notch below the investment grade (at 'BB+') with a positive outlook, citing the risks to the economy from the banks' NPLs. Cyprus is therefore currently rated one notch below investment grade by two rating agencies (Standard & Poor's and Fitch) and three notches below investment grade by Moody's and DBRS, with a positive outlook by the four rating agencies (see Graph 7.3). The high level of NPLs combined with high public, private and external debt hold back further upgrades by the credit rating agencies. This suggests that a marked reduction in NPLs in the banking sector is likely to be viewed positively by the rating agencies. The upcoming sovereign rating reviews are scheduled for 25 May 2018 by DBRS, July by Moody's, September by Standard & Poor's and October by Fitch.

Graph 7.3: **Sovereign long-term ratings, Cyprus**



Source: European Commission

Uncertainties about Cyprus' capacity to service its ESM debt have increased since the previous PPS report, while financing needs in the baseline scenario remain moderate at present. Uncertainties and risks have increased in particular due to the significant increase in gross government debt associated with the placement of government bonds with the CCB. At the time of writing, developments on the CCB were still ongoing. On the other hand, current medium-term fiscal and debt servicing financing needs are moderate mainly due to Cyprus' past active debt management operations. Until mid-2019, the financing needs in the baseline scenario are lower than the current cash buffer. Against this background, continued fiscal discipline, forceful reduction of NPLs and progress on growth-enhancing structural reforms will be of critical importance in consolidating and further improving investor confidence.

ANNEX 1

European Commission Debt Sustainability Analysis

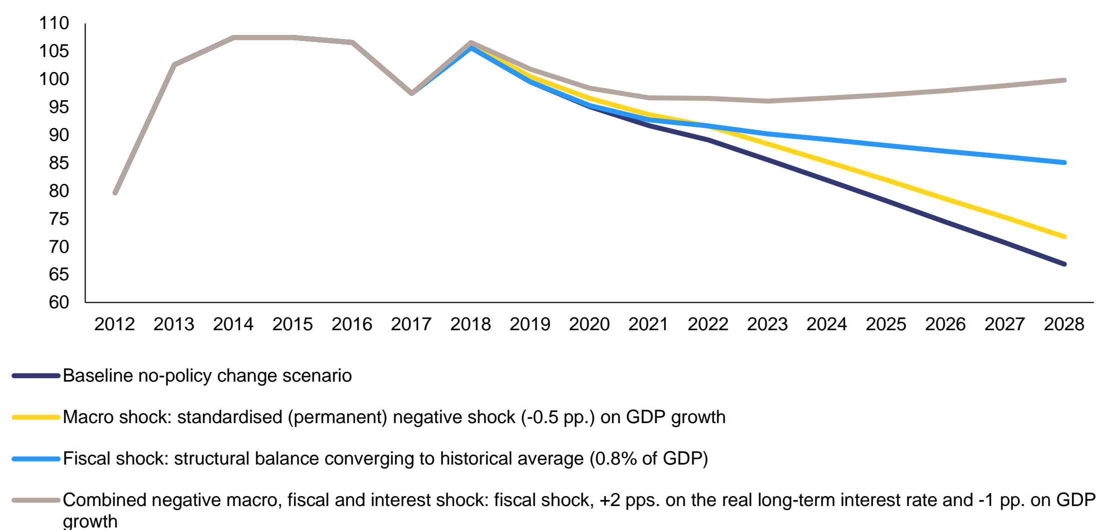
The Commission spring 2018 forecast and the debt sustainability analysis, based on standard Commission methodology, imply an increase of the government debt-to-GDP ratio in 2018 and a steadily declining path afterwards over a 10-year period. After a significant fall in 2017, public debt is projected to increase to 105.7 % of GDP in 2018 due to the issuance of a series of government bonds on 3 April 2018 (totalling EUR 2.35 billion), the proceeds of which were deposited with the CCB. However, in the baseline scenario public debt is projected to steadily decline thereafter and to reach 66.9 % of GDP in 2028. This debt sustainability analysis uses the Commission spring 2018 forecast (2018-2019) as a starting point to ensure consistency across EU Member States. After 2019, the analysis is based on the following standard assumptions in the Commission methodology: (i) the structural primary balance, before the cost of ageing, is kept at a surplus of 3.3 % of GDP under the 'no fiscal policy change' assumption; (ii) inflation converges to 2.0 % by 2022 and remains stable after that; (iii) the real long-term interest rate on new and rolled-over debt converges linearly to 3 % (5 % in nominal terms) by the end of the 10-year projection period, in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group; (iv) real GDP grows at the rate projected according to commonly agreed methods with the EPC's Output Gaps Working Group until t+10, and then grows according to the European Commission - Ageing Working Group's projections (average rate of around 1.5 % in 2018-2028); and (v) ageing costs develop according to the 2018 Ageing Report projections ([19]).

