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Post-Programme Surveillance Report

Cyprus, Autumn 2019

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

The report reflects information available up until 24 October 2019.

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([1]) The executive summary of this report was adopted as Commission Communication C(2019) 8384 on 18 November 2019. The rest of the report reflects the findings of the staff working document SWD(2019) 410 accompanying this communication.

([2]) European Central Bank (ECB) staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

AMC: asset management company

ALMPs: active labour market policies

BoC: Bank of Cyprus

CBC: Central Bank of Cyprus

CCB: Cyprus Cooperative Bank

CET1: common equity tier 1

COLA: cost of living allowance

CyTA: Cyprus Telecommunications Authority

CYSTAT: Statistical Service of Cyprus

DSA: debt sustainability analysis

DTAs: deferred tax assets

DTCs: deferred tax credits

EU: European Union

ECB: European Central Bank

EDP: excessive deficit procedure

EPC: Economic Policy Committee

ESM: European Stability Mechanism

GDP: gross domestic product

GVA: gross value added

HB: Hellenic Bank

HICP: harmonised index of consumer prices

HIO: Health Insurance Organisation

ICT: information and communication technologies

IFRS: International Financial Reporting Standard

IMF: International Monetary Fund

KEDIPES: Cyprus State-owned asset management company

MTO: medium-term objective

NEET: not in education, employment or training

NFC: non-financial corporations

NHIS: National Health Insurance System

NPLs: non-performing loans

OECD: Organisation for Economic Co-operation and Development

PDMO: Public Debt Management Office

PES: public employment services

PPS: post-programme surveillance

SOEs: state-owned enterprises

SPE: special purpose entity

SSM: Single Supervisory Mechanism

VAT: value-added tax

y-o-y: year-on-year

EXECUTIVE SUMMARY

This report presents the findings of the seventh 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 16 to 20 September 2019. The mission was coordinated with the International Monetary Fund's (IMF) Article IV mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System. The next PPS mission will take place in spring 2020.

While remaining strong, economic growth is gradually decelerating. After real GDP growth of 4.1% in 2018, the pace of economic expansion moderated in the first half of 2019, largely reflecting external headwinds. Private consumption held up well on the back of a tightening labour market with still rising employment and disposable income, while investment benefited from a number of large-scale foreign-financed tourism and infrastructure projects. Following record high growth rates in 2016-2018, tourism revenues showed some weakness in the first half of 2019. Inflation is expected to remain subdued amid the deteriorating external environment. Robust, albeit weaker growth is forecast to continue over the medium term on the back of resilient domestic demand. Risks are tilted to the downside, as the sizable current account deficit and the declining, but still elevated private sector indebtedness render Cyprus vulnerable, including to potentially tightening financial conditions.

Fiscal performance is expected to remain strong. The general government balance in 2019 is projected to show a sizable surplus of above 3.7% of GDP on account of buoyant tax revenues and some one-off factors. Surpluses are expected to decline somewhat in 2020 and 2021, partially reflecting the reversal of positive one-effects related to the first stage of the health reform in 2019 and increases in the public sector wage bill due to the stepwise reversal of wage cutting measures implemented during the crisis. The still high public debt-to-GDP ratio is set to decline over the coming years. To firmly anchor its downward path, containing public expenditure remains essential, in accordance with the requirements of the preventive arm of the Stability and Growth Pact. This is particularly important in view of fiscal risks associated with the health insurance reform (especially in relation to the public hospitals' budget execution), upcoming court judgements on the constitutionality of wage and pension cuts during the crisis, and remaining contingent liabilities in the financial sector.

Following last year's sizable reduction in NPLs in the banking sector, progress has slowed throughout 2019. The Cypriot banking sector still has the second highest NPL ratio in the euro area, therefore efforts to further reduce NPLs remain a priority, including plans for further loan sales and securitisations. In this context, the amendments to the foreclosure framework approved by Parliament on 2 August 2019 backtrack on key elements of the reform adopted in July 2018, which was an important step towards improving financial stability and payment discipline through a more effective enforcement of claims and NPL workout. At the request of the President, the August amendments were referred to the Supreme Court, which is expected to decide on their constitutionality in the spring of 2020. Thus, the foreclosure framework as adopted last year remains currently in place. In the meantime, the Central Bank of Cyprus is working on a new proposal to address some of the concerns raised by Parliament during the summer. The ESTIA scheme, which is another pillar of the strategy to reduce NPLs, has been officially launched. While the scheme importantly seeks to support and protect vulnerable borrowers, measures to ensure its functioning are essential in order to balance this aim with also an improvement in payment culture. Rigorously enforcing compliance with the eligibility criteria and swiftly triggering foreclosure procedures in the case of re-defaults are crucial for the ultimate performance of the scheme. Swiftly finalising the establishment of KEDIPES, the largest asset management company in the EU relative to the size of the economy, is essential, including adherence to the state aid commitments and maximisation of recoveries of the assets to repay the state. Additional concerns regarding the financial sector include persistently high operating costs and low profitability.

The structural reform momentum needs to be renewed to support growth and economic resilience going forward. Addressing inefficiencies in the justice system is key for improving the business environment and the enforcement of claims. It is also essential for the effective implementation of the insolvency and foreclosure frameworks as well as NPL resolution. Furthermore, setting up a reliable and transparent system to issue and transfer title deeds and resolving backlogs in the title deeds issuance are long overdue. Other reforms to improve the business environment and attract investment need to be accelerated, such as privatisation, the simplification of procedures to obtain building permits and the introduction of fast-track approval for strategic investments. Public administration reform and the reform of local governments remain a high priority, in view of the expected significant increase in administrative efficiency. Furthermore, the implementation of the national health system continues to require close monitoring given the potential sizeable fiscal implications, particularly in the initial set-up years.

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1. INTRODUCTION

Cyprus implemented an economic adjustment programme from April 2013 to March 2016. The three-year programme was approved by the Council of EU Economic and Finance Ministers (Ecofin Council) and the Executive Board of the International Monetary Fund (IMF) in March 2013. The programme disbursed about €7.3 billion in financing from the European Stability Mechanism (ESM) and the IMF, from an overall financial envelope of around €10 billion. Its objective was to put Cyprus's public finances back on a sustainable path, ensure financial stability, implement structural reforms to restore competitiveness, and regain international capital market access at sustainable rates.

Staff from the European Commission, in liaison with staff from the European Central Bank (ECB), carried out the seventh post-programme surveillance (PPS) mission to Cyprus between 16 and 20 September 2019. The mission was coordinated with an IMF Article IV mission. Staff from the ESM also participated in the meetings dealing with the ESM's Early Warning System. The aim of PPS is to broadly monitor the economic, fiscal and financial conditions of a country that has received financial assistance in order to assess its capacity to repay it. ([3]) While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate.

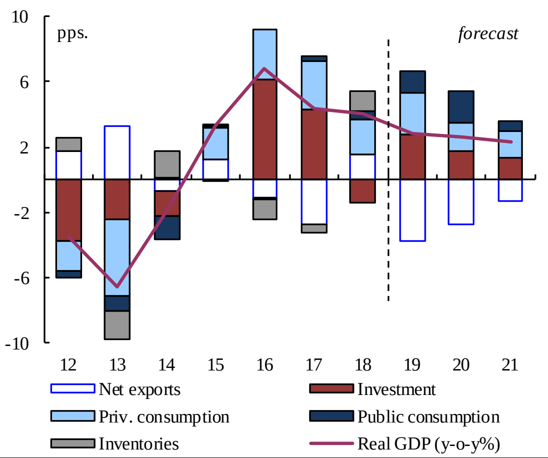
([3]) Post-programme surveillance is provided for by Article 14 of two-pack Regulation (EU) No 472/2013. The surveillance started after the EU/IMF financial assistance programme expired and will last until at least 75% of the financial assistance has been repaid.

2. MACROECONOMIC OUTLOOK

Macroeconomic situation and outlook

Although still strong, economic growth is decelerating. After a solid real GDP growth of 4.1% in 2018 ([4]) growth slowed to 3.4% and 3.2% year-on-year in the first and second quarters of 2019. The deceleration mainly reflects the weakening external environment, while domestic demand held up well. External headwinds are expected to continue, leading to more moderate growth, which is projected at 2.9% this year, 2.6% in 2020 and 2.3% in 2021.

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



Source: European Commission

Solid private consumption is supported by rising real disposable income. Household consumption continued to rise on the back of strong employment growth and moderately increasing wages. Low inflation has further supported real purchasing power of households. Private consumption is expected to be the main driver for growth in the second half of the year and in 2020.

Investment continues to be geared towards residential construction, supported by the Citizenship by Investment (CbI) Scheme. The number of applications filed to benefit from the scheme rose sharply on account of the announced revisions to the scheme (effective mid-July 2019, most notably the requirement to fulfil part of the investment in the form of a donation). Investments under the scheme brought in significant amounts of funds from countries outside the European Union, with the bulk flowing into the property market. The contribution of ship registrations to investment growth was negligible in the first half of 2019, unlike in the past. Such ship registrations, driven by a favourable tax regime, bring in fee revenues to Cyprus but otherwise have very limited links and spill-overs to the country's real economy. While ship registrations are volatile and difficult to forecast, in the second half of the year the number of citizenship scheme applications is expected to reach the pre-set annual maximum, thus limiting the financial stimulus to construction. The concentration of investments in sectors driven by the citizenship scheme (i.e. residential construction) and related to low taxation seems to be a short-sighted strategy, with no impact on increasing productivity.

At the same time, the long-standing needs for investment in infrastructure remain unaddressed and, could impede Cyprus's growth potential in the future. Investment in water and waste management is long overdue. Investments in solar energy are small despite the country's natural advantage in this area. Green investments and the circular economy are not treated as a priority, despite the high risks that this may harm Cyprus' population and tourism revenues in the longer term. The lack of pre-school facilities and after-school care seriously impede women's participation in the labour force or their full-time employment. More investment in these areas could help Cyprus to diversify sources of growth and to address growth bottlenecks.

Public consumption is also set to provide ongoing support to growth. The contribution of public consumption to growth was positive in the first months of 2019 and is expected to remain so over the forecast horizon. In particular, public wages are set to continue rising in the coming years, driven by (i) the gradual reversal of the public wage cuts that followed the crisis, (ii) the hiring of doctors in the country's public hospitals, (iii) automatic indexation, (iv) wage increments and (v) the unfreezing of promotions. Furthermore, the ruling by the Constitutional Court (expected by the end of this year) on the constitutionality of the public sector payroll and pension cuts that have been made since the crisis might result in a further

([4]) Based on the revised National Accounts data for the period 2010-2018, published by Eurostat in October 2019.

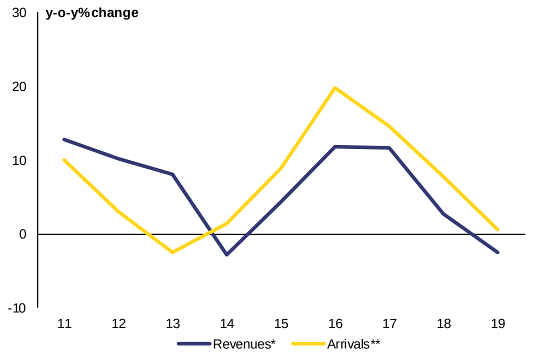
increase in public spending (see Section 3.2 on Fiscal outlook).

