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From:	Kornelios S. Korneliou, Permanent Representation of the Republic of Cyprus to the European Union
date of receipt:	13 May 2016
To:	Mr Carsten PILLATH, Director General, Council of the European Union
Subject:	Stability Programme of Cyprus 2016-2019

Delegations will find attached the Stability Programme of Cyprus 2016-2019.

E-MAIL / ~~FAX~~

SECRÉTARIAT GÉNÉRAL DU CONSEIL DE L'UNION EUROPÉENNE
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PERMANENT REPRESENTATION OF THE REPUBLIC OF CYPRUS
TO THE EUROPEAN UNION

Ref. no.: 04.02.002.013.001

Brussels, 13 May 2016

Dear Mr. Pillath, Dear Carsten,

Republic of Cyprus – Stability Programme 2016-2019

Regarding the above mentioned issue, please find attached a hard copy of the Stability Programme (SP) of the Republic of Cyprus for the period 2016-19, in accordance with the provisions of the Stability and Growth Pact. It is noted that the SP has been prepared in line with the updated Code of Conduct, which sets out the "Guidelines on the format and content of the Stability and Convergence Programmes".

I remain at your disposal for any further information you may need.

Yours sincerely

Kornelios S. KORNELIOU

Mr. Carsten PILLATH
Director-General
General Secretariat of the Council

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Ministry of Finance

Stability Programme 2016-2019

May 2016

CONTENTS

INTRODUCTION

In accordance with the provisions of the Stability and Growth Pact, the Republic of Cyprus submits its Stability Programme (SP) for the period 2016-2019 as approved by the Council of Ministers on 13th May 2016. The SP has been prepared in line with the updated Code of Conduct, which sets out the "Guidelines on the format and content of the Stability and Convergence Programmes". The SP has also been prepared in the context of the European Semester, which gives a clear ex ante dimension to economic policy coordination at EU level and it takes into account the key policy orientations provided in the Annual Growth Survey.

The SP shall be considered as the national medium-term fiscal plan in the sense of Regulation 473/2013 and should be read in conjunction with the National Reform Programme (NRP), which sets out a broad range of structural reform measures and national targets within the context of the EU2020 Strategy. As required by the European Semester, the SP and the NRP have been simultaneously composed and presented to the European Commission.

In this context, the budgetary developments and targets in the SP are consistent with the structural reforms and policy ambitions set out in the NRP. The same holds for the macroeconomic outlook. Inevitably, this leads to a certain degree of overlap between the two documents. The SP elaborates in much greater detail on the macroeconomic outlook and budgetary plans, while the NRP mostly focuses on the various policy measures and reforms in the framework of the priorities of the EU2020 strategy. Where appropriate, cross references are included in both documents.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Cyprus exited its EU-IMF macroeconomic adjustment programme in March 2016, without a backstop successor arrangement. The overall implementation of the programme by the Cypriot authorities was generally acknowledged by peers as very successful and can be attributed to the sheer determination and commitment exhibited by the Cyprus authorities and also, very importantly, the public. The programme met its key objectives, with particular reference to the major reforms implemented in the financial sector which restructured the whole banking sector, strengthening its regulatory and supervisory framework, improving its capital and adequacy ratios leading to improved viability and confidence prospects. Combined with the structural reforms implemented across policy areas, public finances having been set on a sustainable path, and the increased confidence encouraged by the implementation momentum of the programme was reflected in the return of Cyprus to the international capital markets a year in the programme period and the return of the economy to positive growth, with encouraging signs in the labour market.

This Stability Programme outlines the fiscal policy strategy for the period 2016-2019 under the macroeconomic scenario adopted by the government and sets out the main objectives which, in a nutshell, are the entrenchment of growth and job creation leading to improved prosperity of the population. Therefore, with the exit from the programme, the overall policy framework remains focused on macroeconomic stability, sound public finances, leading to a gradual and sustained reduction of the high levels of debt to GDP boosting growth and confidence in the Cyprus economy, but also in achieving and maintaining an investment grade safeguarding a sustained market access at affordable rates. Especially regarding the latter, an additional factor that will affect success in achieving investment grade is to keep up the momentum in the progress achieved in the financial sector challenges, especially where non-performing loans are concerned, an area where substantial steps have been taken and are expected to provide results in the coming years.

The macroeconomic and fiscal forecasts underlying this Programme have been submitted to the Fiscal Council for endorsement and the Council concluded that the headline GDP and budget balance figures as forecast by the Ministry of Finance are considered realistic for the programming period under consideration.

Fiscal Policy Objectives

The objective of the government's fiscal policy for 2016-2019 is to follow a broadly neutral, countercyclical fiscal stance, allowing automatic stabilizers to operate freely. At the same time, the aim is to maintain high primary surpluses, through the containment of expenditure growth, allowing for the ratio of debt to GDP to decline at a satisfactory pace. In this respect, the developments in the composition of public expenditure for the medium-term concentrate on environmental and social protection, while taking into account the factors impacting on the expenditure concerning health and education sectors. Expenditure on compensation of employees is contained by the application of administrative rules in the evolution of this expenditure category, in the context of the Public Administration Reform and the new COLA framework. Automatic stabilizers are also expected, during the medium-term, to affect especially social protection expenditure items.

The path in the public revenues as a percentage of GDP is mainly governed by the free operation of automatic stabilizers on the revenues from taxation and social contributions. Furthermore, the government policy aims at increased revenue-collection efficiency from the unified Tax Department, as well as through the promotion of an improved regulatory and administrative framework for businesses and investors.

From an institutional perspective, the Budget of 2016 as well as the Medium Term Budgetary Framework 2016-2018 have been prepared according to the provisions of the Fiscal Responsibility and Budget Systems Law of 2014 (N. 20 (I) / 2014) (Umbrella-Law). Among others, the Law institutionalizes robust procedures in the management of public finances, provides for the implementation of a medium term budgetary framework and a shift towards Activity-Based Budgeting (ABB). The Law also provides increased flexibility and accountability to each line ministry in exercising its available financial and human resources to implement their strategic objectives within strict and legally binding expenditure ceilings. In order to ensure impartial fiscal policy, transparency and accountability, the above Law also provides for the establishment and operation of an independent Fiscal Council, which assesses the macroeconomic forecasts and monitors compliance with fiscal rules in the preparation and execution of the budget.

Structural Reform Agenda

In line with the EU priorities, Cyprus is continuing with its structural reform agenda that begun in the context of the macroeconomic adjustment programme, in order to support sustainable growth, in the areas of:

➢ *Pension Reform*

Substantial reforms were introduced, both for the Government Employee Pension Scheme (GEPS) and the General Social Insurance Scheme (GSIS). According to the results of the actuarial study which were peer reviewed in the Ageing Working Group of the Economic Policy Committee in September 2013, the reforms adequately addressed the issue of the high projected increase in pension spending and secured the long-term financial viability of the pension system through 2060.

The reforms included, inter alia:

- for the GSIS: (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012) ;
- for the GEPS: (i) increase the statutory retirement age by 2 years for the various categories of employees; (ii) increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; (iii) while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iv) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; (v) introduce a change of indexation of all benefits from wages to prices; and (vi) pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013);

- total annual public pension benefits for public sector employees and state officials were capped at 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (in place since January 2013);
- pension entitlements that accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees have the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013); and

➢ *Welfare Reform*

The social welfare reform was explicitly aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and better targeting of benefits to ensure public support for those most in need, including the working poor while at the same time respecting the budgetary targets set.

The reform was achieved through:

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance;
- improving the targeting of benefits; and
- providing work incentives to avoid welfare dependency.

To this end, the Cypriot authorities undertook the following steps:

- the level, composition and the eligibility criteria of the new guaranteed minimum income scheme (GMI) was defined on the basis of the level of the minimum consumption basket covering basic needs in order to achieve a decent standard of living, which replaced the outdated public assistance scheme;
- the means testing mechanism was refined by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria across different benefit schemes;
- to eliminate fragmentation all the relevant competences and responsibilities related to the administration and provision of all social benefits were transferred to the Ministry of Labour and Social Insurance.

➢ *Wage Indexation System (COLA) Reform*

To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the wage-setting framework is being reformed in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector was transformed.