However, there are significant adverse risks to the baseline stemming mainly from the financial sector and the large share of non-performing loans. In the baseline, potential additional financial sector financing needs are not taken into account, since uncertain at this stage. In particular, in the short term, there are uncertainties surrounding the CCB sale and possible negative feedback effects on interest rates and GDP growth. Moreover, a weaker fiscal performance could seriously undermine the favourable projected trend in the baseline. In order to illustrate the possible indirect impact from financial sector developments as well as deviations from the fiscal path, three adverse scenarios are considered (see Graph A1.1). The first adverse scenario is a standard macro shock that assumes a decrease in real GDP growth (by 0.5 percentage point (pp.) compared to the baseline) over the forecast period. This keeps the debt trajectory on a steadily declining path, but at a slower pace compared to the baseline scenario, with the public debt being higher by 1.5 % of GDP in 2020 and 4.9 % of GDP in 2028. The second adverse scenario assumes a fiscal shock of the structural primary balance gradually converging towards its 15-year historical average (a surplus of 0.8 % of GDP). In this second scenario, public debt declines at a much slower pace, ending up 18.2 % of GDP higher in 2028 compared to the baseline. The third adverse scenario assumes, in addition to the fiscal shock, negative feedback effects on interest rates and GDP growth, both sustained over the entire projection period ([20]). In this scenario, public debt — after declining in the first few years (until 2023) —starts rising again, reaching around 100 % of GDP by 2028, as higher interest rates feed through new and rolled-over debt. By 2028, public debt is therefore higher by around 33 % of GDP compared to the baseline. Given Cyprus' high level of public debt and uncertainties about the CCB sale, continued fiscal discipline and sustained structural reform efforts are necessary to firmly anchor the debt-to-GDP ratio on a sustainable downward path.

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

([20]) In this scenario, the structural primary balance is assumed to linearly decrease until 2023 (and remain constant after that) to reach its historical average (a lower value of 0.8% of GDP, compared to the 2019 forecast value). In addition, negative feedback effects on interest rates (a sustained shock of +200 basis points) and on real GDP growth rate (a sustained shock of -1 pp. compared to the baseline) are assumed. A sustained shock of +200 basis points (+2 %) on market interest rates can be deemed significant in the current benign market environment. This scenario is more adverse than those assessed in the previous Post-Programme Surveillance reports due to greater uncertainties and downside risks, in particular in relation to the CCB sale.

Graph A1.1: **Debt projections**



Source: European Commission

The indicator-based analysis does not signal high fiscal sustainability risks in the short term, but there are clear indications that the economy's macroeconomic, financial and competitiveness aspects pose significant challenges. In the short term, considerable vulnerabilities have been identified, based on the Commission's early detection indicator of fiscal stress (the S0 indicator). Cyprus has the highest value among the EU countries, remaining below — albeit close to — its critical threshold (see Table A1.1). Furthermore, the financial-competitiveness S0 sub-index is above its critical threshold.

Given the initial high public debt stock and potential contingent liabilities related to the financial sector, there are risks to medium-term sustainability. Based on standard Commission methodology, Cyprus is deemed to be at medium sustainability risk in the medium term due to medium risks attached to the debt sustainability analysis ([21]). The medium-term fiscal sustainability risk indicator S1, at -0.6 % of GDP, points to low risks in the medium term (a negative value indicates that no upfront fiscal adjustment effort is needed to reduce the debt to below the 60% of GDP reference value by 2032). Despite the high level of government debt at present, under the baseline scenario it would decline noticeably given an assumed continuation of the structural primary surplus. This indicator has slightly improved compared to the third PPS review (based on the Commission autumn 2017 forecast). The long-term fiscal sustainability risk indicator S2, being negative, points to low fiscal sustainability risks, under the baseline scenario. This is mainly due to the strong initial budgetary position in terms of the projected structural primary surplus in 2019. A marginal deterioration in the indicator compared to the Commission autumn 2017 forecast is due to higher projected pension-related ageing costs, not fully offset by the stronger initial budgetary position. However, this methodology does not account for risks related to potential contingent liabilities stemming from the financial sector.

Overall, the debt sustainability analysis shows that in the baseline scenario the debt-to-GDP ratio declines after the peak in 2018. However, there are large uncertainties surrounding these projections. In particular, public debt would still be high and remain vulnerable to unfavourable macroeconomic, fiscal and financial market shocks. As illustrated above, a scenario that combines these various adverse shocks could result in the debt ratio no longer being on a declining path over the projection period. In addition, significantly higher than currently expected fiscal costs related to the ongoing sale of CCB could also

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

have a negative impact on debt dynamics, especially if they lead to increased refinancing costs for the sovereign and, thus, higher gross financing needs. These risks underscore the importance of maintaining fiscal discipline over the medium to long term in order to underpin/safeguard a declining trajectory of the debt-to-GDP ratio going forward. In addition, the baseline debt reduction path hinges on medium and long-term economic growth, which points to the need to persevere with the implementation of structural reforms in order to improve competitiveness and boost the potential GDP of the Cypriot economy.