Net exports are likely to be a drag on the economy in 2019 and 2020, particularly exports linked to tourism. Imports are expected to increase alongside solidly growing consumption and investments. Exports, in contrast, are set to contract. Exports of goods substantially declined in the first half of 2019. Exports of services, the driving force behind Cyprus' exports, slightly increased in the first two quarters of the year, but the outlook is uncertain and risks are tilted to the downside. These exports are dominated by tourism services, a sector that recently experienced several setbacks. The positive contribution of other services, such as legal services, accounting or information and communications technology (ICT), is much smaller by comparison.

Tourism is at a crossroads and facing headwinds. After record increases in previous years, tourist arrivals in the first half of 2019 declined, largely on account of air connectivity (bankruptcy of several airlines servicing Cyprus) and increasing competition from neighbouring countries. In July, August and September, however, the number of incoming tourists rose again, putting the total number of arrivals in the first 8 months of the year at a high record. This higher number of arrivals was driven by an increase in the arrival of British tourists. Given the uncertainty surrounding the UK's exit from the EU, this development may not be sustainable. Revenues during the first 7 months of the year contracted by 2.5% year-on-year. The high share of British tourists in total arrivals suggests that revenues from tourism services in the second half of the year are likely to be weaker as the pound sterling has depreciated compared to a year ago and British tourists reportedly tend to stay in their second homes or with friends and relatives, which lowers the amount they spend per day.

The situation of air travel to the island and tourism revenues are set to be negatively affected by the recent bankruptcy of the global travel company Thomas Cook. Air travel to Cyprus was affected by the bankruptcy of several airlines in late 2018 and early 2019. Problems were particularly acute for the German tourist market, which contracted by nearly one fifth after the bankruptcy of Germania. The bankruptcy of Thomas Cook in September 2019 was another serious blow to the Cypriot tourism industry, negatively affecting air travel, hoteliers and related businesses that provided auxiliary services. Thomas Cook accounted for 6-7% of all tourists in Cyprus.

Graph 2.2: **Evolution of tourism revenues and tourism arrivals**



* Data available for the first 7 months in 2019
**Data available for the first 9 months in 2019

Source: Cystat

Meanwhile, the supply of lodging for tourists has strongly expanded. The number of beds in official accommodations has now reached 104,000, up by around one fifth compared to 2018 (87,000 beds). A strong further expansion is in the pipeline, with another 2,000 beds to be added still in 2019 and 3,000 beds in 2020. Generally, new hotels are more upscale, typically funded by Chinese, Greek, Russian and Lebanese investors.

Inflation is expected to remain very low. The continuous decline in prices of non-energy industrial goods is the main force behind weak inflationary pressures. Global competition has been affecting the price of imports, while fierce competition among supermarkets in Cyprus, increased internet sales and the liberalisation of shop opening hours and periods for sales have also been pushing prices down further. The energy prices are expected to decrease in the last quarter of the year and in 2020.

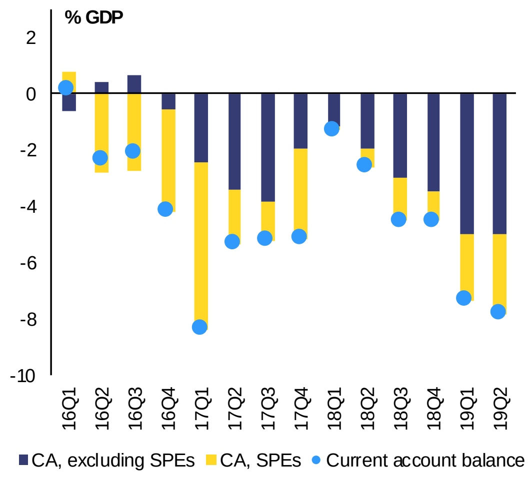
The real estate market is quickly improving, supported by foreign funds from the Citizenship by Investment CbI scheme. The number of transactions continues to increase. Residential property prices in 2018 increased by about 2% in 2018 (Central Bank of Cyprus statistics). According to real estate developers, prices continued to increase moderately in the first three quarters of 2019, at a rate of 1-2% year-on-year. However, the aggregate figures mask large differences between developments in Limassol, where most of the citizenship scheme related transactions take place, and in the rest of the country.

The current account deficit is sizable and continues to widen. The current account deficit in the second quarter of 2019 was 7.8% of GDP on a rolling 4-month basis (according to balance of payments data), widening further from a year earlier. While the bulk of the increase in the deficit is due to transactions by special purpose entities' (SPEs) ([5]) (which have only very limited links to the domestic economy), even the 'SPE adjusted deficit' has been increasing, further adding to the large external debt burden.

Risks to the outlook are tilted to the downside. The global slowdown, the escalation of trade disputes and the continued high levels of private debt are weighing on the country's economic growth and on the outlook for Cyprus. In contrast, up until now, the expected withdrawal of the United Kingdom from the EU has had little impact on Cyprus' economy, despite close historic and economic links. Thomas Cook's bankruptcy seems to be the first materialisation of this risk, with a potentially large impact on growth in the second half of 2019 and 2020. Furthermore, competing tourism markets in Turkey and the Middle East are recovering.

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

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



Source: Central bank of Cyprus, European Commission

Labour market developments

Cyprus is on the path to full employment supported by strong economic growth. Employment is rapidly increasing, in particular in the construction sector. The unemployment rate is steadily falling and stood at 6.8% in August. Long-term unemployment is also on a declining trend. However, despite the favourable developments, youth unemployment and the percentage of young people not in employment, education or training (NEETs), while decreasing, remain above the EU average (14.9% in 2019 Q2 and 13.2% in 2018 respectively).

In the light of a tightening labour market, challenges with regard to labour shortages and skills mismatches are emerging. Shortages of workers are mainly evident in the sectors of tourism, ICT, agriculture and manufacturing. By contrast, there is an over-supply of qualified labour in the financial sector.

Wages are moderately increasing. Wage increases are more pronounced in the public sector, while their rise in the private sector remains limited. Several factors seem to explain this, notably (i) the still persisting slack, (ii) the high flexibility of the Cypriot labour market (with a high share of employment of foreign workers), (iii) new employment concentrated in low-skill sectors (construction and tourism) and (iv) a decline in unionisation. For the first time, the recently agreed collective agreement for the tourism sector provides a legally binding minimum wage for several low-wage occupations. In the construction sector, a collective agreement was also reached. In this context, it was agreed that elements such as working hours, overtime, holidays, contributions for providence and bonuses would be passed in legislation.

Efforts to improve the quality of public employment services and to make active labour market policies (ALMP) more effective need to be accelerated. A new strategic document is being prepared specifying performance indicators and operational targets for public employment services. However, there are concerns with the long-term sustainability of public employment services due to the temporary nature of recent staffing. In this respect, the recruitment of counsellors on a permanent basis needs to be stepped up. More is being done to reach out to NEETs, including mobilising the trade unions, employers and local governments. By implementing a number of ALMP targeted at vulnerable groups, including beneficiaries of the guaranteed minimum income scheme, over the last few years, the authorities have succeeded in reducing unemployment among these groups. However, the launching of a comprehensive monitoring and evaluation system of ALMP is still pending. Furthermore, applying ALMP to tackle skills mismatches remains a challenge.

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE

Cyprus' public finance performance was very strong during the first 8 months of 2019. The general government headline surplus reached 4.3% of GDP and the primary surplus amounted to 5.9% of GDP, compared to 3.5% and 5.1% of GDP in the corresponding period in 2018. This excludes the operations to provide one-off support for the banking sector.

Increases in social contributions and buoyant revenue collection underpinned the large general government surplus. Total revenue collection increased by 12% compared to the same period in 2018, outpacing total expenditure growth of 9.7%. The main contribution to the strong revenue performance was a rise in collection from social contributions (29.7% increase). This was driven by the pre-legislated increase in social contribution rates by one percentage point as of January 2019 and the introduction of contributions to the National Health Insurance System (NHIS) in March 2019. ([6]) Sustained improvements in the labour market situation and robust output growth supported the strong growth of direct tax revenues (9.6%), with corporate taxes increased by about 11%. Indirect taxes increased at a lower rate (1.2%) due to a cut in excise duties on fuels and the abolition of the excise tax on vehicles at the beginning of the year, whereas the growth in VAT collection remained strong at 6.4%.

Expenditure growth also accelerated markedly during the first 8 months of 2019. Total expenditure increased by 9.7% compared to 2.8% over the same period last year, leading to an increase in its share in GDP from 32.7 to 34.7%. The main contribution was the growth of social transfers related to the first stage of the health reform in June 2019, which boosted social insurance expenditure. However, this increase was more than offset by higher contributions. A number of additional categories of expenditure grew significantly faster than expected nominal GDP in 2019 2.9%, namely: (i) the public wage bill (10.1%); (ii) intermediate consumption (20.9%); (iii) and other current expenditures (22.2%). The increase in the public sector wage bill reflects several developments: the step-wise gradual reversal of wage cuts implemented during the crisis, the unfreezing of promotions, annual increments, the introduction of a revised cost of living allowance (COLA) indexation system, the introduction of the NHIS contributions paid for public employees, the effect of increasing social contributions, and the increase in the wage bill of the public health services.

([6]) New social contributions are being introduced progressively in March 2019 and in March 2020 in order to finance the new universal health insurance system. Employers and employees, the self-employed and pensioners, as well as the state will pay out contributions. Total contributions will reach an estimated 2% of GDP in 2019, 5.1% in 2020, and 5.5% of GDP by 2021.

3.2. FISCAL OUTLOOK

Over the medium-term, declining, but still sizeable budgetary surpluses are projected to help reduce public debt. The Commission's Autumn Forecast projects that the headline budget balance will return to surplus in 2019, with an expected headline general government balance of 3.7% of GDP. The deficit of 4.4% of GDP recorded in 2018 was exclusively caused by one-off operations to support the banking sector. Going forward, the headline balance is forecast to record a surplus of 2.6% of GDP in 2020 and of 2.4% in 2021. The structural balance is expected to remain positive, but is set to decline from 1.7% in 2019 to 0.6% in 2020 and 0.4% in 2021 driven by a large output gap. Given the strong fiscal outlook, public debt is projected to decline throughout the forecast horizon. According to the Commission Autumn Forecast, the public debt-to-GDP ratio will progressively decline from 100.6% in 2018 to 94% of GDP in 2019, 88% in 2020 and to 82% in 2021. The projected steady decline of the debt-to-GDP ratio is driven by sizeable headline surpluses, a favourable interest rate-growth differential (snowball effect) supported by robust real growth and active debt management.

The fiscal performance projected for 2019 reflects the impact of several policy measures. Specifically, the increase in social contribution rates by 1 percentage point in January has a positive effect (of 0.4% of GDP) on the fiscal balance. The first stage of the health reform is expected to have a one-off positive fiscal impact of 0.5% of GDP in 2019. This is due to the asynchronous introduction of health contributions (March 2019) and benefit spending (June 2019). The forecast also takes into account the effects of several expansionary measures included in the supplementary budget adopted in June that will increase spending, mostly on military equipment and medical devices (0.2% of GDP); the next step of the reversal of the public wage cuts implemented since the crisis (0.3% of GDP); and the reduction in excise duties (0.3% of GDP).