In more detail, for the duration of the macroeconomic adjustment programme, wage indexation in the public sector has been suspended until the end of 2016. Starting from 2017, wage indexation in the public sector will follow the reformed framework with a change in the frequency of indexation from twice a year to once a year and a change from full indexation to partial indexation of 50%. A mechanism for automatic suspension of application and derogation procedures during adverse economic conditions has been embedded, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation will be effected for the following year.

In the private sector, suspension of COLA for the same duration was also applied. However, from the reforms agreed for the public sector, only the lower frequency of indexation has been agreed to be applied in the private sector, whereas no general agreement has been reached on the change from full indexation to partial indexation (at 50% of inflation).

➢ *Public administration reform*

This reform aims at introducing a more transparent and effective Human Resource Management Framework which includes, inter alia, a revised appointment, appraisal and promotion system, enhanced labour mobility, within the Central Government and across Government organisations, as well as establishing a wage setting mechanism that will contain the overall wage bill growth to below nominal GDP growth. The relevant Bills have been submitted to the House of Representatives and deliberations are ongoing the discussion is expected to be completed after the Parliamentary elections and after the formation of the new Parliament has been completed.

➢ *Immovable Property Tax Reform (IPT)*

In order to improve the fairness of the tax burden and to increase the efficiency of the tax administration, the Cypriot Authorities have conducted a General Valuation for all immovable properties based on the January 1st, 2013 prices, with a view to adopting legislation introducing a revamped immovable property tax framework based on the consolidation of property taxes, at all levels of government in conjunction with a reduction in fees for immovable property transfers. These reforms entail the reallocation of the tax burden from the transaction in property to the use of property, thus encouraging investment and development. More specifically the Immovable Property Tax is envisaged to be applied on a wider tax base, thus allowing for the reduction of the tax burden on households and business while promoting considerably less progressive rates reducing thus the bias against property development. In tandem, the legal framework also specifies the frequency of the mandatory update of the cadastral values every three years thus enhancing equity and fairness.

➢ *Local authorities reform*

In order to face the weaknesses inherent within the current fragmented model of local administration, the Government has devised and proposed to stakeholders a reform framework aiming at the sustainable development of local government. The reform is based on the principle of "compulsory clustering" that will provide the grounds for unified service delivery by strengthening both capacity and accountability. Given the broader synergies and economies of scale, local authorities will be able to offer a wider range of services in a more efficient and effective manner, responding directly at a reduced administrative cost to the needs of citizens and businesses. Thus the reform is expected to create a better environment for citizens, without altering the character or cultural identity of each local community.

- *Autonomisation of public hospitals*

The Cyprus government is in the process of reforming the health sector in Cyprus, so as to create a National Health Insurance System (NHIS) with universal coverage. The aim is to provide high quality health care for all, based on equity and solidarity, in a financially sustainable way, while ensuring free choice of medical providers for all beneficiaries. In order to equip public health care providers with the tools to compete in the NHIS market, without imposing extra burden on public finances, the first step is their transformation into autonomous entities with increased independence, transparency and accountability. It is acknowledged that the autonomisation of public hospitals requires substantial changes that need time to be implemented properly and, therefore, it is a step that has to precede the introduction of the NHIS in Cyprus. To this end, an autonomisation Bill will be concluded in the first semester of 2016, along with a specific road-map for the gradual implementation of the NHIS.

2. ECONOMIC OUTLOOK

2.1 MACROECONOMIC DEVELOPMENTS 2015

2.1.1 GLOBAL ECONOMY

According to the European Commission Winter Forecast 2016, world economic growth exhibited moderate deceleration in 2015 contained at 3.0%, compared to 3.3% the year before, with growth expected to regain momentum and moderately accelerate to 3.3% in 2016 and 3.5% in 2017. The EU continued to grow in 2015, with the real growth rate rising to 1.9%, from 1.4% in 2014. Similarly, the Euro-area economy grew at a rate of 1.6% in 2015 rising marginally from the rate of growth of 2014 of 0.9%. However, although no Member State recorded a recession, growth is still uneven across EU Member States, with Ireland, Malta and Luxemburg recording growth rates of 6.9%, 4.9% and 4.7% respectively, while Finland and Greece stagnated[1].

For two of the most significant trade partners of Cyprus, UK and Russia, the outlook is mixed. The economy of the UK grew by 2.3% in 2015 in contrast with 2.9% the year before, while Russia contracted by 3.7% in 2015, a marked deceleration from a marginally positive growth of 0.7% in 2014. For 2016 and 2017, economic growth in Russia is projected to -1.2% and 0.3% respectively, the main reasons being the domestic political instability, falling commodity prices and structural bottlenecks, with growth expected to marginally resume in 2017. In addition, the imposition of EU sanctions until the end of July 2016 is an additional impediment to growth of the Russian economy, with, however, some repercussions expected on the Cypriot economy.

Table I: External Assumptions, 2015-2019

	2015	2016	2017	2018	2019
Growth assumptions					
World growth excluding EU, GDP growth	3.2	3.4	3.7	3.7	3.7
EU GDP growth	1.9	1.9	2.0	2.0	2.0
US	2.4	2.3	2.2	2.2	2.2
Short-term interest rate (annual average, euro area)	-0.02	-0.25	-0.33	-	-
Long-term interest rate (annual average, euro area, 10-year government bonds, Germany)	0.50	0.27	0.44	0.44	0.44
USD/€ exchange rate (level)	1.11	1.09	1.09	1.09	1.09
Nominal effective exchange rate of the EU (% change)	-8.21	-0.17	-0.27	-	-
World import volumes, excluding EU	0.8	2.2	3.5	3.5	3.5
Oil prices (Brent. USD/barrel)	53.4	39.7	45.3	45.3	45.3

Source: Spring 2016 forecast assumptions and European Commission Winter Forecasts for EU GDP growth; for beyond 2017 remain unchanged.

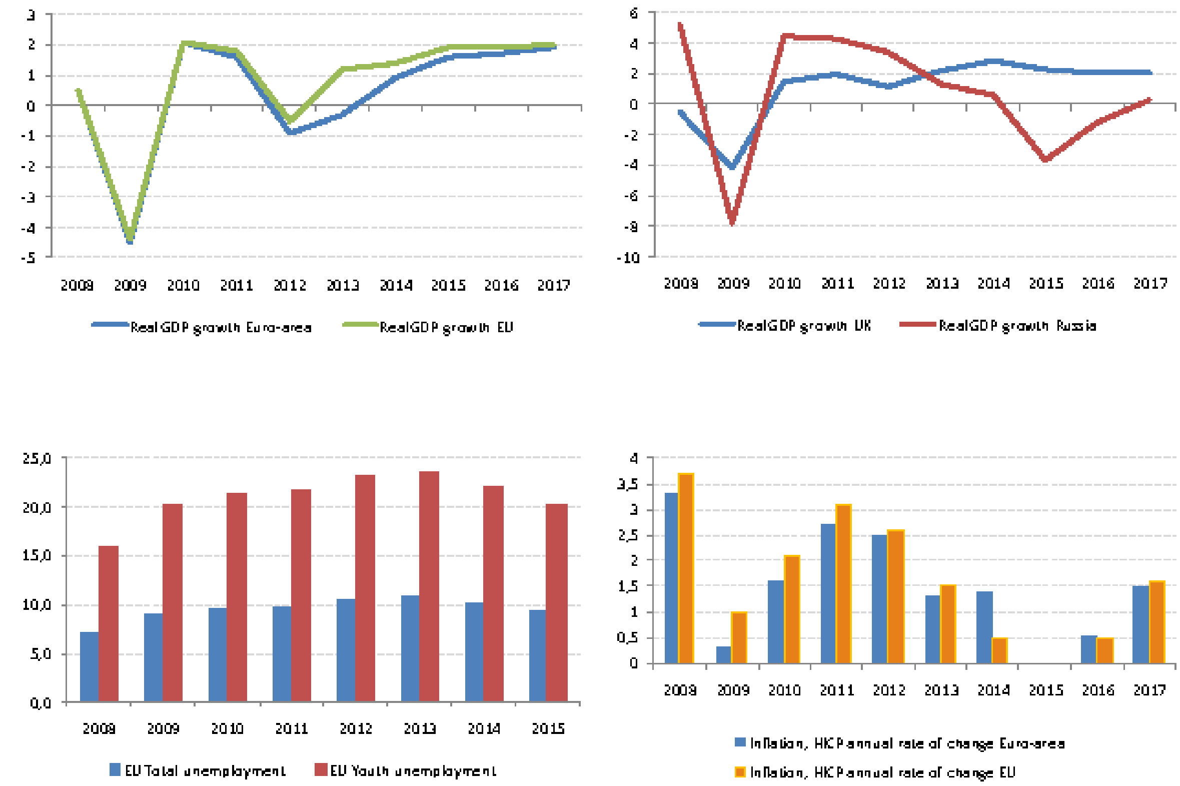
The unemployment rate in the EU remained at high levels, on average, in 2015, albeit it declined to 9.4% from 10.2% in 2014, indicating that the efforts for a return to growth and job creation have to some extent bared fruits.