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

Time period			No-policy-change scenario		PPS third review (autumn 2017)	
Short-term			**LOW risk**		**LOW risk**	
S0 indicator [1]			0.44		0.44	
Fiscal sub-index			0.19	LOW risk	0.19	LOW risk
Financial & competitiveness sub-index			0.57	HIGH risk	0.57	HIGH risk
Medium-term			**MEDIUM risk**		**MEDIUM risk**	
DSA [2]			MEDIUM risk		MEDIUM risk	
S1 indicator [3]			-0.6	LOW risk	0.0	MEDIUM risk
of which						
	Required adjustment given initial budgetary position (IBP)		-3.5		-2.4	
	Debt requirement		3.0		2.7	
	Required adjustment due to cost of ageing (CoA)		-0.1		-0.2	
	of which					
		Pensions	0.6		0.3	
		Healthcare	0.1		0.1	
		Long-term care	0.0		0.0	
		Other	-0.7		-0.6	
Long-term			**LOW risk**		**LOW risk**	
S2 indicator [4]			-1.3		-1.8	
of which						
	Required adjustment given IBP		-2.2		-1.2	
	Required adjustment due to CoA		0.9		-0.5	
	of which					
		Pensions	1.9		0.3	
		Healthcare	0.3		0.2	
		Long-term care	0.2		0.2	
		Other	-1.4		-1.2	

[1] The S0 indicator, which captures short-term fiscal challenges, aims at the early detection of fiscal stress associated with fiscal risks within a one-year period To estimate these risks, S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology fundamentally differs from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and financial-competitiveness sub-indexes, the thresholds are 0.36 and 0.49* respectively.
[2] Debt sustainability analysis is performed based on the 'no fiscal policy change' scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.
[3] The S1 indicator is the medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to reduce the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast period (i.e. from 2020); it must then be sustained, including financing for any additional expenditure until the target date arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, a value between which indicates medium risk. If S1 is below 0 or above 2.5, it indicates low and high risk respectively*.
[4] The S2 indicator is the long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite period, including the costs of ageing. The critical thresholds for S2 are 2 and 6, a value between which indicates medium risk. If S2 is below 2 or above 6, it indicates low and high risk respectively*.
* For more information, see the Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.
Source: European Commission

ANNEX 2

European Commission macroeconomic and fiscal projections (2018 Spring Forecast)

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

	2013	2014	2015	2016	2017	2018	2019
Real economy			*(percent change)*				
Real GDP	-5.9	-1.4	2.0	3.4	3.9	3.6	3.3
Domestic demand incl. inventories	-9.4	-1.2	2.9	5.1	8.3	5.2	4.5
Total consumption expenditure	-6.4	-0.9	1.6	2.7	4.0	3.1	2.9
Private consumption expenditure	-5.9	0.7	2.6	3.3	4.2	3.4	2.9
Government consumption expenditure	-8.1	-7.2	-2.6	-0.4	2.7	1.5	3.3
Gross fixed capital formation	-12.9	-17.5	13.6	35.0	27.8	13.4	9.8
Exports of goods and services	1.9	4.2	5.8	4.0	3.4	2.3	1.9
Imports of goods and services	-4.9	4.6	7.4	6.8	10.1	4.8	3.7
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	-7.4	-3.3	3.0	6.8	8.2	5.4	4.7
Foreign trade	3.7	-0.1	-0.9	-1.7	-4.4	-1.8	-1.3
Changes in inventories	-2.2	2.1	-0.1	-1.7	0.1	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	-1.1	-1.6	-1.2	-0.7	1.5	1.5	1.7
HICP	0.4	-0.3	-1.5	-1.2	0.7	0.7	1.2
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	15.9	16.1	15.0	13.0	11.1	9.0	7.1
Employment	-5.9	-1.8	1.5	3.3	3.4	2.8	2.8
Compensation per employee	-5.4	-3.6	-1.2	-0.7	0.7	1.4	2.0
Labour productivity	0.0	0.4	0.5	0.1	0.5	1.1	0.9
Unit labour costs	-5.4	-4.0	-1.7	-0.8	0.2	0.6	1.4
Public finance (1)			*(percent of GDP)*				
General government balance	-5.1	-9.0	-1.3	0.3	1.8	2.0	2.2
Total revenue	36.7	39.8	39.3	38.9	39.9	39.6	39.6
Total expenditure	41.9	48.8	40.7	38.6	38.1	37.6	37.3
General government primary balance	-1.3	-5.5	2.5	3.6	5.0	5.0	5.1
Gross debt	102.6	107.5	107.5	106.6	97.5	105.7	99.5
Balance of payments			*(percent of GDP)*				
Current external balance	-4.9	-4.4	-1.4	-4.9	-8.1	-9.0	-9.7
Ext. bal. of goods and services	1.8	2.0	0.8	-0.8	-4.0	-5.0	-5.8
Exports goods and services	58.6	62.1	64.5	64.7	63.8	62.8	61.8
Imports goods and services	56.8	60.0	63.7	65.5	67.8	67.8	67.5
Balance of services	18.0	18.0	17.5	20.4	19.5	20.0	20.0
Balance of goods	-16.2	-16.0	-16.7	-21.2	-23.5	-25.0	-25.7
Balance of primary income	-4.6	-3.7	0.7	-1.6	-1.9	-1.9	-1.9
Balance of secondary income	-2.1	-2.8	-2.9	-2.5	-2.1	-2.0	-2.0
Memorandum item			*(EUR bn)*				
Nominal GDP	18.1	17.6	17.7	18.2	19.2	20.2	21.2