The projected decline in the headline general government surplus to 2.6% in 2020 will be primarily caused by additional costs from the next step of the gradual reversal of public sector wage cuts since the crisis (0.3% of GDP) and by the expiration of the positive one-off effect from the first stage of the health reform (0.5% of GDP). Overall, it is assumed that the introduction of the NHIS contributions will have a neutral budgetary effect over 2020 and 2021, with revenues and spending expected to increase by around 5.5% of GDP by 2020. Moreover, the statistical treatment of a signature bonus for the exploration of hydrocarbons is expected to contribute to the deterioration of the budget balance in 2020. This bonus improved the accounts in 2017-2019 (by 0.15% of GDP per year) and expires in 2020. It is estimated that the introduction of the ESTIA scheme will have a negative cumulative fiscal impact of around €80 million by 2021. The 2020 draft budgetary plan submitted by the Cypriot authorities projects a headline balance of 3.8% of GDP in 2019 and 2.7% in 2020 and 2.6% in 2021. The structural balance is expected to record a surplus of 2.2% in 2019 and 1% in 2020 and 2021.

Risks to the fiscal outlook remain mainly on the downside. Court cases that could lead to the reversal of civil service pay cuts implemented during the crisis represent a substantial short-term fiscal risk. The final decision is expected by the end of the year or early next year and could lead to substantial fiscal costs in addition to already legislated stepwise reversals of wage cuts. In this context, mounting pressures to further increase public expenditure emphasise the need for a strict management of public expenditure. Reliance on cyclical tax collection developments to finance permanent spending is to be avoided in order to maintain the favourable fiscal position and the path of debt reduction. This is particularly crucial amid concerns about the sustainability of the recent strong increases in tax revenue. On the positive side, the state-owned asset management company KEDIPES which manages assets and loans transferred from Cyprus Cooperative Bank (CCB), could generate surpluses in the coming years, thus providing the state with additional fiscal resources.

The potential realisation of contingent liabilities remains a major risk to public finances. These consist of implicit contingent liabilities relating to the financial sector and explicit contingent liabilities related to state-owned enterprises and guarantees (asset protection scheme) created with the sale of CCB. Additional risks stem from the uncertain fiscal impact of the second stage of reform of the health sector (see Section 3.3 on Policy issues). In particular, the government has committed to cover any shortfalls in the budget of public hospitals during the first five years of their newfound autonomy.

With a declining, but still high public debt ratio, Cyprus remains exposed to macroeconomic, fiscal and interest rate and economic shocks. Primary surpluses should allow the public debt-to-GDP ratio to decline in the coming years. However, Cyprus' public debt ratio remains high, exposing Cyprus to potential shocks, including potentially deteriorating financing conditions in a less positive macroeconomic environment. In addition, the potential realisation of financial sector related contingent liabilities could also lead to higher risk premia. These risks are somewhat mitigated by contained medium-term financing needs (see Section 5 on Sovereign financing), increased investors' confidence in Cyprus sovereign debt (as reflected by the investment rating and declining yields) and active debt management. The debt sustainability analysis in Annex 1 presents the vulnerability of the public debt trajectory to shocks to GDP growth, government primary balance and interest rates.

3.3. POLICY ISSUES

National healthcare system

Roll-out of the NHIS has started, but challenges remain with potential fiscal risks that warrant monitoring. The implementation of the first phase of reform of the national healthcare system, focusing on outpatient healthcare, started in June

2019. The number of registrations by citizens in the first months has been high and the enrolment of health providers has been constantly increasing since the roll-out of the NHIS. Despite the relatively smooth introduction of the system, challenges remain, notably with the execution of public hospitals' budget. There are also significant challenges and delays with regard to the preparations of the second phase (autonomisation of public hospitals). In particular, it remains uncertain whether private hospitals will participate in the scheme. The understaffing of public hospitals remains an issue, and it is generally uncertain whether public hospitals will be financially sustainable after their autonomisation. This adds to the potential fiscal impact of the healthcare reform, as the law stipulates that the government will subsidise any potential deficit of public hospitals during their first 5 years of autonomy. In view of its potential sizeable fiscal impact, the reform needs to be carefully monitored to identify possible financial slippages and ensure the system is sustainable over time.

State-owned enterprises and privatisation

Progress on privatisation projects remains very limited. The tender procedure to privatise the port of Larnaca is slowly progressing. An Israeli-Cypriot consortium submitted an updated proposal in July that is under legal evaluation. The country's House of Representatives has reported no intention of approving the corporatisation of the Cyprus Telecommunications Authority. No notable progress has been made in privatising other assets, such as the Cyprus Stock Exchange. Progress on the individual privatisation projects could attract further foreign investment into Cyprus and reduce the state's exposure to contingent liabilities from public companies. In addition, it remains key to step up efforts to improve the corporate governance of state-owned enterprises and to ensure more effective monitoring of their operations, while minimising fiscal risks.

Public financial management and revenue administration

Implementation of the public financial management framework is progressing slowly. The key institutions involved in the assessment of investment projects have seen their administrative capacity further strengthened over the last few years thanks to guidelines and staff training. It is still to be decided whether to set up a unit responsible for public-private partnerships within the Ministry of Transport. The next round of EU-funded projects will be assessed according to the new project assessment standards. The authorities reported improvements in data collection from local government and state-owned enterprises, while reporting at the municipal level remained more problematic in terms of both data quality and coverage.

Efforts to enhance revenue administration and fight tax evasion continue. Measures against tax evasion continue to primarily target revenue collection from taxpayers with the largest potential impact (e.g. construction companies, liberal professions) by providing incentives for greater voluntary compliance. A law amendment approved by the council of ministers in October aims at criminalising the non-payment of income taxes. Seven chapters of the Tax Procedure Code are awaiting legal vetting, while chapters on administrative penalties, criminal provisions and tax collection are still to be agreed. The integration of the tax administration system is progressing slowly. The tender for introducing a new tax IT system has been launched with the evaluation process expected to be completed by the end of the year. However, it will take several years before the new tax IT system is fully up and running. The creation of a tax portal that will enhance communication between the tax authorities and taxpayers is underway.

Public administration issues

The long awaited horizontal reform of public administration is still pending. The revised draft bills to modernise the appraisal system for civil servants and the procedures for promoting them were submitted to the House of Representatives for enactment in October, following a long consultation with those concerned. The main changes compared to the initial proposal are the removal of the good performers' quota, the introduction of an assessment centre to select all levels of management and the greater weight given to experience, performance and academic background in the criteria used to decide on promotions.

A more permanent solution to contain the public sector payroll is essential. The collective agreement covering the broader public sector, which is currently in place, ensures that increases in the public sector payroll are in line with developments in fiscal conditions and nominal GDP growth. Nevertheless, given the mounting pressure to increase public sector wages, and the additional fiscal risk related to the court cases on the constitutionality of the public sector wage and benefit cuts during the crisis (see Section 3.2 on Fiscal outlook), the introduction of a binding and permanent mechanism needs to be reconsidered.

Local government reform

The reform of local government is progressing. Discussions on this reform in the House of Representatives had been at a standstill since 2015. Currently, three revised proposals ([7]) are gathering support. The first draft bill aims to improve the efficiency of water and waste management and is expected to be submitted to the House of Representatives by end-2019. The second draft bill, also to be submitted to the House of Representatives by end-2019, aims to create 35 clusters of communities (compared to today's 350 communities) with their own budgets in order to benefit from economies of scale. The third draft bill is aimed at a more fundamental reform of local government. It proposes to significantly reduce the number of municipalities and grant them new responsibilities, including maintaining a local police force, managing schools and overseeing small infrastructural projects. At the same time, the municipalities will have greater administrative and financial autonomy. Overall, the authorities expect that the reform will make local governments significantly more efficient while generating savings in public funds. The proposal is in the final stage of preparation. Importantly, the reform is also set to simplify the procedures for building and spatial permits and speed up the issuance of title deeds (see Section 4.4 on Other policy issues for more details on immovable property rights).

([7]) Based on recommendations made by an independent expert appointed in November 2018 in an effort to overcome the controversial issues faced during the discussions in the House of Representatives.

4. FINANCIAL SECTOR

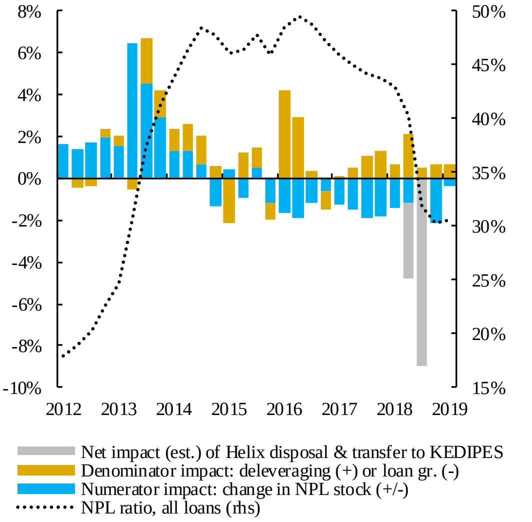
4.1. DEVELOPMENTS IN THE BANKING SECTOR

Asset quality

Following a strong reduction in non-performing loans (NPLs) in 2018, the NPL ratio declined only marginally in 2019. The total stock of NPLs – at €10.1 billion (30.8% of gross loans) in May 2019, remained virtually unchanged from the end of 2018 (see Graph 4.1 and Table 4.1). ([8]) However, the planned sale of large-scale NPL portfolios by the two biggest banks, if successful, would imply a significant further reduction in the coming year. The envisaged transactions would in turn, increase the NPL stock held outside the banking sector, which has grown significantly in 2018 (see Graphs 4.1 and 4.2), representing more than half of the entire NPL stock.

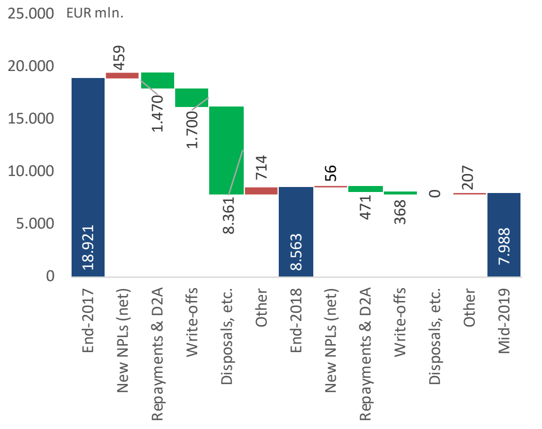
Resolving the remaining NPLs continues to be challenging. The largest volume of NPLs held by the banks as of May 2019 belonged to households, amounting to €5.1 billion, or 37.7% of gross loans to households (see Table 4.1). The NPLs of non-financial corporations amounted to €4.2 billion, or in relative terms a NPL ratio of 31.4%. Moreover, the share of NPLs for which banks deem no negotiation options ('terminated accounts') has gradually been growing and reached 56%. ([9]) This growth partially reflects the under-representation of terminated accounts in the already disposed NPL portfolios. Nevertheless, it could be interpreted as a positive signal that banks were able to dispose terminated loans for which cash collections were virtually non-existent.

Graph 4.1: **Changes in the NPL ratio and breakdown**



Source: Central Bank of Cyprus

Graph 4.2: **Evolution of the fixed-term NPLs since end-2017**



Figures cover only the fixed-term loans, which represent around 83 % of all NPLs. New NPLs include new defaults and re-defaults on restructured loans and are net of curing loans (i.e. migrations into performing status). Repayments and debt-to-asset/equity swaps (D2A) include cash repayments and acquisition of property or equity through D2A. Disposals include loan sales, securitisations, and transfers (to KEDIPES) out of the banking sector. Other items include accrued interest on NPLs, currency fluctuations of loans denominated in foreign currency, unwinding of interest, and other expenses.
Source: Central Bank of Cyprus

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

([9]) Share of terminated accounts in the fixed-term NPL stock.