[1] Eurostat has published updated figures for 2015 whish show a growth rate of 7.8% in Ireland, 6.3% in Malta and 4.8% in Luxemburg. Greece, on the other hand exhibits marginal recession at -0.2% and Finland marginal growth at 0.5%.

Inflation rate in the EU and the euro area remained low in 2015 at 0.0%, compared to 0.5% in 2014. The developments in the international price of oil are a significant reason for the low inflation rates, with deflation observed in a number of Member States in 2015. Inflation is expected to pick up pace, but only moderately in 2016 and 2017 at 0.5% and 1.6% respectively. The continued environment of low oil prices will weigh positively on the prospects of consumption growth, due to increased spending power by households.

The euro's exchange rate in relation to the Russian ruble appreciated significantly in 2015, due to the political developments in the Ukraine, making the European economy less competitive for the Russian market. On the other hand, competitiveness increased in relation to the UK and the US, since the euro depreciated in 2015 vis-à-vis the dollar and pound Sterling.

Figure 1: International macroeconomic indices



2.1.2 DOMESTIC ECONOMY

According to latest estimates published on 18th March 2015, the economy grew by 1.6% in real terms in 2015, following a three-year contraction. This positive outturn marks the exit of Cyprus from the macroeconomic adjustment programme, indicating that stabilization factors have started producing results in the economy, attributed inter alia to sound economic policies and structural efforts exerted under the macroeconomic adjustment programme as well as the overall improvement in the levels of confidence.

Growth in 2015 was driven by domestic demand. Domestic demand grew by 2.9%, mainly driven by private consumption expenditure which, grew by 1.9% in real terms. Gross fixed capital formation expanded by 14.0%, making it the biggest contributor to growth, which is especially attributed to investment growth in transport equipment. Real imports grew by 4.0% mirroring trend of domestic demand, while real exports also grew by 1.9%.

From a sectoral perspective, the economy grew mainly due to the strong performance of tourism and business services. In more detail, economic growth is mainly attributed to the sectors of administrative and support service activities (6.2%), accommodation and food service activities (5.1%) and professional scientific and technical activities (4.5%). Other sectors also exhibited significant positive growth, including financial service activities (2.5%) and manufacturing (2.2%).

Table II: Selected economic indicators, 2013-2015, y-o-y %

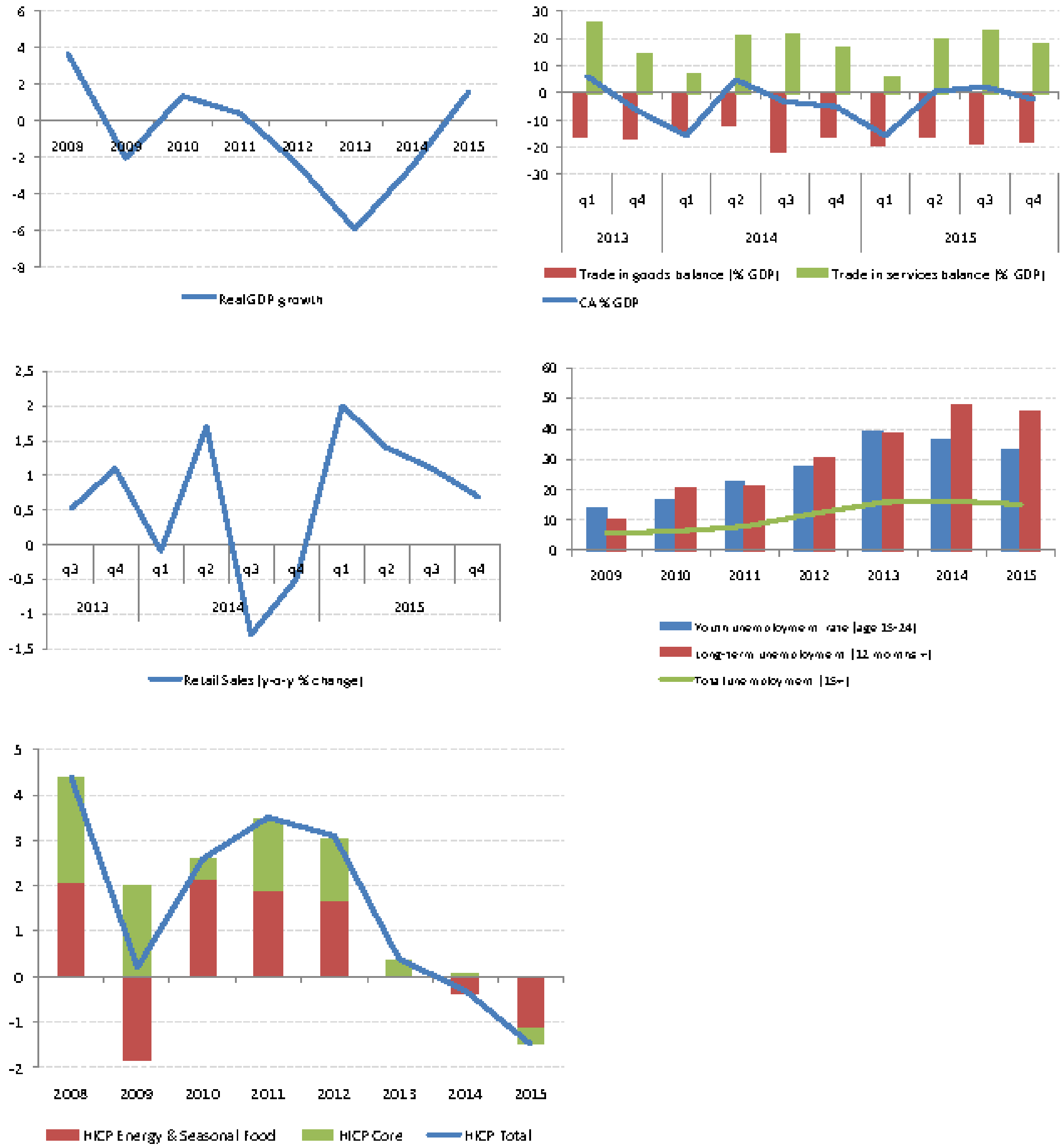
	2013	2014	2015
GDP (constant prices)	-5.9	-2.5	1.6
Public consumption	*-4.1*	*-9.0*	*1.1*
Private consumption	*-5.9*	*0.6*	*1.9*
Gross Fixed Capital Formation	*-15.2*	*-18.0*	*14.0*
Exports	*1.8*	*-0.5*	*1.9*
Imports	*-3.0*	*2.0*	*4.0*
Tourist arrivals (000's)	2,405.4	2,441.2	2,659.4
Tourist arrivals growth	-2.4	1.5	8.9
HICP	0.4	-0.3	-1.5
Labour productivity growth (persons)	0.0	-0.2	0.7
Employment growth	-6.0	-2.3	0.9
Compensation of employees	-9.4	-6.2	-0.2
Unemployment rate (Labour Force Survey)	15.9	16.1	15.0
Trade balance of goods (% of GDP)	-16.3	-16.2	-18.2
Trade balance of services (% of GDP)	17.4	16.9	16.8
Current account balance (% of GDP)	-4.5	-4.6	-3.6

The stabilization of the economy and return to economic growth is reflected in the marginally positive growth in employment in 2015, of around 0.9%. Employment growth was stronger in the business and administrative sectors of the economy, but also in the hotels and restaurants sector, as well as, arts and entertainment. The unemployment rate averaged around 15.0% of the labour force in 2015, after peaking at 16.1% in 2014.