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

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

percent change unless otherwise stated	2013	2014	2015	2016	2017	2018	2019
1. Private consumption expenditure	-5.9	0.7	2.6	3.3	4.2	3.4	2.9
2. Government consumption expenditure	-8.1	-7.2	-2.6	-0.4	2.7	1.5	3.3
3. Gross fixed capital formation	-12.9	-17.5	13.6	35.0	27.8	13.4	9.8
4. Domestic demand excl. inventories	-7.4	-3.3	3.0	6.8	8.2	5.4	4.7
5. Changes in inventories (contr. to growth)	-2.2	2.1	-0.1	-1.7	0.1	0.0	0.0
6. Domestic demand incl. inventories	-9.4	-1.2	2.9	5.1	8.3	5.2	4.5
7. Exports of goods and services	1.9	4.2	5.8	4.0	3.4	2.3	1.9
7a. - of which goods	-12.5	2.1	1.7	-9.0	-4.9	-2.5	-0.5
7b. - of which services	7.8	4.9	7.1	7.9	5.4	3.5	2.4
8. Final demand	-5.5	0.8	4.0	4.7	6.4	4.1	3.5
9. Imports of goods and services	-4.9	4.6	7.4	6.8	10.1	4.8	3.7
9a. - of which goods	-15.3	5.1	6.6	11.0	8.3	6.7	4.9
9b. - of which services	11.4	3.9	8.4	1.8	12.4	2.5	2.2
10. GDP at market prices	-5.9	-1.4	2.0	3.4	3.9	3.6	3.3
(Contribution to change in GDP)							
11. Final domestic demand	-7.4	-3.3	3.0	6.8	8.2	5.4	4.7
12. Changes in inventories	-2.2	2.1	-0.1	-1.7	0.1	0.0	0.0
13. Net exports	3.7	-0.1	-0.9	-1.7	-4.4	-1.8	-1.3

Source: European Commission

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

percent change unless otherwise stated	2013	2014	2015	2016	2017	2018	2019
1. Private consumption expenditure	-5.9	0.2	0.8	2.0	5.0	4.3	4.2
2. Government consumption expenditure	-12.4	-11.6	-3.1	-0.7	4.5	3.1	5.1
3. Gross fixed capital formation	-12.7	-19.9	12.2	37.8	27.9	14.6	11.2
4. Domestic demand excl. inventories	-8.1	-4.8	1.5	6.3	8.8	6.2	5.8
5. Changes in inventories (contr. to growth)	-0.2	0.1	0.2	-0.1	-0.1	-0.1	-0.1
6. Domestic demand incl. inventories	-10.0	-3.2	2.1	4.3	8.8	6.2	5.8
7. Exports of goods and services	2.1	2.7	4.8	3.0	4.0	3.4	3.5
7a. - of which goods	-10.7	3.5	2.5	-9.9	-4.5	-1.6	0.8
7b. - of which services	7.4	2.4	5.6	7.3	6.4	4.7	4.1
8. Final demand	-5.8	-1.0	3.1	3.8	6.9	5.2	5.0
9. Imports of goods and services	-3.7	2.5	7.0	5.5	9.2	5.2	4.7
9a. - of which goods	-13.7	-0.6	4.1	10.5	8.3	7.0	5.8
9b. - of which services	12.1	6.2	10.3	0.2	10.2	3.0	3.3
10. Gross national income at market prices	-8.5	-2.0	5.3	0.4	5.0	5.2	5.1
11. Gross value added at basis prices	-6.7	-4.3	0.9	2.2	4.6	5.5	5.5
12. Gross domestic product at market prices	-6.9	-2.9	0.8	2.7	5.5	5.2	5.1