Table 4.1: **Soundness indicators for the banking sector in Cyprus**

	2012	2013	2014	2015	2016	2017	2018				2019	
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	June	Sept	Dec	Mar	May
NPLs*, all loans (EUR billions)	15.6	26.0	27.3	26.7	23.8	20.6	19.9	16.6	11.0	10.3	10.1	10.1
NPLs*, all loans (% of total)	22.6	41.5	47.8	45.8	47.2	43.7	43.0	40.3	31.8	30.3	30.6	30.8
NPLs*, loans to NFCs (% of total)	..	..	58.0	56.0	56.4	50.3	48.4	39.4	36.3	33.3	31.5	31.4
Restructured non-performing (% of total)	..	12.5	23.3	25.9	25.7	22.8	22.3	16.4	15.4	14.4	14.1	14.0
Restructured performing (% of total)	..	12.2	5.3	7.5	9.4	8.6	7.9	8.6	8.3	6.8	6.2	6.2
NPLs*, loans to households (% of total)	..	43.3	52.7	56.2	55.9	53.9	53.6	52.5	38.0	37.6	37.8	37.7
Restructured non-performing (% of total)	..	6.7	13.9	18.0	20.0	19.7	19.8	19.4	16.8	17.1	17.1	16.9
Restructured performing (% of total)	..	10.4	8.9	6.7	7.7	8.3	8.0	7.6	8.5	7.1	6.2	5.7
Coverage rate (Impairments / NPLs)*	47.9	37.7	32.9	37.8	41.7	46.8	48.6	48.3	51.9	51.3	52.3	52.2
Cost-to-income ratio	55.6	53.4	40.4	44.1	52.5	53.6	63.9	74.3	60.0	62.4	70.3	n.a.
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	2.2	2.3	1.8	1.8	2.0	n.a.
Common Equity Tier 1 ratio	..	..	14.2	15.6	15.9	14.9	14.1	14.2	14.9	15.1	15.6	n.a.
Return on assets (annualised)	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.9	0.3	0.4	0.2	0.7	n.a.

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

Looking forward, progress in resolving remaining NPLs crucially hinges on further portfolio sales, loan restructuring and on the take-up of the ESTIA scheme. Banks are currently working to prepare additional large NPL portfolio sales, which could be finalised in 2020. However, the recent amendments weakening the foreclosure framework, if implemented ([10]) (see Section 4.2), may lower investor appetite for those assets. Beyond portfolio sales, the performance of restructuring solutions continues to remain low as evidenced by the slow progress in NPL reduction within the first half of 2019 (see Graph 4.2). The State support scheme, ESTIA, for NPLs backed with primary residences should drive a further reduction in NPLs if it is taken-up by borrowers. The scheme seeks to support and protect vulnerable borrowers; an important objective that should be balanced with the need to improve payment culture.

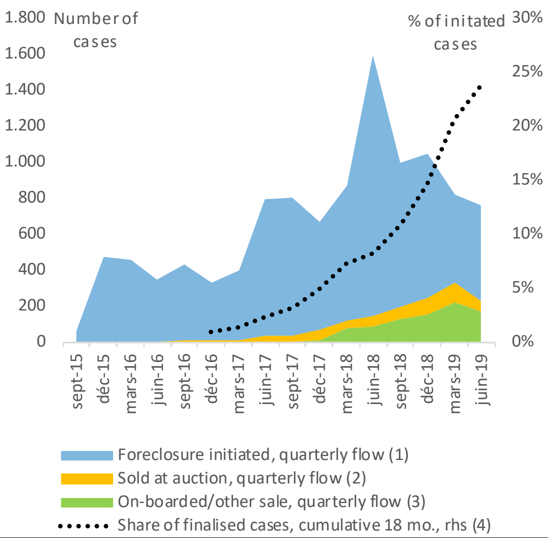
Banks appear to be more willing to use foreclosures as an NPL workout option. The share of foreclosure cases that are successfully finalised has been increasing steeply (see Graph 4.3). However, the number of initiated cases appears to be declining since late 2018, which may be linked to the significant delays in the implementation of the ESTIA scheme (see Section 4.2). The August 2019 amendments to the foreclosure framework, if eventually approved, may reverse the trend towards an increased use of foreclosure procedures. Another concern is the significant portion of foreclosure cases that result in a repossession of the collateral property by banks (i.e. on-boarding), which in turn increase further their real estate exposures, especially for Bank of Cyprus. Furthermore, around two thirds of all foreclosure cases involve farmland or other land as collateral, while the bulk of the NPL stock is backed by residential properties. ([11])

Coverage levels continue to increase gradually. The average coverage ratio for the banking sector was 52.3% as of May 2019, up from 48.6% a year ago. This positive development largely reflects the transfer of Cyprus Cooperative Bank's (CCB) bad assets to the state-owned asset management company, KEDIPES. However, a part of the overall provisioning levels is explained by the offsetting of accrued interest on NPLs. The aggregate coverage level continues to exceed the EU average of 45%.

([10]) At the request of the President, the August amendments were referred to the Supreme Court, which is expected to decide on their constitutionality in the spring of 2020. In the meantime, the foreclosure framework as adopted by Parliament in July 2018 will remain in force.

([11]) It remains to be seen whether foreclosure activity will increase for the NPLs collateralised by residential property.

Graph 4.3: **Evolution of foreclosure activity**



(1) Properties for which a notification has been served of the intention of selling the property within the relevant quarter. (2) Properties successfully sold in an auction within the quarter. (3) Properties sold or repossessed and held on the balance sheet of the originating bank following an unsuccessful auction. (4) The ratio gives the share of cases that were finalised with a sale or repossession over the past 18 months.
Source: Central Bank of Cyprus

Profitability, capitalisation and liquidity

While the banking sector recorded modest profits, pressures on profitability remain significant. As of March 2019, the net profits for the banking sector stood at €108 million, which is virtually unchanged from a year ago. However, the first quarter figures for 2019 have benefited significantly from the conversion of deferred tax assets (DTAs) to deferred tax credits (DTCs) for Bank of Cyprus. ([12]) Indeed, before-tax profits were low at €2 million, compared to €166 million a year ago. The net interest margin declined from 2.3% at mid-2018 to 2.0% in mid-2019, although these figures overstate the results due to the inclusion of accrued interest on NPLs. Recent NPL reductions, the injection of capital in Hellenic Bank and the one-off DTAs-to-DTCs conversion have strengthened the aggregate capital position to 16.3%, up from 15.1% at end-2018.

([12]) A March 2019 law provided for the conversion of deferred tax assets (DTAs) of Bank of Cyprus, transferred from Laiki following its resolution in 2013, to deferred tax credits (DTCs), which resulted in an immediate accounting profit of €101 million and an improved CET1 capital position of €285 million.

Excess liquidity weighs heavily on profitability prospects. With a regulatory liquidity buffer of €21.7 billion, which represents one third of total assets, Cypriot banks continue to maintain significant excess liquidity. Several banks aim to address this issue by reducing the size of customer deposits through lower interest rates, which are at historical lows ranging from 0.3% to 0.5%. However, these efforts have not been successful to date, partly due to the unavailability of alternative low-risk investment opportunities for retail savers. Despite lower deposit rates, total outstanding resident deposits of locally active banks have increased by around 0.8% in the first three quarters of 2019. In contrast, non-resident deposits declined by 0.5% over the same time period. Some banks already charge negative rates to large corporate deposits, but these have not been extended to retail depositors yet.

Meeting the minimum requirement for own funds and eligible liabilities (MREL) will be challenging. Binding MREL targets or phase-in arrangements for Cypriot banks have not yet been announced by the Single Resolution Board. Due to their heavy reliance on deposit funding, Cypriot banks will need to raise more non-deposit funding to meet their MREL requirements. This will create additional pressure on banks already facing profitability and asset quality challenges.

Profitability could be improved by enhancing efficiency and diversifying investment. All major banks are engaging in measures to reduce their physical footprint. The cost-to-income ratio was 70.3% in March 2019. It remains substantially higher than the EU average, and it is artificially lowered by including the accrued interest income on impaired assets and not the offsetting provisioning charges. Moreover, staff costs can only be reduced slowly and in a delayed manner, due to the strongly unionised sector. Although the larger banks have already invested to enhance their internet banking capacities, there is still significant room for improvement, especially for the online marketing of products. In addition, the declining, but still high level of private indebtedness severely constrains the pool of bankable investment projects. In addition to improved NPL resolution actions that can address the debt overhang, broader measures to improve the investment climate could also help generate better investment opportunities for banks, firms and retail savers.

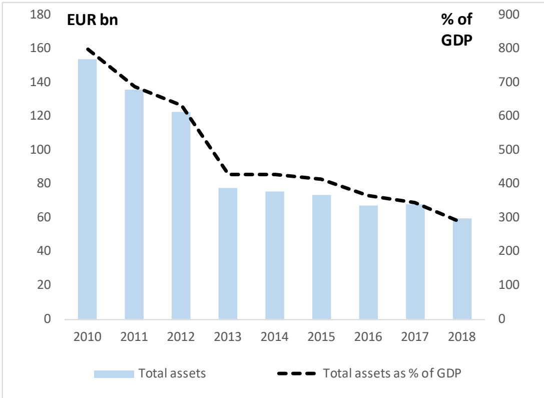
Lending

New lending remains relatively flat. In the first half of 2019, new lending to residents was €1.5 billion, which does not exhibit any significant change from prior periods since 2017. Similarly, new lending to non-residents was only €0.9 billion in the first half of 2019, down from €3.3 billion in the entire year of 2018. These developments reflect low credit demand and the scarcity of profitable investment opportunities. Strong competition, a subdued demand for loans, the low interest rate environment and the ample supply of liquidity have driven loan rates to historical lows. Lending rates on household mortgages stood at 2.1% at mid-2019, while for corporate loans, the rates were 3.2% for loans up to 1 million.

Overview of the largest domestic banks

Considerable progress has been made with deleveraging and de-risking banks' balance sheets. Thanks to the carve-out of the distressed assets of CCB during its liquidation and major sales of NPLs, the banking sector shrunk to below 300% of GDP in mid-2019, compared to 350% at the end of 2017, and more than 700% before the financial crisis of 2013 (see Graph 4.4). Performing CCB assets were acquired by Hellenic Bank, benefiting from an asset protection scheme. ([13]) The importance of subsidiaries of Greek banks in Cyprus, once a channel of contagion, has overall been reduced, although in some cases NPLs remain elevated. The decline in non-resident deposits, together with targeted efforts, including roadshows, has helped stabilise correspondent banking relations that were previously under pressure. ([14])

Graph 4.4: **Evolution of banks' balance sheets**



Source: Central Bank of Cyprus

Bank of Cyprus (BoC), the largest domestic bank, aims to further improve the quality of its assets. Despite the Helix I sale, which was finalised in mid-2019, the bank's NPL ratio amounted to 33% at end-June 2019. In March 2019, BoC disposed of a small portfolio of terminated loans (with a gross value of €245 million) to APS Loan Management (a foreign NPL investor). The BoC's direct real estate exposure remains large, at around €1.4 billion in mid-2019, primarily on account of debt-to-asset swaps and the repossessions of foreclosed assets. In the short term, the sale of the Helix II portfolio (comprising up to €2.8 billion of NPLs) in the first half of 2020), with ongoing additional sales of unsecured loans and collateralised loans granted to foreigners (of €0.4 billion), together with additional reductions in NPLs due to ESTIA, should help improve asset quality further.