Compensation of employees marginally contracted in 2015 by 0.2%, in contrast to a marked contraction by 9.4% in 2013 and by 6.2% in 2014. As a consequence, nominal unit labour costs continued to decrease in 2015 by 1.7%, in addition to previous reductions of 3.3% in 2014 and 2013.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), continued to decelerate in 2015 by 1.5% compared to a deflation of 0.3% in 2014. Deflation is driven by the developments in international oil prices, with a significant impact on energy prices in Cyprus. The HICP, excluding seasonal food and energy, decreased by 0.4%, compared to an increase of 0.1% in 2014 and 0.4% in 2013.

Figure 2: Economic trends



According to the latest provisional balance of payments data for 2015, the current account recorded a deficit of €634,2 million, or -3.6% of GDP, compared with a deficit of €791,5 million in 2014, or -4.6% in 2014, mainly due to developments in the income account. The trade balance of goods was at a deficit of €3,178.5 million in 2015 (-18.2% of GDP), which is an increased in comparison to a deficit of €2.812.2 million in 2014

(-16.2%). The trade balance of services was at a surplus of €2,933.7 million in 2015 (16.8% of GDP), remaining broadly unchanged compared to €2,933.0 million in 2014 (16.9% of GDP). The primary income account recorded a surplus of €60.5 million in 2015, compared to a deficit of €488.8 million in 2014. The surplus in the primary income account concerned mostly direct investment and portfolio investment income. The secondary income account continued to record a deficit in 2015 of €449.9 million, compared to a deficit of €423.5 million in 2014.

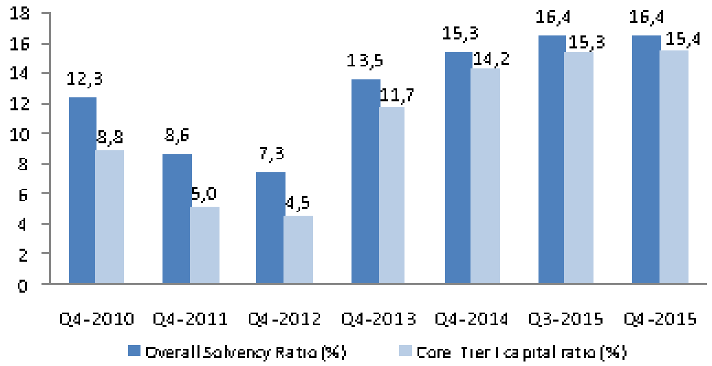
The international investment position of Cyprus in 2015 improved, reaching a net liability position of €22,507 million compared with €24,468 million in 2014, due to developments in direct and "other" investment. The negative position in the IIP is mainly driven by the liability positions in "other" and foreign direct investment. The external debt of Cyprus amounted to €102,488 million in 2015 compared with €97,327 million in 2014.

2.1.3 FINANCIAL SECTOR DEVELOPMENTS

Banking sector developments

The Cyprus banking sector is dominated by the three large domestic banks (Bank of Cyprus, Co-Operative Central Bank and Hellenic Bank) which collectively represent a share of 78% in total deposits while, the remaining market consists of the four Greek subsidiaries with a market share of 15% in total deposits and other smaller credit institutions.

Figure 3: Overall Solvency Ratio (%) and Core Tier I Capital Ratio (%) , aggregate banking sector



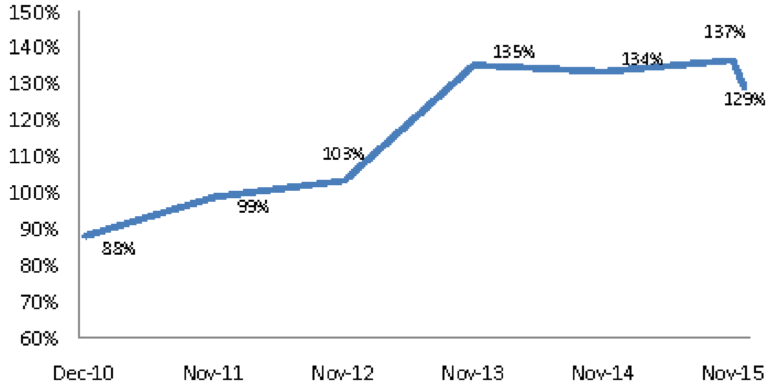
The three large domestic banks have been recapitalised in the last three years on the basis of an independent due diligence exercise conducted by an international firm under the direction and review of the ECB and IMF, the comprehensive assessment conducted in 2014 by the European Central Bank which included Asset Quality Reviews and Stress Tests as a precondition for the undertaking of the direct supervision of the systemically significant Eurozone banks and more recently as a result of the SREP exercise performed by the SSM. As part of the restructuring process, the infusion of equity capital and retained profits boosted overall solvency ratio across the Cypriot banking system by around 9 percentage points (Dec 12: 7.3% to Dec 15: 16.4%).

A significant downsizing of the Cypriot banking sector took place in the past three years. Total assets decreased from 631% of GDP end of 2012 to 420% in Dec 2015[2], as a result of the ring-fencing of the Cypriot operations of local banks through the sale of their Greek operations and certain other overseas subsidiaries, the decrease in domestic bank lending due to the deleveraging process and the substantial increase in the provisions for bad debts.

[2] Source: Central Bank of Cyprus

Prior to March 2013, the loan/deposit ratio was consistently lower than 100% which indicates that the Cypriot banking system's loans were funded by deposits. Following the "bail-in" of uninsured depositors in March 2013, where a substantial share of deposits was converted into equity as part of the recapitalisation of the two major banks and the withdrawal of deposits from the system that ensued, the loans/deposits ratio increased but it has recently stabilised.

Figure 4: Loans/deposits ratio



The parameters of the financial sector have shown substantial improvements and are now based on sounder fundamentals in terms of capitalization and liquidity. Banks' strategies are based on deleveraging through the disposal of non-core operations, focus on domestic operations (core businesses) and at the same time strengthening of their capital and liquidity positions.

The deposit base has remained broadly stable, and in recent months has risen moderately. The stabilisation of deposits contributed to the full abolishment of capital controls in April 6, 2015, which combined with the successful completion of the Banks Comprehensive Evaluation at the end of October 2014, marked the further strengthening of confidence in our banking system. The outstanding amount of deposits reached €46bln in Dec-15 recording a net increase of €203mln compared to €235mln in Jan-16. It is noted that net increase does not include changes due to reclassifications, foreign exchange and other adjustments.

Figure 5: Evolution of deposits (annual growth rates)

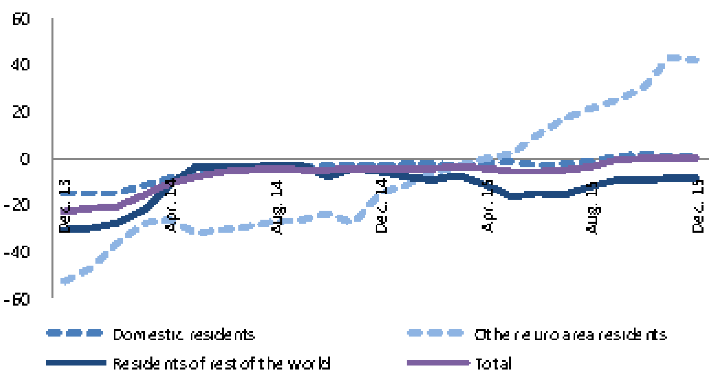
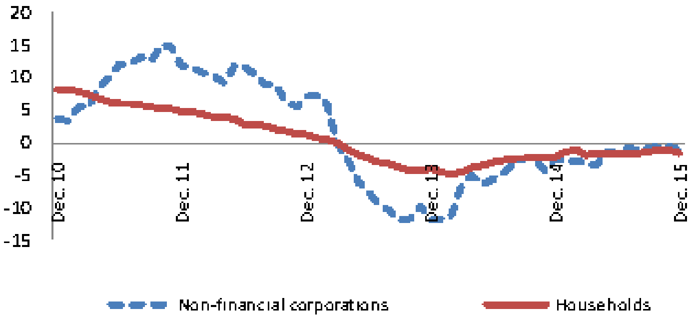