Source: European Commission

Table A2.4: **Implicit deflators**

percent change	2013	2014	2015	2016	2017	2018	2019
1. Private consumption expenditure	0.0	-0.5	-1.8	-1.3	0.7	0.9	1.3
2. Government consumption expenditure	-4.6	-4.8	-0.6	-0.4	1.8	1.6	1.8
3. Gross fixed capital formation	0.2	-2.9	-1.2	2.1	-0.5	1.1	1.3
4. Domestic demand incl. inventories	-0.6	-1.9	-0.8	-0.8	0.5	1.0	1.3
5. Exports of goods and services	0.2	-1.5	-0.9	-0.6	0.8	1.1	1.5
6. Final demand	-0.3	-1.8	-0.8	-0.7	0.6	1.0	1.4
7. Imports of goods and services	1.3	-2.0	-0.4	-1.0	-0.9	0.4	1.0
8. Gross domestic product at market prices	-1.1	-1.6	-1.2	-0.7	1.5	1.5	1.7
HICP	0.4	-0.3	-1.5	-1.2	0.7	0.7	1.2

Source: European Commission

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

Percent change unless otherwise stated	2013	2014	2015	2016	2017	2018	2019
1. Labour productivity	0.0	0.4	0.5	0.1	0.5	1.1	0.9
2. Compensation per employee	-5.4	-3.6	-1.2	-0.7	0.7	1.4	2.0
3. Unit labour costs	-5.4	-4.0	-1.7	-0.8	0.3	0.3	1.1
4. Total population	-0.2	-1.1	-0.6	0.5	0.9	0.6	0.7
5. Population of working age (15-64 years)	-0.8	-2.1	-1.6	-0.1	0.3	0.3	0.3
6. Employment	-5.9	-1.9	1.5	3.3	3.4	2.8	2.8
7. Unemployment rate (1)	15.9	16.1	15.0	13.0	11.1	9.0	7.1

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

Table A2.6: **External balance**

EUR bn unless otherwise stated	2013	2014	2015	2016	2017	2018	2019
1. Exports of goods (fob)	2.7	2.8	2.9	2.6	2.5	2.4	2.5
2. Imports of goods (fob)	5.7	5.6	5.8	6.5	7.0	7.5	7.9
3. Trade balance (goods, fob/fob) (1-2)	-2.9	-2.8	-3.0	-3.9	-4.5	-5.1	-5.5
3.1 p.m. (3) as % of GDP	-16.2	-16.0	-16.7	-21.2	-23.5	-25.0	-25.7
4. Exports of services	7.9	8.1	8.6	9.2	9.8	10.2	10.7
5. Imports of services	4.7	4.9	5.5	5.5	6.0	6.2	6.4
6. Service balance (4-5)	3.3	3.2	3.1	3.7	3.8	4.0	4.2
6.1 p.m. 6 as % of GDP	18.0	18.0	17.5	20.4	19.5	20.0	20.0
7. External balance of goods and services (3+6)	0.3	0.4	0.1	-0.1	-0.8	-1.0	-1.2
7.1 p.m. 7 as % of GDP	1.8	2.0	0.8	-0.8	-4.0	-5.0	-5.8
8. Balance of primary and secondary incomes	-1.2	-1.1	-0.4	-0.7	-0.8	-0.8	-0.8
8.1 - of which, balance of primary income	-0.8	-0.6	0.1	-0.3	-0.4	-0.4	-0.4
8.2 - of which, balance of secondary income	-0.4	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4
8.3 p.m. 8 as % of GDP	-6.7	-6.4	-2.2	-4.1	-4.1	-4.0	-3.9
9. Current external balance (7+8)	-0.9	-0.8	-0.3	-0.9	-1.6	-1.8	-2.1
9.1 p.m. 9 as % of GDP	-4.9	-4.4	-1.4	-4.9	-8.1	-9.0	-9.7
10. Net capital transactions	0.3	0.0	0.0	0.0	0.1	0.1	0.1
11. Net lending (+)/net borrowing (-) (9+10)	-0.6	-0.8	-0.2	-0.9	-1.5	-1.7	-2.0
11.1 p.m. 11 as % of GDP	-3.5	-4.6	-1.1	-4.7	-7.6	-8.6	-9.3