Going forward, BoC's low profitability remains a key concern. Like its competitors in the domestic market, BoC has a significant amount of excess liquidity, which cannot be profitably invested. The bank's profits were helped by a one-off conversion of DTAs into DTCs, which in accounting terms created €285 million of capital (with a CET1 impact of 190 bps). The off-loading of the Helix I portfolio and the conversion mentioned helped raise the bank's CET1 ratio to 14.9% as of June 2019.

The business model and risk profile of Hellenic Bank (HB) have changed significantly following the acquisition of CCB's performing assets. The incorporation of these assets into HB's balance sheet has made HB the second largest bank in

([13]) Hellenic Bank took over almost the entire Cyprus Cooperative Bank performing loan portfolio, all government bonds and customer deposits. Around €2.1 billion (gross book value) of the performing loans transferred to Hellenic Bank are covered by the asset protection schemes (APSs) provided by Cyprus Cooperative Bank and counter-guaranteed by the Cypriot Republic. Hellenic Bank also took over a portfolio of NPLs worth approximately €0.7 billion (gross book value), covered by the APSs entirely. Under the current set-up of the APSs, the Cypriot government would provide compensation for 90% of the approved credit risk losses, while Hellenic Bank would be exposed to 10%. The duration of the APSs will be 10 to 12 years, depending on the loans.

([14]) See Post-Programme Surveillance Report Cyprus, Spring 2019, pg. 20.

Cyprus. First quarter results of 2019 show that the bank's regulatory capital ratios improved due to the capital raise of €150 million, completed in Q1, and through the full appropriation to capital of the 2018 total income (€296 million). The overall NPL ratio remained at 32.6% at the end of March 2019, barely changed from end-2018. The operational integration of the acquired parts of CCB (including the migration to a common IT infrastructure) was finalised in September 2019. A remaining challenge is closing the gap between the salary structure of former CCB employees and HB employees.

HB has started adjusting its business model. The bank faces pressure with its net interest income and low demand for loans, which challenges profitability. HB's cost-to-income ratio remained high at 64% in Q1 2019, including on account of limited fee income. Excess liquidity (43% loan-to-deposit ratio) continues to be a major challenge and the net interest margin remains low. To remedy that, the bank introduced negative rates (40 bps) on €400 million corporate deposits.

4.2. FOLLOW-UP ON THE 2018 THREE-PILLAR STRATEGY TO REDUCE NPLS

Developments regarding foreclosure and insolvency frameworks

The amendments to the foreclosure framework approved by Parliament in August 2019 constitute a severe backtracking on the reform of the framework adopted in July 2018. The 2018 reform was a key step forward in improving financial stability, inter alia by strengthening the effective enforcement of claims and the effective workout of NPLs. It was also an important component of the State-aid decision by the Directorate-General for Competition on the sale of performing CCB assets to HB.

The revised foreclosure framework, if implemented, can be expected to have adverse effects on progress in NPL resolution and financial stability. First, the new law will imply longer and more cumbersome foreclosure procedures — with negative implications for bank profitability, capitalisation and credit ratings. Second, the amendments will weigh on the prospects and the price of future NPL portfolio sales. Third, the inflow of new NPLs is likely to accelerate, as the incentives for borrowers to adhere to the contractual repayment schedule may be reduced by the extension of foreclosure deadlines and recovery periods. This may also have consequences for the functioning of the ESTIA scheme, which was supposed to help reduce the amount of NPLs by using a 'carrot' (subsidies) and 'stick' (threat of swift initiation of foreclosure procedures) approach.

The future of the foreclosure framework remains uncertain. At the request of the President of Cyprus, the amendments to the foreclosure framework approved by Parliament on 2 August 2019 were referred to the Supreme Court, which is expected to decide on their constitutionality in the spring of 2020. In the meantime, the foreclosure framework as adopted by Parliament in July 2018 will remain effective. Nonetheless, even if the Supreme Court were to determine that the amendments of August 2019 are unconstitutional, some damage would result from investor perceptions that the legal framework in Cyprus is not stable. Moreover, there is evidence that the amended foreclosure framework, if eventually enacted, may have a perceptible impact on the pricing of NPL portfolio sales. The amendments would also heavily affect the asset recovery prospects of the state-owned asset management company KEDIPES. In the meantime, the Central Bank of Cyprus is working on a new proposal to address the concerns raised by Parliament during the summer, notably regarding borrowers claiming that they have been unfairly treated by lenders. The details of this mechanism are not yet available.

Electronic auctions could begin in the second quarter of 2020. The ministerial decree setting the technical specifications of the e-auction system is to be approved before the end of the year. A pilot of the new system has already been successfully tested. The electronic process could streamline the sale of collateral and consequently help to the enforcement claims.

There has been limited progress with insolvency proceedings. Examinership and personal insolvency arrangements continue to be scarcely used despite last year's legislative amendments. The new Department of Insolvency, which is to be up and running by early 2020, should enhance the efficiency and effectiveness of the insolvency framework. Meanwhile, the regulation of the insolvency practitioners' profession is currently under review. In particular, the authorities are reviewing the design of the framework for licensing insolvency practitioners and will soon finalise the training programmes and certification standards for the profession.

Cyprus Asset Management Company (KEDIPES)

Progress in setting up KEDIPES was slower than expected. With a net book value of 20 % of GDP, KEDIPES is the largest asset management company in the EU relative to the size of the economy. Adequate capacity building, proper governance and operational independence of KEDIPES are key to achieving the goal of maximising government proceeds. As of September 2019, the organisational set-up, with the appointment of the full new Board of Directors and the CEO position, had still not been finalised. BDO Ireland was appointed as an advisor and is currently in the process of drafting the business plan and evaluating the organisational structure, the revision of the servicer agreement (currently with Altamira) and the sale of KEDIPES shares in Altamira. The poor quality of data on borrowers (e.g. regarding their occupation and income) makes it difficult to determine the appropriate resolution strategies, with the risk they will be ineffective. Once operational, the strategy for KEDIPES will likely focus on: the ESTIA scheme, restructuring, foreclosures and NPL sales. Furthermore, from the authorities' point of view, KEDIPES should become a much leaner organisation dealing with oversight of the servicer, managing operations with HB and making regular payments to the government.

The ESTIA scheme

The period for applying to the ESTIA scheme started with a modest initial uptake. After several months of delay, the ESTIA scheme, which provides subsidies to qualifying borrowers with NPLs collateralised by primary residences, was launched on 2 September 2019. ([15]) Applications can be submitted up to mid-November 2019 and will be assessed by the government by March 2020. While the number of applications has so far been modest, a larger number could be expected before the end date, as borrowers need time to prepare the required application documents. However, a lower-than-expected take-up could also reflect the reluctance of borrowers to reveal information on their net-asset position in the application.

The design and implementation of ESTIA raise concerns. Although aiming to protect vulnerable borrowers, the scheme will also grant subsidies to borrowers with significant wealth, which may further raise incentives for strategic defaults and undermine the already weak payment culture in Cyprus. There are also concerns about the authorities' insufficient capacity to verify compliance with eligibility criteria, including the wealth criterion for assets held abroad. The scheme's contribution to the reduction of NPLs remains uncertain, as borrowers may be reluctant to participate if they are unwilling to declare their asset positions. Another uncertainty is the viability criteria, which need to be checked by banks for all applicants. Lastly, the scheme's success depends crucially on rigorous adherence to the 2018 strengthened collateral enforcement regime.

4.3. THE NON-BANK FINANCIAL SECTOR

The integration of the supervisors of the pension funds and insurance companies is progressing slowly. The draft legislation covering the functioning of the new independent supervisory authority is expected to be submitted for discussion in Parliament and adopted by the end of 2019, so that it can be implemented next year. Management of the several hundred small occupational pension funds remains an issue. The entry into force of the new legislation and the increased supervisory powers should trigger a

([15]) The ESTIA scheme is designed to provide debt reduction subsidies for eligible borrowers with NPLs backed by primary residences. Under the scheme, the government will pay a subsidy to lower the debt servicing costs, including interest charges, of all eligible performing borrowers by one third. The eligibility criteria are: (i) a maximum net household income ranging from €20 000 to €60 000, depending on family size; (ii) a primary residence with market value of up to €350 000, and with at least 20% of the outstanding balance more than 90 days past due as of end September 2017; and, (iii) a maximum net wealth of 80% of the market value of the primary residence, capped at €250 000.

consolidation of these funds. For the insurance sector, the new legislation and planned integration are expected to bring an increase in staff. Concerning the failure of Olympic Insurance (a firm incorporated in Cyprus, but having its main activity in Bulgaria), the court appointed liquidators at the end of August 2019. Without a burden-sharing agreement, the handling of claims from Bulgaria is expected to proceed slowly via arbitration and with very limited compensation, given the company's few remaining assets.

Diversifying the investment opportunities for retail savers and the financing possibilities for corporations remains a challenge. Cyprus ranks lowest within the EU in terms of non-bank financing of the non-financial corporations, as listed shares account for only around 2% of the total financial liabilities of businesses. Households hold nearly two thirds of their financial assets as cash and bank deposits, the highest ratio in the EU. The local stock and bond markets are small, especially since the 2001 crash and the more recent 2013 financial crisis, which discouraged investment in capital market instruments. In addition, the poor protection of minority shareholders and the ineffective insolvency procedures deter the capital market development. At the same time, the aim of the major banks is to expand their product portfolios by selling investment and life insurance products. The Securities and Exchange Commission is making efforts to develop the alternative investment fund industry, following the example of Luxemburg and Ireland. Although these funds currently cater mostly to investors from other countries, the growing expertise and activity may be leveraged to provide wider investment opportunities to domestic investors.

4.4. OTHER POLICY ISSUES

Reforming the justice system

Addressing inefficiencies in the justice system is key in reducing NPLs. With the sale and wind-down of the CCB in 2018, the government has committed to gradually — within 18 months after the State aid decision on 19 June 2018 — implement measures to significantly improve the handling of NPL cases by the courts. These commitments are part of a broader reform of the judicial system, which is expected to make judicial proceedings more efficient and therefore improve debt repayment discipline. The European Commission, through the Structural Reform Support Service, is providing technical support to the authorities to help them prepare the reform.

Preparations to overhaul the judicial system continue, but implementation has been delayed. Efforts to recruit additional judges and set up a taskforce to clear a fifteen-year backlog of cases, including cases dealing with NPLs, have been postponed. As a result, it is expected that the much needed increase in capacity of the courts will be delayed at least until end-2019. On the positive side, the recruitment procedure, which is currently underway, is based on a new set of recruitment criteria, recommended by an independent study supported by the European Commission. In the meantime, six existing judges have been assigned to handle financial disputes, including the ones related to NPLs. The six judges have started reviewing cases, while they still need to undergo training.

The establishment of new courts should be speeded up to help reduce the duration of court proceedings. Legislative proposals to establish two commercial courts and a court of appeal are pending for adoption by the House of Representatives. By contrast, the Administrative Court for International Protection (mainly dealing with asylum seeker cases), which was enacted in 2018, started operations in June 2019. These new courts are expected to significantly improve the handling of cases by the judicial system, including cases involving NPLs.

Review of the rules of civil procedures and the introduction of an IT system have been considerably delayed. The revision of the rules of civil procedures, which was expected to be finalised and adopted end-2019, has been postponed for at least 1 year. These new rules are expected to increase the efficiency of the judicial system as a whole. The much needed IT system and computerisation of the court administration is delayed due to difficulties in the tendering procedure.