Figure 6: Loans to domestic non-financial corporations and households (annual growth rates %)

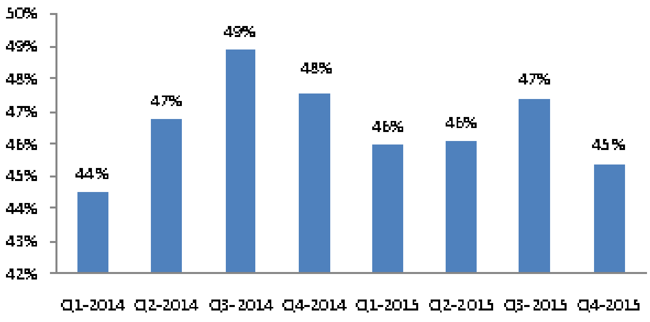


Total loans exhibit negative growth rates since May 2013. In Jan-16 the annual growth rate of total loans stood at -7.9% compared to -3.4% in Dec-15. The decrease is due to loan repayments of loans previously transferred from non-resident MFIs and is not related to the domestic economic activity. New lending remains weak due to banks' efforts to further deleverage and correct their balance sheets.

Non-performing facilities (NPFs)

The major challenge now faced by the banking system is the NPFs which as at end 2015 were estimated at 46% of total lending. Isolating lending which presents over 90 days past due (+90 dpd) the ratio drops to 36% of total lending.

Figure 7: NPFs/Gross Loans

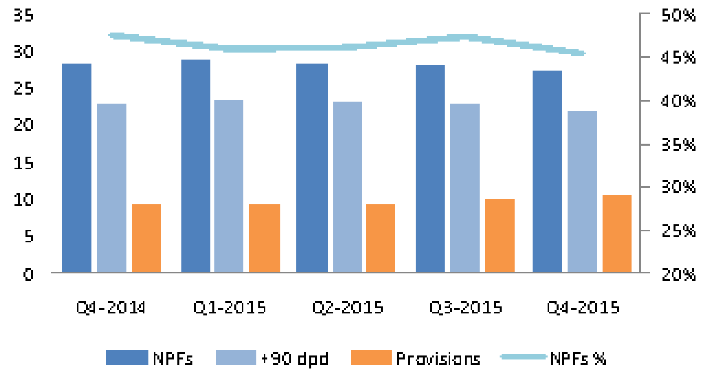


Banks have established internal arrangements and devoted substantial resources to deal with NPFs. NPFs are estimated to have reached their peak and the expectation is that a high percentage of restructured NPFs will be cured and moved to performing status thus gradually leading to a reduction in the NPF ratios. Based on the analysis of data on NPFs for local operations, total NPFs reached €26.685mln on 31 December 2015 compared to €27.328mln on 31 December 2014. It is noted that NPFs are classified based on the EBA harmonised definition which includes loans that have been restructured and, even though they meet the revised repayment program, retain the NPF status for at least 12 months after restructuring before they are moved to performing status. More prudent provisioning policies are implemented by credit institutions.

The restructuring activity has been escalating and performance of restructured loans has been recently improving. The CBC has recently imposed restructuring targets to banks aiming to incentivise them to increase the quantity and quality of restructurings of NPFs. The net restructured/forborne balances standing at the end of each month are affected, apart from the new restructurings, by the repayments and migrations out of the "forborne" category due to expiry of the observance period.

It is also noted that, according to the data collected by the CBC, 81% of fixed-term loans which were restructured between 1 January 2014 and 31 December 2015, abide by the new repayment schedule agreed as part of the restructuring. The data collected further reveals a migration during December 2015 of restructured loans from the category of non-performing to performing facilities, totaling €336mln following the successful completion of the observance period. This migration is in the right direction and the CBC aims, through the restructuring targets imposed on banks, to increase the amount of such migrations.

Figure 8: Non Perfmoming Facilities, €bln



In addition one of the targets set relates to early arrears management and aims to incentivise banks to act early on borrowers and contain the new NPF formation.

Accumulated provisions on lending represent 38.3% of NPFs reflecting the high level of collateral held for NPFs and the fact that heavy restructuring activity is being undertaken with a view to cure NPFs of viable customers and thus minimise credit losses. The provision coverage is estimated to have further increased through substantial additional provisions by the banks during the last quarter of 2015.

Regulation/Supervision

The legislation on solving the backlog of title deed transfers was adopted and the legislation on the sale of loans as well as the Law and Regulations for the transposition of the Deposit Guarantee Scheme Directive came into force.

A credit register covering all credit facilities from all credit institutions has been established and became operational since September 2014 facilitating banks in their credit decisions.

The institutional and legislative framework regarding NPFs has also been significantly improved.

The new Directive on Credit Granting and Review Processes of 2016 has been published by the CBC on 19th February 2016. The directive simplifies the procedures to be followed by banks for loans origination while keeping the repayment ability of the borrower as the primary criterion.

The legal framework on insolvency and foreclosure has been modernised providing incentives for borrowers and lenders to agree on restructuring solutions. Legislation has been passed to enable the sale of loans to third parties and a securitisation framework is being prepared that will add another tool in the arrears management tools that banks have in their hands.

The foreclosures framework has been modernized with a view to enhancing its effectiveness, incentivizing borrowers with an ability to pay to honour their obligations and speeding up the foreclosure process.

The legislative framework is being tested in practice and systematic monitoring has been put in place with a view to identify weaknesses.

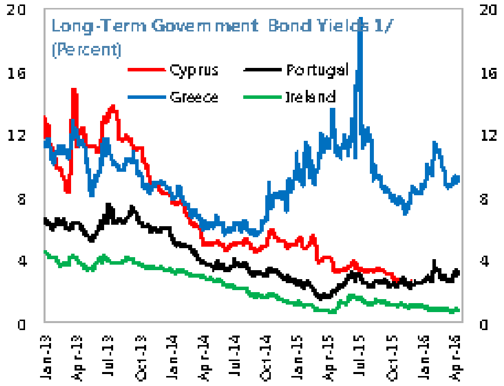
QE & Normal Monetary Operations

Cyprus has concluded its €10 billion bailout program with a better-than-expected performance in March 2016. According to ECB rules, which exclude non-investment-grade rated borrowers from the ECB's Quantitative Easing (QE) purchases unless a bailout programme-related waiver is in place, Cyprus is no longer eligible for QE support or for using Cyprus sovereign bonds as collateral in monetary policy operations.

However, the effects for Cypriot banks are expected to be modest, due to the successful exit of Cyprus from the adjustment program, the enhanced resilience of the economy and the improved confidence by investors.

Spreads

Government bond yield spreads for Cyprus have significantly decreased from January 2013 to May 2016, following an initial period of considerable volatility in 2013.



1/ 10-year government bonds. For Cyprus, longest maturity available for the time period.
Source: Bloomberg.

The latest developments indicate that despite the exclusion of the Republic from the QE program, the effects have so far been very moderate as spreads to Germany have actually narrowed slightly since the beginning of March 2016, dropping from 402 basis points on the 1st of March to 379 basis points on the 4th of May. As positive developments in the economy and subsequent improved ratings perceptions feed into the pricing calculations we expect both absolute yields and spreads to drop in the near term.

Insurance and Pension Funds

Based on the government's policy of strengthening and consolidating the supervision of insurance companies and occupational pension retirement funds, a study was conducted for the setting up of a new supervisory authority which will be responsible for the supervision of the two sectors. The study which was prepared by experts from a member state and from the European Insurance and Occupational Pensions Authority (EIOPA), analyses the needs and sets up the necessary steps for creating this new supervisory authority based on international best practices. The government is currently in the process of assigning the task to an appropriate Project Team which, prepare an action plan for the implementation of these recommendations. It is envisaged that the unified and strengthened supervisor, will help the industry and provide increased transparency and stability in the two sectors.