Source: European Commission

Table A2.7: **Fiscal accounts**

	2013	2014*	2015	2016	2017	2018	2019
			levels, EUR m				
Taxes on production and imports	2,475	2,600	2,608	2,740	3,041	3,200	3,334
Taxes on income and wealth	1,874	1,812	1,761	1,755	1,835	1,915	2,003
Social contributions	1,362	1,445	1,483	1,545	1,707	1,790	1,950
Other current resources	793	1,028	1,024	1,005	998	1,009	1,026
Total current revenue	6,504	6,884	6,876	7,044	7,582	7,914	8,313
Capital transfers received	160	130	101	43	89	89	89
Total government revenue	6,664	7,014	6,976	7,087	7,671	8,003	8,402
Compensation of employees	2,594	2,341	2,271	2,260	2,350	2,445	2,571
Intermediate consumption	645	575	548	531	594	628	663
Social transfers	2,484	2,469	2,468	2,564	2,618	2,690	2,777
Interest payments (1)	696	607	674	604	611	615	605
Subsidies	95	80	72	97	55	56	56
Other current expenditure	403	395	463	398	462	495	521
Total current expenditure	6,911	6,462	6,491	6,449	6,685	6,922	7,187
Total capital expenditure (2) (3)	678	2,125	718	574	637	678	736
Total government expenditure	7,595	8,592	7,213	7,028	7,328	7,606	7,928
General government balance	-931	-1,577	-236	59	344	397	473
General government primary balance	-235	-971	438	663	955	1,011	1,078
			% of GDP				
Taxes on production and imports	13.6	14.8	14.7	15.0	15.8	15.8	15.7
Taxes on income and wealth	10.3	10.3	9.9	9.6	9.6	9.5	9.4
Social contributions	7.5	8.2	8.4	8.5	8.9	8.9	9.2
Other current resources	4.4	5.8	5.8	5.5	5.2	5.0	4.8
Total current revenue	35.9	39.1	38.8	38.7	39.5	39.2	39.1
Capital transfers received	0.9	0.7	0.6	0.2	0.5	0.4	0.4
Total government revenue	36.7	39.8	39.3	38.9	39.9	39.6	39.6
Compensation of employees	14.3	13.3	12.8	12.4	12.2	12.1	12.1
Intermediate consumption	3.6	3.3	3.1	2.9	3.1	3.1	3.1
Social transfers	13.7	14.0	13.9	14.1	13.6	13.3	13.1
Interest payments (1)	3.8	3.4	3.8	3.3	3.2	3.0	2.8
Subsidies	0.5	0.5	0.4	0.5	0.3	0.3	0.3
Other current expenditure	2.2	2.2	2.6	2.2	2.4	2.5	2.5
Total current expenditure	38.1	36.7	36.6	35.4	34.8	34.3	33.8
Total capital expenditure (2) (3)	3.7	12.1	4.0	3.2	3.3	3.4	3.5
Total government expenditure	41.9	48.8	40.7	38.6	38.1	37.6	37.3
General government balance	-5.1	-9.0	-1.3	0.3	1.8	2.0	2.2
General government primary balance	-1.3	-5.5	2.5	3.6	5.0	5.0	5.1
Nominal GDP	18.1	17.6	17.7	18.2	19.2	20.2	21.2

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

Table A2.8: **Debt developments**

	2013	2014*	2015	2016	2017	2018	2019
Gross debt (% of GDP)	102.6	107.5	107.5	106.6	97.5	105.7	99.5
Real GDP growth (% change in PYP)	-4.2	-2.4	0.4	2.2	3.2	5.2	4.9
Nominal GDP (EUR bn)	18.1	17.6	17.7	18.2	19.2	20.2	21.2
General government balance (% of GDP)	-5.1	-9.0	-1.3	0.3	1.8	2.0	2.2
Change in gross debt ratio (pps change)	22.9	4.9	0.0	-0.9	-9.1	8.2	-6.1
	Contribution to the change in stock						
Primary balance	1.3	5.5	-2.5	-3.6	-5.0	-5.0	-5.1
Snow-ball effect	9.8	6.6	2.9	0.5	-2.3	-1.7	-2.2
of which							
Interest expenditure	3.8	3.4	3.8	3.3	3.2	3.0	2.8
Real growth effect	5.1	1.5	-2.1	-3.6	-3.9	-3.3	-3.4
Inflation effect	0.9	1.7	1.3	0.7	-1.5	-1.4	-1.7
Stock-flow adjustments	11.9	-7.2	-0.5	2.2	-1.8	15.0	1.3

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

ADDENDUM

1. Introduction

This addendum to the PPS report aims at providing a brief overview of the significant developments in the Cypriot banking sector that materialised in June 2018, after the report was drafted and discussed at the Economic and Financial Committee.