A stronger enforcement of judgments should become an essential element of the reform as this would also help improve debt repayment

discipline. The long awaited amendment to the Civil Procedure Law to make it easier to carry out court decisions to seize movable property is expected to be submitted to the House of Representatives in autumn 2019. In parallel to efforts made to significantly reduce the duration of court proceedings, extra efforts are needed to enforce the court judgements. Both aspects of the reform are considered important in strengthening the debt repayment discipline.

Immovable property rights

A significant number of buyers, who have paid the full price for a property, still do not have a title deed. ([16]) About 3,000 so-called trapped buyers ([17]) are waiting for the title deeds to be transferred to them, and progress is slow. This is hindering the liquidation of collaterals. A revised 'Trapped Buyers Law' ([18]) was adopted by the House of Representatives in July 2019. The main addition is the provision to notify all interested parties before the title deed is transferred to the buyer. This gives banks the opportunity to object to the procedure and table evidence to stop the transfer if deemed valid by the Department of Lands and Surveys. This is expected to address the concerns expressed by the banks ([19]), which were the main contestants of the initial law. The banks filed law suits and appeals before the courts, thus speeding up the transfer of the remaining eligible title deeds.

Apart from the 'trapped buyers', a significant number of title deeds remains to be issued. Authorities reduced the backlog of unissued title deeds to 23,000 in September 2019, down from 24,000 in March 2019. The slow progress is due to the fact that the remaining cases are the most difficult ones, i.e. there is a serious divergence from building and planning permits, which prevents local governments from issuing the necessary certificates. The upcoming local government reform and the planned revision of the building permits law, which would enable past cases to be regularised, may address these impediments from re-emerging (see Section 3.3 on Policy issues).

Efforts to establish a credible new system for property transactions should be stepped up. Consultations among authorities and interested parties (banks and developers) to agree on a new system are on hold. A proposal currently discussed with stakeholders aims at ensuring that the buyers, who have paid the full amount, will receive their title deeds quickly and without a risk of refusal. To better protect future buyers, the new system should include a transparent framework agreement between the developers and the banks, based on international good practice, and due diligence in property transactions. The absence of a credible system may lead to an increase in the backlog, in particular under the current buoyant construction activity, and may further weaken foreclosure procedures.

Discussions to simplify the procedures for issuing building and planning permits are advancing. The building permits law is currently under revision following consultation with the private sector (architects and engineers) to increase its involvement in safety and compliance for the construction of buildings. This, coupled with the local government reform (see Section 3.3 on Policy issues), should significantly simplify the monitoring procedures and speed up the issuance of title deeds.

([16]) The legal document proving a property ownership right.
([17]) Cases where developers did not repay their mortgages on the specific property and where the banks are therefore reluctant to release the mortgage, thus preventing the property from being transferred to the buyer.
([18]) The law refers to sales registered before 2015 and enforces the granting of the title deed to the buyer, who fully paid the price of the property. The unpaid mortgage is shifted to another asset.
([19]) However, it is noted that the Attorney General considered that the revised law, like with the initial law, raise concerns about its constitutionality, which may surface if banks decide again to refer the law to the courts.

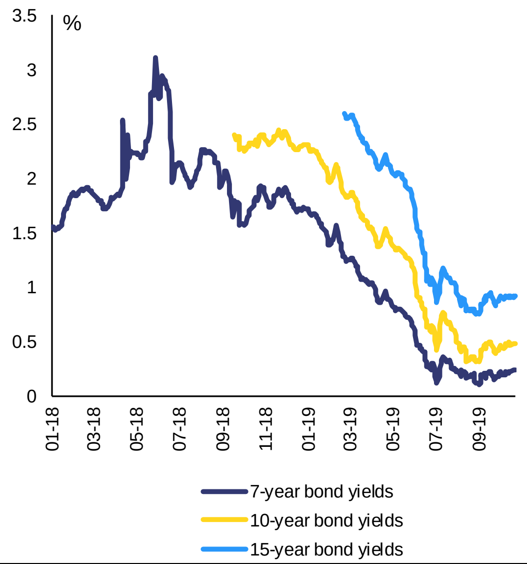
5. SOVEREIGN FINANCING AND ABILITY TO REPAY

Cyprus issued several international bonds in 2019, with the latest market tapping in October. Following the issuance of three international benchmarks (5-year, 15-year and 30-year bonds) in the first part of the year ([20]), the government repaid the outstanding Russian loan (of around €1.56 billion) ahead of schedule in September 2019. ([21]) In October, to strengthen the government cash buffer, Cyprus did a tap issue of 350 million in total. It borrowed €100 million through the 15-year bond (with a primary yield of 0.98%) and 250 million via the 30-year bond (with a primary yield of 1.54%).

Market conditions have been very favourable throughout the year, with yields trending downwards. Cypriot sovereign bonds have performed well in the secondary markets, with yields displaying a downward trend across the yield curve and reaching very low levels. The 7-year bonds reached yields of around 0.2% by the end of October 2019; the yields of the 10-year and 15-year bonds stood at around 0.5% and at 0.9% respectively, while the 30-year maturity bond was at 1.5% (see Graph 5.1). The sovereign long-term credit rating of Cyprus remains at 'investment grade' by Standard & Poor, Fitch and DBRS, and at below investment grade by Moody's.

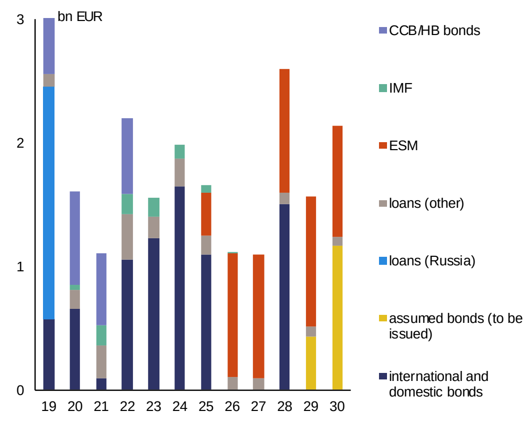
The sovereign financing needs are contained. With the October bond issuance, the government cash buffer at the end of 2019 will cover Cyprus' regular financing needs for the following 9 months. Gross financing needs for 2020 are estimated at around €1 billion or 4.2% of GDP, excluding T-bills. ([22]) It consists of €1.6 billion of debt redemption needs (see Graph 5.2), which are partly offset by €0.6 billion revenues from the projected headline general government surplus. Over the medium term, total financing needs are expected to be contained (below 7% of GDP), in particular for 2020 and 2021 due to the early repayment of the Russian loan and the projected government surpluses. Furthermore, in the course of next year, the government plans to repay the IMF loan earlier, reducing further the country's medium term financing needs. ([23])

Graph 5.1: **Cyprus sovereign bond yields**



Source: Bloomberg

Graph 5.2: **Medium and long-term debt amortisation**



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

([20]) The government first tapped the international markets in February with a €1 billion bond with a maturity of 15 years (with a primary yield of 2.76%). One month later, in April 2019, Cyprus proceeded with another issuance of a 30-year bond (worth €750 million, with a primary yield of 2.84%) and a 5-year bond (worth €500 million, with a primary yield of 0.67%).

([21]) Russia granted the loan to Cyprus in 2011 and it was due in 2021. The early repayment took place on 2 September 2019, using proceeds from the April bond issuance and the fiscal surplus.

([22]) When accounting for the early repayment of the IMF loan, the gross financing needs increase to €1.7 billion, excluding T-bills. The debt redemption needs for 2020 increase to approximately €2.3 billion. The remaining IMF loan amounts to €0.7 billion.

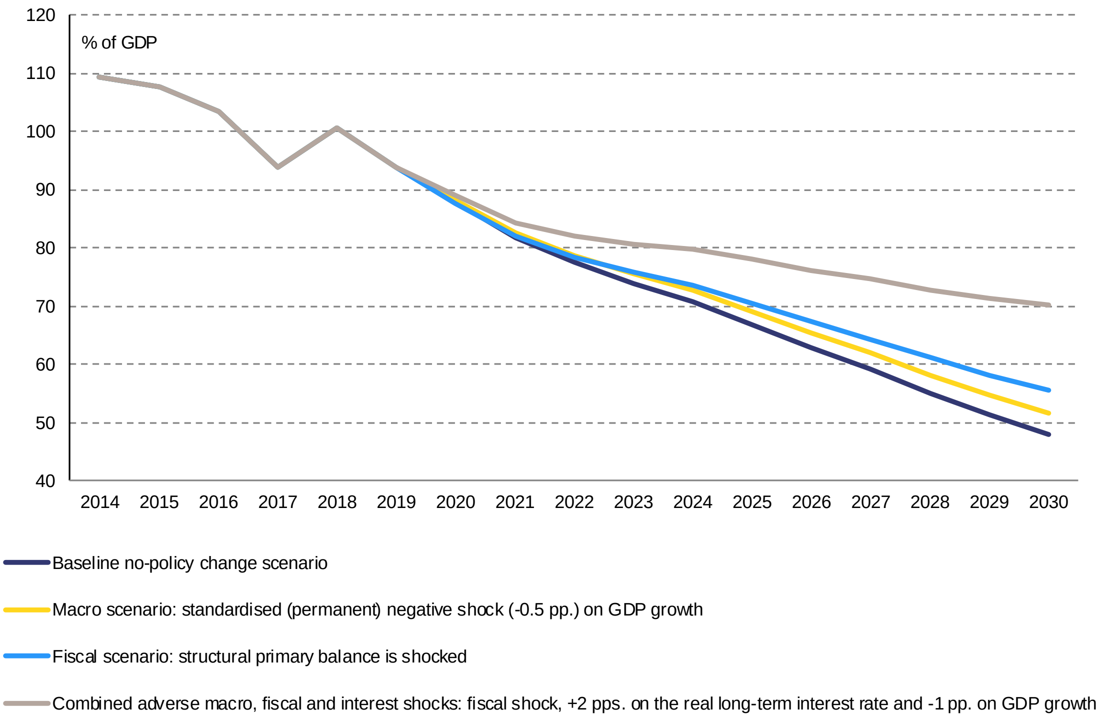
([23]) See previous footnote.

Risks to Cyprus' capacity to service its European Stability Mechanism debt remain low in the short term. Cyprus' capacity to repay remains sound in the short term in view of still robust growth and expected large primary surpluses (see Annex 1 on Debt sustainability analysis). To maintain its repayment capacity in the medium and long term, it is essential for Cyprus to ensure fiscal discipline, reduce further the NPLs and make progress on structural reforms that improve the long-term growth potential.

ANNEX 1
European Commission Debt Sustainability Analysis

Based on standard Commission methodology, the Commission's autumn 2019 forecast and the debt sustainability analysis (DSA) ([24]) show that government debt is projected to fall from 100.6% of GDP in 2018 to below 50% of GDP in 2030. ([25]) While in 2018 the government debt-to-GDP ratio increased by approximately 7 percentage points (pps), to above 100% ([26]), in 2019 public debt is expected to decline to 93.8% of GDP – on the back of a large primary surplus and a favourable interest rate-growth differential (snowball effect) supported by robust real growth (see Table A2.8). For 2020 and 2021, the debt-to-GDP ratio is forecast to come down to 87.8% and 81.8%, respectively – underpinned by forecasts of strong fiscal performance and output growth, decreasing interest expenditure, and active debt management operations. Afterwards, in the baseline scenario, the government debt is projected to steadily decline to below 50% of GDP in 2030 (see Graph A1.1).