Financial Services Supervision

The government, under its clear policy direction to enhance the capabilities of the supervisory authorities, has worked with the Cyprus Securities and Exchange Commission (CySEC) for its capacity building. To that effect the human resources available for CySEC have increased substantially. At the same time CySEC has developed a Risk Based Supervision Framework which has been implemented in almost all Departments of CySEC in 2015. This framework has substantially improved the application of supervisory activities, as this is now more tailor made in addressing the risks involved in either entities or activities.

Investment funds

As from 2010 onwards the government has been working methodically in cooperation with the Cyprus Securities and Exchange Commission (CySEC) and the industry in preparing a modern legal framework for collective investments schemes. The framework that was created comprises of three laws, one on UCITS (2012) one on Alternative Investment Fund Managers (2013) and one on Alternative Investment Funds (2014).

This legal framework is reviewed periodically in order to meet new challenges of the sector and further enhance it. Currently, amending bills are being drawn, especially for the alternative investment funds law, with a view to help establish a funds industry in Cyprus in a well-regulated and supervised environment while at the same time, offering alternative means of financing to SMEs and other organisations.

Financial Leasing Framework

The House of Representatives has recently enacted the Financial Leasing Law of 2016, whose purpose is the creation of a new legal framework for the development of financial leasing services with adequate supervision and strict conditions, which will provide businesses and citizens with an alternative tool of financing. The benefits that arise from the said law are the following:

(a) Alternative means of financing where the legal owner is the leasing company or the bank, which consequently generates lower credit risks.

(b) It can help reduce non-performing loans by converting such loans to leasing contracts.

(c) More flexibility is provided to the lessee as he is not the owner of the lease hold (therefore he has possibility to terminate the lease) and he may have to pay lower rent (installment) due to lower credit risk of the leasing company or due to an increased acquisition price at the end of the lease period.

2.2 MACROECONOMIC OUTLOOK 2016-2019

2.2.1 GROWTH PROSPECTS 2016-2019

Medium-term Scenario 2016-2019

In the medium-term, the outlook of the economy is expected to continue to improve. Due to an environment of increased confidence and improved credit conditions, created by the restructuring of the banking system and the expected gradual improvement in the percentage of non-performing loans, as well as the gradual normalization in the labour market, growth is expected to accelerate in the forecast horizon of this Programme. The improved macroeconomic environment is expected to attract new investments. In addition, the fiscal adjustment that has been achieved enables the adoption of neutral fiscal policy stance providing boost to the already positive economic growth through the free operation of automatic stabilizers which are expected to continue to further contribute positively to the course of recovery.

Domestic demand is expected to continue growing, while employment is expected to continue increasing and unemployment gradually decreasing. Imports are expected to grow in line with consumption. All of the above, combined with the improved expectations regarding the investment opportunities provided in the energy and tourism sector, create a positive outlook for the Cyprus economy.

For 2016, the economy is estimated to grow in real terms at around 2.2%. This is primarily supported by a continued positive contribution of private consumption to growth, driven by an improvement in disposable income, due to inflation and employment expectations. In particular, energy prices are projected to continue decreasing, and where employment is concerned, the positive trend of 2015 is expected to continue in line with growth expectations. Potential output is estimated at 0.0%, indicating a reduced output gap, which still remains significant.

Growth is forecast to reach 2.5% in 2017 and remain at that level both in 2018 and 2019. Inflation, measured by HICP, is projected to climb to 0.5%, 1.6% and 2.0% in 2017, 2018 and 2019, respectively. Potential growth is estimated at 1.0% in 2017, 2.0% in 2018 and 2.0% in 2019.[3] Based on this scenario, the stabilization of the economy and the upswing in growth will gradually close the output gap towards the end of the medium-term horizon of the Stability Programme. Deflation is estimated to continue also in 2016, with HICP decreasing by 0.7%, and gain momentum in the years 2017-2019 in par with growth expectations for the economy.

Table III: Medium Term Framework, 2016-2015

Annual rate of change	2015	2016	2017	2018	2019
Real GDP	**1.6**	**2.2**	**2.5**	**2.5**	**2.5**
Gov. Consumption	*1.1*	*0.6*	*1.3*	*0.5*	*0.1*
Pr. Consumption	*1.9*	*1.9*	*1.9*	*2.4*	*2.6*
GFCF	*14.0*	*5.0*	*4.7*	*3.5*	*3.5*
Exports	*1.9*	*2.7*	*3.2*	*3.4*	*3.6*
Imports	*4.0*	*2.4*	*2.6*	*3.0*	*3.2*
Deflator	-1.4	-0.5	0.5	1.5	2.0
Nominal GDP	0.2	1.7	3.0	4.0	4.6
HICP	-1.5	-0.7	0.5	1.6	2.0
CPI	-2.1	-1.0	0.0	1.5	2.0
Employment	0.9	1.2	1.5	1.5	1.5
Unemployment	15.0	13.5	12.5	11.5	10.0
Compensation of employees	-0.2	1.2	2.0	2.5	3.0
Compensation per employee	-1.0	0.0	0.5	1.0	1.5

Following three years of negative potential output growth, potential output is estimated to shrink further by 1.3% in 2015, gaining pace from 2016 onwards as the economy is emerging out of the crisis. On average for the period 2016-2019, potential growth will average at 1.3%. The TFP contribution will average at 0.2%, labour contribution at 0.9% and capital contribution at 0.2%, in comparison to -0.4%, -1.0% and 0.0% respectively in the period 2012-2015.

Growth is estimated to remain relatively strong over the projection horizon, mostly due to internal drivers. Consumption will continue to provide a positive contribution to growth, again due to inflation and employment expectations. Investment growth is estimated to continue contributing positively to growth, albeit at more moderate levels compared to 2015, due to new projects that will be implemented and include inter alia the construction of Marinas, a casino resort and an infrastructure development by the University of Cyprus. Additional investment projects are expected over the projection horizon, but are not included in the forecasts for GFCF, due to the uncertainty surrounding them and concern renewable energy projects, as well as investment in the hydrocarbons sector.

From a sectoral perspective, growth is expected to be mainly export-led, due to the performance in the sectors of professional and shipping services which are expected to continue on a positive trend. Furthermore, the prospects of the tourism sector in 2016 are exceptionally positive, particularly concerning the Russian market, but also other markets, due to the rising geopolitical tensions in the eastern Mediterranean region.

[3] Estimates for potential output are based on Ministry of Finance's calculations. Differences from latest Commission estimations are mainly due to a different growth path for GDP.

The current account deficit improved significantly in recent years, mostly due to a cyclical correction of the goods balance. In general, however, on average an annual deficit of around 5% of GDP was recorded for the period 2012-2014 by the primary and secondary balances reflecting the net outflows from the profitability of companies with foreign shareholding and net outflows from non-resident compensation of employees. At the same time, an average marginal surplus/deficit of around 1% is recorded in the goods and services balance. As the economy recovers the deficit of the goods balance is expected to widen again, but the deficit in the balance of goods and services will shrink down to 0.8% of GDP due to the positive expectations in the balance of services. The current account deficit will thus improve in the medium-term, down to 3% by 2018. This estimation relies on the expectation that the balance of primary incomes and transfers will hover around the 2015 value, as a percentage of GDP, for the period covered in this Stability Programme.

Table IV: External balances

% of GDP	Year 2015	Year 2016	Year 2017	Year 2018	Year 2019
Current account	**-3.6**	**-3.4**	**-3.2**	**-3.0**	**-3.0**
- Balance on goods and services	*-1.4*	*-1.2*	*-0.9*	*-0.8*	*-0.8*
- Balance of primary incomes and transfers	*-2.2*	*-2.3*	*-2.3*	*-2.2*	*-2.2*

2.2.2 LABOUR MARKET

In the labour market, the dynamics indicate five consecutive quarters of positive growth and the medium-term scenario envisages employment growth to pick up in 2016 at around 1.2% and stabilize at 1.5% for the remainder of the forecast period. The unemployment rate is projected to decrease to 13.5% in 2016 and continue on a decreasing path for the forecast period at 12.5% in 2017, 11.5% in 2018 and 10.0% in 2019, in line with an entrenching growth recovery. Productivity growth is expected to average some 1.0% per annum over the medium-term, which is slightly higher than 0.7% in 2015.