On 15 June 2018, the Cypriot government endorsed an agreement in principle with Hellenic Bank for the sale of part of the assets of the Cyprus Cooperative Bank (CCB). As already mentioned in the PPS report, the sale of the CCB the second largest bank in the country and which was publicly owned was initiated on 19 March. On 17 June, the government of Cyprus notified to the Commission for assessment under EU State aid rules their plans to support the orderly liquidation of the CCB, including the sale and full integration of some of the CCB's assets and deposits into Hellenic Bank. On 19 June, the Commission approved the Cypriot measures to facilitate the liquidation of the CCB under national law. On 25 June, a business transfer agreement was signed between Hellenic Bank and the CCB. However, finalising the transaction is still subject to a number of approvals by the relevant EU and national authorities, as well as the conclusion of a capital raise by Hellenic Bank. Therefore, the transaction may take several months to be finalised.

These are the final steps in the restructuring process of the CCB, which was initiated by the Cypriot authorities in February 2014 and modified in December 2015. Contrary to expectations at the time, the CCB was unable to return to viability: it failed to recover much money from its very significant portfolio of non-performing loans (NPLs), partly because of the CCB's own governance failures and partly because of obstacles created by the Cypriot legal framework to work out NPLs.

When completed, the transaction is expected to remove around EUR 6 billion of NPLs (25-30% of all NPLs) from the Cypriot banking sector, shifting them and the associated financial costs and risks via a newly created asset management company, i.e. 'Residual entity' to the state. Given the significance of this development, this addendum updates the PPS report by providing a brief overview of the State aid decision of 19 June as well as an initial assessment of the likely impact of the sale on the financial sector and the fiscal and macroeconomic outlook.

2. Sale of the CCB

2.1. Overview of the sale process and State aid measures decision

The sale agreement entails that parts of the CCB's assets and liabilities will be fully integrated into Hellenic Bank, while the rest will remain in the CCB's Residual entity, to be owned and financed by the state and wound down over time. No bidder was ready to take over the CCB's assets and liabilities at a positive price. Therefore, public financial support measures were deemed necessary to support the sale of certain assets and the customer deposits. These measures mainly consist of (i) an injection by the State of around EUR 3.5 billion in the CCB (which will absorb losses made by the Residual entity), of which EUR 2.5 billion was already provided on 3 April, and (ii) a counter-guarantee by the State of the guarantees provided by the CCB to Hellenic Bank, including a large asset protection scheme on a portfolio of the transferred assets (which will cover a large share of losses made by Hellenic Bank on specific assets purchased from the CCB).

The restructuring of the CCB is part of the banking crisis legacy. It started before the application of the post-crisis European Union legal framework on Bank Recovery and Resolution (Directive 2014/59/EU[22], BRRD). The responsibility to deal with such legacy cases lies with the Member States concerned and is governed by national law preceding the transposition of the BRRD and needs to comply with in particular the EU State aid rules.

The Commission concluded that the public support measures constitute State aid, which is compatible with the internal market under

(22) Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 190).

State aid rules, including the 2013 Banking Communication[23]. In particular, the public support has been instrumental in allowing the orderly market exit of the CCB, through the full integration of some activities into another credit institution and the wind down of the CCB's Residual entity. The Commission also confirmed that the measures do not constitute State aid to Hellenic Bank, because it was selected in an open, transparent and non-discriminatory private sales process, fully managed by a private global investment bank, ensuring that the activities were sold at the best offer available. As part of the burden sharing requirements, in the absence of subordinated bondholders, the shareholders of the CCB – represented by the State and the Resolution Fund – will be left in the Residual entity.

According to the State aid decision underpinned by Cyprus' commitments, the CCB's Residual entity will be entirely focused on working out its remaining assets. Thus, it will no longer carry out any economic activities and will cease to compete in the banking sector (and not receive any financing from the ECB or Central Bank of Cyprus), which will ensure that the distortion of competition arising from the aid will be limited.

2.2. Commitments

As part of the State aid decision, the Cypriot government has made a series of commitments. These cover, among others, the integration of the CCB's activities into Hellenic Bank and the winding down of the CCB's Residual entity, as well as the efficient work-out of NPLs in Cyprus. Implementation of these commitments is not only necessary to ensure that the distortions of competition are limited to the minimum necessary but also to help safeguarding prospective financial stability.

Cyprus also committed to introduce significant amendments in the insolvency, foreclosure and sale of loans legislations and to reform the judicial system. These reforms should improve the capacity of creditors to recover money from defaulted borrowers and therefore contribute to reducing NPLs.

The compliance of Cyprus with the commitments stemming from the State aid decision will be closely monitored by an independent monitoring trustee. The trustee will report back to the Commission on a regular basis. In parallel, the Commission will continue following closely the actions taken to reduce NPLs under the EU standard surveillance, including Post-Programme Surveillance and the Macroeconomic Imbalances Procedure.