Graph A1.1: **DSA scenarios**



Source: European Commission

For the outer years (from 2022 onwards), the debt sustainability analysis is based on the following standard assumptions in the Commission's methodology ([27]): (i) the structural primary balance before the cost of ageing is kept at a surplus of 2.2% of GDP under the 'no fiscal policy change' assumption; (ii) inflation converges to 2.0% by 2024 and remains stable after that; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to market-based forward rates by the end of the 10-year

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

([25]) Historical GDP series were revised in October 2019, leading to changes in the debt-to-GDP ratios, including for 2018. Before the GDP revision, public debt for 2018 was reported at 102.5%.

([26]) The increase in debt in 2018 is due to the one-off government support measures related to the State-owned Cyprus Cooperative Bank. In order to support the sale of the second largest bank, the government issued a series of bonds in April and July 2018 (totalling approximately EUR 3.2 billion). For more details, see Country Report Cyprus 2019, Box 4.2.1.

([27]) The debt sustainability analysis uses the Commission's Autumn 2019 forecast for 2019, 2020 and 2021 as a starting point in order to ensure consistency across EU Member States, and then following 2021 it is based on the standard assumptions explained above.

projection period,; [28] (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 1.8% in 2019-2030); and (v) ageing costs develop according to the 2018 Ageing Report projections. [29]

However, the path of the debt-to-GDP ratio is sensitive to shocks to growth, fiscal performance, and interest rates. In the baseline scenario, the debt-to-GDP ratio is expected to decline on average by approximately 3.7 pps of GDP per year from 2022 onwards. Graph A1.1 illustrates the vulnerability of this favourable trajectory to three alternative scenarios. The first adverse scenario is a standard macroeconomic shock that assumes a decrease in real GDP growth (by 0.5 percentage point (pp.) compared to the baseline) over the projection period. It also assumes that the lower growth path does not have any repercussions on the government balance. In this scenario, the debt reduction decelerates compared to the baseline scenario, with government debt standing at a higher level (51.6% of GDP) than the baseline (48.1% of GDP) at the end of the projection period. The second scenario assumes that the structural primary balance worsens by half of the forecasted cumulative change over the two forecast years (i.e. the primary surplus is smaller); the structural primary balance is then kept constant at this lower level over the remaining projection period until 2030. [30] As a result, the government debt is deemed to decline at a slower pace, ending up 7.4 pps of GDP higher in 2030 compared to the baseline. Last, a more severe scenario assumes a combination of negative macroeconomic and fiscal shocks together with a sustained increase in interest rates over the entire projection period. [31] Under this scenario, the government debt is on a more modest declining trend, set to reach 70.2% of GDP level by 2030, as higher interest rates feed through new and rolled-over debt. More generally, additional analysis of stochastic projections shows that, given the historical volatility of the Cypriot economy, debt projections are surrounded by considerable uncertainty.

The fiscal sustainability analysis no longer points to fiscal risks in the short term, but some financial and competitiveness variables indicate that possible short-term challenges remain. Table A1.1 presents the Commission's fiscal sustainability framework, which differentiates fiscal risks across the short, medium and long term. [32] After banking support measures negatively affected fiscal variables in 2018, the fiscal sub-index of S0 is now again in check. As a result, the S0 indicator has now returned below, but close to the critical threshold and thus no longer signals high risks of fiscal stress over a one-year period. Nevertheless, the second S0 sub-index shows that there still are considerable vulnerabilities coming from financial and competitiveness aspects of the economy, such as the current account deficit, the large negative net international investment position, and high private indebtedness, a significant fraction of which is short-term.

In the medium and long term, Cyprus is now assessed to face low fiscal sustainability risks, driven by improvements in the DSA as compared to the last PPS report. [33] The medium-term fiscal risk is assessed based on two main tools: the DSA and the S1 sustainability gap indicator (see Table A1.1). The

(28) This constitutes a change with respect to the previous interest rate methodology (see European Commission, "Debt Sustainability Monitor 2019", forthcoming).
(29) 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.
(30) This scenario incorporates a feedback effect on GDP growth whereby a 1 pp. of GDP expansion impacts positively baseline GDP growth by 0.75 pp. in the same year.
(31) In this scenario, the structural primary balance (SPB) is assumed to worsen as per the negative shock described above, i.e. to fall by half of the SPB's cumulative change over the two forecast years and then stay constant at this lower level over the remaining projection period till 2030. In addition, negative feedback effects on interest rates (a sustained shock of +200 basis points) and on real GDP growth rate (a sustained shock of -1 pp. compared to the baseline) are assumed. A sustained shock of +200 basis points (+2%) on market interest rates can be deemed significant in the current market environment.
(32) For more details on the Commission's fiscal sustainability methodology, please see the Fiscal Sustainability Report 2018.
(33) This PPS review shows that Cyprus switches to facing low sustainability risks in the medium and long term, whereas the last review done in the spring of 2019 indicated medium risks. The change in the assessment is driven by the DSA, which now shows low risks instead of medium risks. The DSA indicates low risks when the baseline scenario shows that the government debt is on a declining path and by the end of the projection period the debt level falls below the Treaty's 60% of GDP value, and furthermore, this dynamics has to be confirmed by different more adverse scenarios (as indicated in Graph A.1.1).

negative value of S1 indicates that no upfront fiscal adjustment effort is needed, in addition to the baseline, to reduce the debt below the reference value of 60% of GDP by 2033; therefore, this points to a low risk in the medium term. Furthermore, the DSA also shows a low risk, as indicated above by the baseline scenario where the debt-to-GDP ratio is projected to decline to below the critical 60% threshold by 2030. Over the long-term, Cyprus is assessed to face low fiscal sustainability risk because both indicators, the S2 sustainability gap indicator and the DSA, show low risk in the long-term.

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

Time frame			Current PPS review (autumn 2019)		Sixth PPS review (spring 2019)	
Short-term			**Low risk**		**HIGH risk**	
S0 indicator [1]			0.45		0.54	
Fiscal subindex			0.23	LOW risk	0.5	HIGH risk
Financial & competitiveness subindex			0.57	HIGH risk	0.6	HIGH risk
Medium-term			**LOW risk**		**MEDIUM risk**	
DSA [2]			LOW risk		MEDIUM risk	
S1 indicator [3]			-2.4	LOW risk	-0.7	LOW risk
of which	Initial Budgetary Position		-4.0		-2.8	
	Debt Requirement		1.8		2.2	
	Cost of Ageing		-0.2		-0.1	
	of which	Pensions	0.5		0.5	
		Health care	0.1		0.1	
		Long-term care	0.0		0.0	
		Other	-0.8		-0.7	
Long-term			**LOW risk**		**MEDIUM risk**	
DSA [2]			LOW risk		MEDIUM risk	
S2 indicator [4]			-0.7	LOW risk	-0.7	LOW risk
of which	Initial Budgetary Position		-1.6		-1.6	
	Cost of Ageing		0.9		0.9	
	of which	Pensions	1.7		1.7	
		Health care	0.3		0.2	
		Long-term care	0.2		0.2	
		Other	-1.2		-1.3	

Note: the 'Commission' no-policy-change scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' autumn 2019 forecast until 2021. Age-related expenditure as given in the 2018 Ageing Report.

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

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

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

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

* For more information see Fiscal Sustainability Report 2018.

Source: European Commission

Maintaining sound public finances and sustaining growth-enhancing structural reforms remains essential for ensuring a sustainable downward path of the public debt. While on a declining trend, the government debt is sensitive to adverse shocks that generate uncertainties surrounding its projected path, as indicated by the adverse DSA scenarios and stochastic projections. In view of these risks and given the still high level of public debt, increased explicit contingent liabilities in relation to the financial sector and large NPLs, Cyprus will benefit from sustaining its strong fiscal performance.

ANNEX 2

European Commission macroeconomic and fiscal projections (2019 Autumn Forecast)

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

	2015	2016	2017	2018	2019	2020	2021
Real economy			*(percent change)*				
Real GDP	3,4	6,7	4,4	4,1	2,9	2,6	2,3
Domestic demand incl. inventories	2,1	8,0	7,2	2,5	6,7	5,3	3,4
Private consumption expenditure	2,8	4,4	4,5	3,3	3,8	2,7	2,5
Government consumption expenditure	0,5	-0,9	2,1	3,5	8,7	11,7	3,7
Gross fixed capital formation	-0,2	48,9	24,1	-6,6	14,7	8,3	6,0
Exports of goods and services	9,9	7,2	8,7	4,6	-2,5	-1,3	0,7
Imports of goods and services	8,1	9,0	12,8	2,4	2,6	2,5	2,5
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	2,0	9,0	7,6	1,3	6,6	5,4	3,6
Foreign trade	1,3	-1,1	-2,7	1,6	-3,7	-2,8	-1,3
Changes in inventories	0,1	-1,2	-0,5	1,2	0,0	0,0	0,0
Inflation			*(percent change)*				
GDP deflator	-0,9	-0,8	1,7	1,4	1,5	1,5	1,7
HICP	-1,5	-1,2	0,7	0,8	0,6	0,7	1,3
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	15,0	13,0	11,1	8,4	7,2	6,3	5,7
Employment	1,6	4,7	5,3	4,1	2,5	2,2	1,8
Compensation per employee	-1,4	-0,9	1,0	0,5	3,4	3,1	3,0
Labour productivity	1,8	2,0	-0,9	0,0	0,4	0,5	0,5
Unit labour costs	-3,1	-2,9	1,9	0,6	3,0	2,7	2,5
Public finance			*(percent of GDP)*				
General government balance	-1,0	0,1	1,7	-4,4	3,7	2,6	2,4
Total revenue	39,7	37,7	38,6	39,2	41,6	44,0	44,3
Total expenditure	40,6	37,6	36,9	43,6	37,9	41,4	41,9
General government primary balance	2,2	2,8	4,2	-2,0	6,0	4,6	4,1
Gross debt	107,5	103,4	93,9	100,6	93,8	87,8	81,8
Balance of payments			*(percent of GDP)*				
Current external balance	-0,5	-4,2	-5,1	-4,4	-8,1	-10,6	-11,1
Ext. bal. of goods and services	2,6	1,7	-0,4	0,8	-2,8	-5,4	-6,4
Exports goods and services	70,3	70,8	73,0	73,1	69,3	66,5	65,3
Imports goods and services	67,7	69,0	73,4	72,3	72,1	72,0	71,7
Balance of services	20,8	23,8	24,6	22,9	21,8	20,1	19,9
Balance of goods	-18,2	-22,1	-25,0	-22,1	-24,7	-25,6	-26,3
Balance of primary income	-0,7	-4,0	-3,0	-3,5	-3,5	-3,5	-3,5
Balance of secondary income	-2,4	-1,9	-1,7	-1,7	-1,7	-1,6	-1,1
Memorandum item			*(EUR bn)*				
Nominal GDP	17,8	18,9	20,0	21,1	22,1	23,0	23,9