Compensation per employee in 2015 declined contributing to a decline of nominal unit labour costs and further improvement in cost competitiveness. Over the medium term horizon, compensation per employee is projected to moderately pick up pace due to improved economic conditions and the expiration of the wage freeze in the broader public sector as from 2017 onwards.

Table V: Labour market developments

	2012	2013	2014	2015	2016	2017	2018	2019
Employment (persons) growth	-3.2	-6.0	-2.3	0.9	1.2	1.5	1.5	1.5
Unemployment rate	11.8	15.9	16.1	15.0	13.5	12.5	11.5	10.0
Compensation per employee, growth	0.7	-3.3	-3.5	-1.0	0.0	0.5	1.0	1.5
Nominal unit labour cost, growth	0.0	-3.3	-3.3	-1.7	-1.0	-0.5	0.0	0.5
Productivity (persons)	0.8	0.0	-0.2	0.7	1.0	1.0	1.0	1.0

The composition of unemployment shows that youth unemployment and long-term unemployment remain the major challenges in the labour market, but with encouraging signs of de-escalation.

2.2.3 PRICE DEVELOPMENTS

Inflation, as measured by HICP, has remained in negative territory in the first months of 2016, mainly due to the effects of energy prices. Therefore, taking into account the projected trends in international oil prices, HICP is estimated to average at around -0.7% in 2016, with the upswing in economic activity acting as a mitigating factor. Based on the basic external assumptions on oil prices ($39.7 per barrel in 2016 and $45.3 per barrel in 2017) and the dollar/euro exchange rate (1.09$/€ in 2016 and 2017), inflation in the medium-term horizon is forecasted to pick up at 0.5%, 1.6% and 2.0% in 2017, 2018 and 2019, respectively, also in line with the trend in economic growth.

Downside risks to the medium-term outlook are associated with the high levels of non-performing loans that pose risks to the stability of the banking system and the outlook of the economy. Growth could also be derailed from external sources of risk due to a:

- Continuation of the recession in Russia in conditions of protracted decline in oil prices but also from developments concerning EU-Russia relations.
- Weaker than expected growth in the euro area as a result of worsening global economic conditions.
- Slower than expected growth in the UK and further weakening of the pound against the euro as a result of a global slowdown and the political uncertainty regarding the future of the country in the EU after the referendum for BREXIT.
- Possible negative developments in connection with Greece.

Upside risks relate to a prolonged period of political instability in Turkey and in Egypt which translates to positive effects for the tourism sector in particular.

2.2.4 MACROECONOMIC IMBALANCES

Private debt

The Annual Financial Accounts (AFA)[4], with latest available data for 2014, were published at the end of October 2015. The results show that consolidated indebtedness levels of the Private Non-Financial Sector (PNFS) remains high, compared to the indicative threshold (133%) set by the EU Commission in the scoreboard of macroeconomic imbalances.

In more detail, the PNFS sector debt stood at 348% of GDP in 2014 remained high, as the deleveraging progress both for non-financial corporations (NFCs) and households (HHs) was outweighed by the rate of contraction of nominal GDP. Despite important reforms, non-performing loans in the banking system continue to remain excessively high. However, the recent adoption of the foreclosure and insolvency legislative framework by Parliament in April 2015, is expected to significantly speed up loan restructurings for households, as well as corporations, thus gradually reducing the level of debt and non-performing loans. Indeed, the significant increase recorded in the number of loan restructurings is indicative. As a result, following 2015 the private sector is projected to successfully engage in active deleveraging.

It is important to note that a sizeable amount of private sector debt relates to the inclusion of Special Purpose Entities' (SPEs) debt in the Non-Financial Corporations (NFCs) figures i.e. ship-owning companies'

[4] Based on ESA 2010 (incl. Special Purpose Entities).

debt mainly from abroad, after the ESA2010 accounting and compilation changes. Also, if the debt figures are adjusted for the corresponding asset side of the financial accounts, the net PNFS debt to GDP ratio falls from 348% slightly below the threshold level (129%). Analysing the yearly change in debt-to-GDP ratio, the increase in the ratio can be decomposed into four main drivers:

- Two affecting the numerator:
  - net credit flows[5] (new loans minus repayments);
  - other changes in the outstanding nominal debt such as reclassifications, revaluations (debt write-downs), securitisations etc.
- Two affecting the denominator
  - real GDP growth;
  - inflation measured by the GDP deflator.

Under the assumption that the PNFS debt has continued to deleverage in the course of 2015, in conjunction with the fact that a positive nominal GDP growth rate was recorded for 2015, a reduction in the PNFS debt as a per cent of GDP should be evident in the AFA 2015 figures.

External Competitiveness – NIIP

Special Purpose Entities (SPEs) affect the imports and exports of goods as the change of ownership of ships is reflected as imports/exports of ships. In the services account, financial SPEs have zero impact as there is a decrease in the category of other business services and an increase in financial services. While ship owning SPEs have a positive impact, the primary balance is negatively affected as the profit from transport services (ship owning) is transferred abroad to foreign shareholders.

The persistent negative current account deficits create a persistent negative exposure in the NIIP position, however, this may not be considered to be a problem if sustainable non debt creating FDI flows finance these deficits. During the past few years, the Cypriot current account deficits were mostly financed by "other investment" (foreign deposits) which is, however, considered to be very liquid, while Foreign Direct Investment (FDI) only partially financed current account deficits. It should be noted that during 2013-2014, following the correction in the economy, the current account deficits were fully financed by FDI flows (excluding SPEs), a trend that may continue in the coming years given the expected foreign investment relating to the casino and the energy sector.

External Competitiveness – Current Account Balance

The current account deficit improved significantly in recent years with the most significant correction registering in the goods balance. During the period 2012-2014, an annual deficit of around 5% was produced by the primary and secondary balances, reflecting the net outflows from the profitably of companies with foreign shareholding and net outflows from non-resident compensation of employees. At the same time, an average marginal surplus/deficit of around 1% was recorded in the goods and services balance.

[5] However, it should be noted that as other changes do not include exchange rate fluctuations, the net credit flows figures may be distorted.

Considering the medium-term developments, the cyclical correction of the current account due to the correction in the goods balance is not expected to continue as the economy enters a recovery phase where the deficit in the goods balance is expected to widen again. However, the deficit in the balance of goods and services as a whole is expected to decrease as a percentage of GDP due to the expectations for the balance of services, contributing to an improvement of the current account deficit in the medium-term, down to 3% by 2018. These estimations imply a balance of primary incomes and transfers around the 2015 value for the medium term horizon.

Table VI: Balance of Payments, 2008-2015

in per cent of GDP	2008	2009	2010	2011	2012	2013	2014	2015
Exports of Goods	12.1	13.2	14.0	15.5	15.6	15.0	16.1	14.3
Imports of Goods	42.6	35.0	37.1	35.8	33.7	31.3	32.3	32.5
Goods	-30.4	-21.8	-23.1	-20.3	-18.0	-16.3	-16.2	-18.2
Services	17.5	16.4	16.5	17.2	16.9	17.4	16.9	16.8
Primary Income	-2.5	-1.3	-3.0	0.3	-3.1	-3.5	-2.8	0.3
Secondary Income	-0.3	-1.1	-1.0	-1.1	-1.4	-2.1	-2.4	-2.6
Goods & Services balance	**-12.9**	**-5.4**	**-6.6**	**-3.1**	**-1.1**	**1.1**	**0.7**	**-1.4**
Current Account Balance	**-15.6**	**-7.7**	**-10.7**	**-4.0**	**-5.6**	**-4.5**	**-4.6**	**-3.6**

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1 POLICY STRATEGY

As already stated the Government main policy objective is to safeguard macroeconomic stability to facilitate growth and jobs creation. To this end fiscal policy will be geared towards the maintenance of high primary surpluses during the programming period and beyond in order to facilitate the gradual decline of debt-to-GDP ratio at a satisfactory pace. Taking into account the cyclical position of the Cyprus economy and the fiscal achievements during the macroeconomic adjustment programme, the Government intends to continue with the maintenance of a broadly neutral fiscal stance allowing automatic stabilizers to operate freely.