3. Impact on financial sector

The CCB sale will result in moving a significant share of NPLs out of the Cypriot banking system. In particular, the total stock of NPLs within the Cypriot banking system will drop from its end-2017 volume of EUR 21 billion to around EUR 15 billion, thus removing about 25-30 % of NPLs from the banking sector. When the sale is completed the NPLs of Hellenic Bank are also expected to fall from currently around 52 % to around 30-33 % of total loans. This significant reduction in the stock of NPLs is expected to increase confidence in the banking system. The transfer of performing loans to Hellenic Bank, which has invested to improve its risk management framework, may also reduce the likelihood that those loans fall into non-performing status over time.

Full and effective implementation of the reform commitments undertaken by the Cypriot authorities is crucial to bring about a positive impact on the banking sector as a whole. The amendments of the insolvency and foreclosure frameworks aim to increase NPL recovery rates and reduce the losses for both the banking system and the State. A well-functioning insolvency framework should reduce the likelihood of banks' balance sheets being filled with non-recoverable NPLs. Well-functioning insolvency and foreclosure frameworks should also strengthen the viability of Hellenic Bank after the sale as well as of the entire banking sector, which is still highly burdened by NPLs.

The effective management of the Residual entity will also be crucial to efficiently work out NPLs

(23) Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ("2013 Banking Communication") OJ C 216, 30.07.2013, p. 1.

thereby reducing the net costs to the State. This requires that the governance of the Residual entity is carefully designed and in line with best international practice, and that the staff is competent, adequately trained and incentivised. Against this background, it will be important that the scheme that the authorities intend to introduce for vulnerable borrowers is also carefully reviewed and designed, so as not to undermine the efforts being made to improve the payment culture.

All in all, the CCB sale could have a positive long-term impact although it also entails downside risks. On the one hand, further consolidation of the banking sector in Cyprus is a welcome step, given the size of the economy. The sale process is also expected to increase the stability of the banking sector and improve depositors' confidence. On the other hand, it reinforces the interlinkages between the financial sector and the sovereign. Moreover, the authorities should also closely monitor potential adverse effects that may arise due to the increased concentration in the banking sector, in particular on lending rates and conditions.

4. Impact on macroeconomic and fiscal outlook

The very high stock of NPLs and developments in the financial sector since 2018 were the major downside risks to the Cypriot macroeconomic outlook, which will be reduced with the completion of the sale. Cyprus macroeconomic performance has been particularly robust in the last couple of years. Growth was 3.9% in 2017, placing Cyprus among the fastest growing economies in the Euro Area, and is expected to remain strong in 2018 and 2019. Unemployment fell rapidly but wage pressures remained contained, keeping a lid on inflation. However, very high ratio of NPLs and the recent developments related to the CCB increased the risks and added a major uncertainty. The orderly sale of the CCB combined with market exit and the foreseen strengthening of the foreclosure and insolvency frameworks would reduce the uncertainties and risks to the macroeconomic outlook. Furthermore, these changes aim to improve the payment discipline and the overall soundness of the banking sector, restore the healthy flow of credit in the economy and strengthen investors' confidence.

Following the remarkably strong fiscal performance in recent years, the costs of the CCB sale assumed by the State are expected to noticeably dent the fiscal outlook. After falling significantly to 97.5 % of GDP in 2017, the issuance of government debt to the CCB in April 2018 per se increased public debt to a projected 105.7 % of GDP in 2018. The completion of the CCB sale gives rise to further fiscal costs and increases the sovereign exposure to the developments in the financial sector. In particular, public debt is estimated to increase to around 110 % of GDP in 2018, with the agreed in principle issuance of additional government debt to the CCB, which also entails a corresponding increase in financing needs. Moreover, contingent liabilities, in the form of government guarantees, are expected to increase substantially, notably due to the large agreed asset protection scheme in favour of Hellenic Bank.

While there are also mitigating factors, the significant fiscal risks being incurred underscore the need for a continuation of very prudent fiscal policy. The fiscal position is projected to remain strong, with the headline surplus expected at around 2 % of GDP in 2018 and 2019, excluding the potential fiscal impact of the measures related to the CCB. In addition, public debt is projected to resume a declining path in 2019. Moreover, while the sale of the CCB was ongoing, Cyprus' sovereign credit rating was upgraded by Fitch and DBRS by one notch, both keeping outlook at positive. It is worth noting in this context that the potential impact on public finances of the bank support measures is subject to a formal decision on the statistical treatment by the competent authorities, EUROSTAT and CYSTAT. It should furthermore be kept in mind that the current government headline surplus, refinancing costs and financing needs projections are also subject to uncertainty and rely on the continuation of current strong macroeconomic conditions, fiscal discipline, and favourable financing conditions for the banking sector and the sovereign. As illustrated by the recent market volatility, there is no room for complacency. Thus, a continuous prudent budgetary policy remains essential to safeguard fiscal sustainability in line with the requirements under the preventive arm of the Stability and Growth Pact.

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