Source: European Commission

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

percent change unless otherwise stated	2015	2016	2017	2018	2019	2020	2021
1. Private consumption expenditure	2,8	4,4	4,5	3,3	3,8	2,7	2,5
2. Government consumption expenditure	0,5	-0,9	2,1	3,5	8,7	11,7	3,7
3. Gross fixed capital formation	-0,2	48,9	24,1	-6,6	14,7	8,3	6,0
4. Domestic demand excl. inventories	2,0	9,3	7,6	1,3	6,7	5,3	3,4
5. Changes in inventories (contr. to growth)	0,1	-1,2	-0,5	1,2	0,0	0,0	0,0
6. Domestic demand incl. inventories	2,1	8,0	7,2	2,5	6,7	5,3	3,4
7. Exports of goods and services	9,9	7,2	8,7	4,6	-2,5	-1,3	0,7
7a. - of which goods	7,0	-8,9	4,7	31,8	-9,5	0,0	0,1
7b. - of which services	10,8	12,0	9,7	-1,7	-0,4	-1,7	0,9
8. Final demand	5,2	7,7	7,8	3,4	2,8	2,6	2,4
9. Imports of goods and services	8,1	9,0	12,8	2,4	2,6	2,5	2,5
9a. - of which goods	6,6	11,1	13,7	4,7	4,0	3,9	3,8
9b. - of which services	9,8	6,9	11,9	-0,2	1,0	0,9	0,8
10. GDP at market prices	3,4	6,7	4,4	4,1	2,9	2,6	2,3
(Contribution to change in GDP)							
11. Final domestic demand	2,0	9,0	7,6	1,3	6,6	5,4	3,6
12. Changes in inventories	0,1	-1,2	-0,5	1,2	0,0	0,0	0,0
13. Net exports	1,3	-1,1	-2,7	1,6	-3,7	-2,8	-1,3

Source: European Commission

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

percent change unless otherwise stated	2015	2016	2017	2018	2019	2020	2021
1. Private consumption expenditure	0,8	2,8	5,4	5,0	4,4	3,4	3,8
2. Government consumption expenditure	0,0	-1,3	4,0	4,9	14,1	16,6	6,0
3. Gross fixed capital formation	0,6	48,9	26,1	-4,5	16,2	9,8	7,6
4. Domestic demand excl. inventories	0,6	8,1	8,9	3,0	8,2	6,8	5,0
5. Changes in inventories	0,1	-1,2	-0,5	1,2	0,0	0,0	0,0
6. Domestic demand incl. inventories	0,7	6,9	8,4	4,3	8,2	6,8	5,0
7. Exports of goods and services	8,9	6,5	9,6	5,6	-1,1	0,1	2,1
7a. - of which goods	7,8	-9,8	5,2	32,1	-8,5	1,2	1,3
7b. - of which services	9,3	11,3	10,6	-0,5	1,2	-0,2	2,3
8. Final demand	4,0	6,7	8,9	4,8	4,2	4,1	3,9
9. Imports of goods and services	6,4	8,0	12,9	3,9	4,1	4,0	3,6
9a. - of which goods	2,8	10,5	14,5	7,0	5,6	5,5	5,0
9b. - of which services	10,3	5,3	11,1	0,4	2,3	2,3	1,8
10. Gross national income at market prices	4,5	2,3	7,2	4,9	4,4	4,2	4,0
11. Gross value added at basis prices	2,4	5,8	5,2	5,1	4,6	4,4	4,3
12. Gross domestic product at market prices	2,4	5,9	6,2	5,5	4,4	4,2	4,1

Source: European Commission

Table A2.4: **Implicit deflators**

percent change	2015	2016	2017	2018	2019	2020	2021
1. Private consumption expenditure	-2,0	-1,5	0,9	1,7	0,6	0,8	1,3
2. Government consumption expenditure	-0,6	-0,4	1,8	1,4	5,0	4,4	2,2
3. Gross fixed capital formation	0,8	0,0	1,6	2,3	1,3	1,4	1,5
4. Domestic demand incl. inventories	-1,4	-1,1	1,2	1,7	1,4	1,5	1,5
5. Exports of goods and services	-0,9	-0,6	0,8	1,0	1,5	1,4	1,4
6. Final demand	-1,2	-0,9	1,0	1,4	1,4	1,5	1,4
7. Imports of goods and services	-1,6	-1,0	0,1	1,5	1,4	1,5	1,1
8. Gross domestic product at market prices	-0,9	-0,8	1,7	1,4	1,5	1,5	1,7
HICP	-1,5	-1,2	0,7	0,8	0,6	0,7	1,3

Source: European Commission

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

percent change	2015	2016	2017	2018	2019	2020	2021
1. Labour productivity	1,8	2,0	-0,9	0,0	0,4	0,5	0,5
2. Compensation per employee	-1,4	-0,9	1,0	0,5	3,4	3,1	3,0
3. Unit labour costs	-3,1	-2,9	1,9	0,6	3,0	2,7	2,5
4. Total population	-0,6	0,5	0,9	1,2	0,7	0,8	0,9
5. Population of working age (15-64 years)	-1,6	-0,1	0,5	0,3	0,3	0,4	0,4
6. Employment	1,6	4,7	5,3	4,1	2,5	2,2	1,8
7. Unemployment rate (1)	15,0	13,0	11,1	8,4	7,2	6,3	5,7

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

Table A2.6: **External balance**

EUR bn unless otherwise stated	2015	2016	2017	2018	2019	2020	2021
1. Exports of goods (fob)	2,9	2,6	2,7	3,6	3,3	3,3	3,4
2. Imports of goods (fob)	6,1	6,8	7,7	8,3	8,7	9,2	9,7
3. Trade balance (goods, fob/fob) (1-2)	-3,2	-4,2	-5,0	-4,7	-5,4	-5,9	-6,3
3.1 p.m. (3) as % of GDP	-18,2	-22,1	-25,0	-22,1	-24,7	-25,6	-26,3
4. Exports of services	9,7	10,8	11,9	11,8	12,0	12,0	12,2
5. Imports of services	6,0	6,3	7,0	7,0	7,2	7,3	7,5
6. Service balance (4-5)	3,7	4,5	4,9	4,8	4,8	4,6	4,8
6.1 p.m. (6) as % of GDP	20,8	23,8	24,6	22,9	21,8	20,1	19,9
7. External balance of goods and services (3+6)	0,5	0,3	-0,1	0,2	-0,6	-1,3	-1,5
7.1 p.m. (7) as % of GDP	2,6	1,7	-0,4	0,8	-2,8	-5,4	-6,4
8. Balance of primary and secondary incomes	-0,5	-1,1	-0,9	-1,1	-1,2	-1,2	-1,1
8.1 - of which, balance of primary income	-0,1	-0,8	-0,6	-0,8	-0,8	-0,8	-0,8
8.2 - of which, balance of secondary income	-0,4	-0,4	-0,3	-0,4	-0,4	-0,4	-0,3
8.3 p.m. (8) as % of GDP	-3,1	-5,9	-4,7	-5,2	-5,3	-5,2	-4,7
9. Current external balance (7+8)	-0,1	-0,8	-1,0	-0,9	-1,8	-2,4	-2,6
9.1 p.m. (9) as % of GDP	-0,5	-4,2	-5,1	-4,4	-8,1	-10,6	-11,1
10. Net capital transactions	0,0	0,0	0,1	0,1	0,2	0,2	0,2
11. Net lending (+)/net borrowing (-) (9+10)	-0,1	-0,8	-0,9	-0,8	-1,6	-2,3	-2,5
11.1 p.m. (11) as % of GDP	-0,4	-4,1	-4,7	-3,8	-7,1	-9,9	-10,3

Source: European Commission

Table A2.7: **Fiscal accounts**

	2015	2016	2017	2018	2019	2020	2021
			levels, EUR m				
Taxes on production and imports	2.626	2.757	3.076	3.329	3.396	3.509	3.627
Taxes on income and wealth	1.765	1.759	1.840	1.925	2.088	2.172	2.257
Social contributions	1.483	1.545	1.710	1.847	2.462	3.271	3.516
Other current resources	1.095	1.012	1.014	1.063	1.041	1.039	1.070
Total current revenue	6.969	7.072	7.639	8.163	8.986	9.991	10.469
Capital transfers received	101	43	89	125	186	130	130
Total government revenue	7.069	7.115	7.728	8.287	9.172	10.120	10.599
Compensation of employees	2.280	2.269	2.364	2.483	2.730	2.956	3.158
Intermediate consumption	676	654	720	806	876	890	912
Social transfers	2.468	2.564	2.620	2.709	3.106	4.019	4.302
Interest payments	566	504	509	510	497	456	414
Subsidies	72	97	55	60	66	66	66
Other current expenditure	464	398	464	462	489	521	547
Total current expenditure	6.525	6.487	6.732	7.030	7.764	8.908	9.399
Total capital expenditure	717	612	664	2.184	587	606	626
Total government expenditure	7.243	7.098	7.396	9.213	8.350	9.513	10.024
General government balance	-173	17	333	-926	822	607	575
General government primary balance	393	521	841	-416	1.319	1.063	988
			% of GDP				
Taxes on production and imports	14,7	14,6	15,3	15,7	15,4	15,3	15,2
Taxes on income and wealth	9,9	9,3	9,2	9,1	9,5	9,5	9,4
Social contributions	8,3	8,2	8,5	8,7	11,2	14,2	14,7
Other current resources	6,1	5,4	5,1	5,0	4,7	4,5	4,5
Total current revenue	39,1	37,5	38,1	38,6	40,7	43,5	43,8
Capital transfers received	0,6	0,2	0,4	0,6	0,8	0,6	0,5
Total government revenue	39,7	37,7	38,6	39,2	41,6	44,0	44,3
Compensation of employees	12,8	12,0	11,8	11,7	12,4	12,9	13,2
Intermediate consumption	3,8	3,5	3,6	3,8	4,0	3,9	3,8
Social transfers	13,8	13,6	13,1	12,8	14,1	17,5	18,0
Interest payments	3,2	2,7	2,5	2,4	2,3	2,0	1,7
Subsidies	0,4	0,5	0,3	0,3	0,3	0,3	0,3
Other current expenditure	2,6	2,1	2,3	2,2	2,2	2,3	2,3
Total current expenditure	36,6	34,4	33,6	33,3	35,2	38,8	39,3
Total capital expenditure	4,0	3,2	3,3	10,3	2,7	2,6	2,6
Total government expenditure	40,6	37,6	36,9	43,6	37,9	41,4	41,9
General government balance	-1,0	0,1	1,7	-4,4	3,7	2,6	2,4
General government primary balance	2,2	2,8	4,2	-2,0	6,0	4,6	4,1
Memorandum item							
Nominal GDP (billion euro)	17,8	18,9	20,0	21,1	22,1	23,0	23,9

Source: European Commission

Table A2.8: **Debt developments**

	2015	2016	2017	2018	2019	2020	2021
Gross debt (% of GDP)	107,5	103,4	93,9	100,6	93,8	87,8	81,8
Real GDP growth (% change)	3,4	6,7	4,4	4,1	2,9	2,6	2,3
Nominal GDP (EUR bn)	17,8	18,9	20,0	21,1	22,1	23,0	23,9
General government balance (% of GDP)	-1,0	0,1	1,7	-4,4	3,7	2,6	2,4
Change in gross debt ratio (pps change)	-1,7	-4,1	-9,5	6,7	-6,7	-6,0	-6,0
	Contribution to the change in stock						
Primary balance	-2,2	-2,8	-4,2	2,0	-6,0	-4,6	-4,1
Snow-ball effect	0,6	-3,3	-3,4	-2,4	-1,9	-1,7	-1,7
of which							
Interest expenditure	3,2	2,7	2,5	2,4	2,3	2,0	1,7
Real growth effect	-3,6	-6,9	-4,2	-3,6	-2,8	-2,4	-2,0
Inflation effect	1,0	0,8	-1,7	-1,2	-1,4	-1,3	-1,4
Stock-flow adjustments	-0,1	1,9	-1,8	7,2	1,2	0,4	-0,2

Source: European Commission

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