3.2 MEDIUM TERM OBJECTIVE

The medium-term fiscal strategy of the government is consistent with the fiscal rules embedded in our Public Financial Management Framework through inter alia the enactment of the Fiscal Responsibility and Budget Systems Law. According with the law, the overall budgetary position rule establishes that the general government structural fiscal balance is balanced or in surplus in the medium term.

The general government deficit increased from 4.9% of GDP in 2013 to 8.9% in 2014. Excluding the recapitalization of the Cooperative Credit Institutions (8.7% of GDP in 2014), the deficit in 2014 would have already recorded a close to balance position at -0.2% of GDP, well below the reference value of 3% deficit. The correction of the deficit by 4.7 percentage points of GDP amid a negative output gap of 4.1 per cent of potential output is significant. In 2015, a deficit of 1.0% of GDP was achieved amid an additional state aid support provided to the Cooperative Sector of about 1 per cent of GDP. Excluding this support the budget balance in 2015 was in balance. In structural terms, the general government balance turned positive in 2014 reaching 4.0% of GDP and continued to be in surplus of about 2.3% of GDP in 2015, with the government therefore overachieving its Medium-Term Budgetary Objective (MTO).

Over the medium term, the government opts for a broadly neutral fiscal stance, which will safeguard the fiscal achievements and the respect of the national MTO. The neutral fiscal stance to be followed will lock in the fiscal consolidation achieved, with the aim to maintain and enhance credibility thus facilitating access to the international markets at favourable rates on a sustainable basis.

The cyclically adjusted balance net of one-off and other temporary measures is calculated using the potential output estimates of the Ministry of Finance. The differences in the estimation of potential output with the most recent estimates published by the Commission are mainly due to differences in the macroeconomic scenario, which envisages gains in factors of production such as labour and capital over the medium term. The output gap is projected to close by 2018, two years earlier than the methodology followed by the Commission which assumes a closure of the output gap at 2020 for all Member States.

The structural balance in 2015 is estimated to be in surplus at 2.4% of GDP, compared to a structural surplus of 4.0% in 2014. According to the central scenario of this Programme, the structural budgetary position is projected to remain in surplus overall over the period 2016-2019, at about 0.1% of GDP.

Table VII: Potential GDP and Output Gap estimations

	2014	2015	2016	2017	2018	2019
Real GDP growth	-2.6	1.6	2.2	2.5	2.5	2.5
Comparison with Commission Winter Forecast	*-2.5*	*1.4*	*1.5*	*2.0*	*-*	*-*
Potential GDP growth	-1.7	-1.3	0.0	1.0	2.0	2.0
Comparison with Commission estimation, based on Winter Forecast	*-1.7*	*-1.3*	*-0.9*	*-0.5*	*0.0*	*0.5*
Output Gap (% GDP)	-6.8	-4.1	-2.0	-0.5	0.0	0.5
Comparison with Commission estimation, based on Winter Forecast	*-6.8*	*-4.3*	*-1.9*	*0.5*	*0.3*	*0.2*

The developments in the general government balance are influenced by the progress on the expenditure side, since over the programming period 2016-2019, expenditure as per cent of GDP is forecast to decrease by 2.7 percentage points of GDP, while revenue as per cent of GDP is forecast to exhibit a decrease by 1.2 percentage points of GDP. In per cent of GDP, total expenditure declines from 40.1% in 2015 down to 38.7% in 2016, 38.4% in 2017 and contained at 37.4% in 2019. This development is attributed to the one-off expenditure increasing measures of 2015 wearing off, along with a contained rate of growth in compensation of employees and the decline in expenditures associated with the cyclical upturn, complemented by a decrease in interest expenditure.

Table VIII: Components of Fiscal Adjustment and Medium-term Objective

Δ between Y_T and Y_{T-1} percent of GDP	2015	2016	2017	2018	2019	Total Adjustment 2016-2019
Revenue developments	-0.8	-0.7	-0.5	-0.2	0.1	-1.2
Expenditure developments	-8.6	-1.3	-0.3	-0.6	-0.5	-2.7
General Government Balance	7.8	0.7	-0.2	0.4	0.6	**1.5**
Cyclical Component	1.4	1.1	0.8	0.3	0.3	2.4
Cyclically-adjusted Balance	6.4	-0.4	-0.9	0.1	0.3	**-0.9**
One-off measures	8.0	1.3	0.0	0.0	0.0	1.2
Structural balance	-1.6	-1.7	-0.9	0.1	0.3	**-2.1**

Note: The figures may not add up to the total due to rounding effects

Revenue over the period 2016-2019 is projected to decrease by 1.2 percentage points of GDP, and decline from 38.4% in 2016 of GDP to 37.8% in 2019. This is a result of the termination of the temporary contribution on emoluments of public and private sector employees as from 2017, the phasing in of the VAT Directive on e-services and a fall in "other revenue" over the medium term due to a declining dividend from the Central Bank of Cyprus.

3.3 CORRECTION OF THE EXCESSIVE DEFICIT

Following a peak of the general government budget deficit in 2014 at -8.9% of GDP, in 2015 the general government deficit decreased to -1.0% of GDP. The budget balance outcome for 2014 and 2015 includes the recapitalization of the Cooperative Credit Institutions estimated at 8.7 per cent of GDP and 1 per cent of GDP respectively. Excluding the costs of recapitalization, the budget balance of 2014 was marginally in deficit of 0.2 per cent of GDP and the budget balance for 2015 was in balance. These developments allow the commencement of the abrogation of the Excessive Deficit Procedure for the Republic of Cyprus, which was initiated by the ECOFIN Council[6] on 13th July 2010, a year earlier than the relevant Council

[6] Council Decision of 13 July 2010 on the existence of an excessive deficit in Cyprus (2010/401/EU).

Recommendation[7]. These developments as well as the forecast path of the general government budget balance for 2016-2019 indicate the sustainability of the correction, and maintaining a safety margin against breaching the threshold of 3% of GDP throughout the forecast period.

Table IX: Components of Fiscal Adjustment and Medium-term Objective

General government balance	2010	2011	2012	2013	2014	2015	2016
€mln	-911.0	-1.121.6	-1.129.3	-890.7	-1.543.0	-180.2	-62.7
% of GDP	-4.8	-5.7	-5.8	-4.9	-8.9	-1.0	-0.4
EDP ceiling for general government balance	-6.0	-4.5	-3.0	-6.5	-8.4	-6.3	-2.9

Background

On 13th July 2010, the ECOFIN Council initiated the Excessive Deficit Procedure against the Republic of Cyprus, given that the fiscal deficit in 2009 exceeded the threshold of 3% of GDP. The Council established the deadline of 13th January 2011 for the Government of the Republic of Cyprus to take effective action and specify the measures that will be required to progress towards the correction of the excessive deficit. At the same time, the Council issued a Recommendation with a deadline to correct the excessive deficit by 2012 at the latest.

It is noted that, the oversize of the banking sector of Cyprus relative to the economy at the time, its exposure to the Greek economy as well as its holdings in Greek Government Bonds and in conjunction with the weak fiscal position of the Government, the Republic of Cyprus in June 2011 has lost access to the capital markets.

The Government of the Republic of Cyprus, in November and December 2011, has notified the Commission of all actions taken in the area of public finances in respect of the ECOFIN Council recommendation and with the view to correct the excessive deficit by 2012.

On February 15th 2011, the Council took note of a communication by the Commission assessing action taken by the authorities in Cyprus in order to bring government deficit below 3% of GDP by 2012. It shared the Commission's view that Cyprus had taken effective action representing adequate progress towards correcting deficit within the time horizon set in its recommendation, and that no further steps were required under the EU's excessive deficit procedure. In addition, on 11th January 2012, the Commission in its Staff Working Document - Analysis by the Commission services of the budgetary situation in Cyprus in response to the Council Recommendation of July 13th, 2010 with a view to bringing an end to the situation of excessive deficit - concluded that an additional consolidation package adopted by the authorities, amounting to an additional fiscal effort of ½% of GDP, confirmed the government's efforts to correct excessive deficit by 2012. Taking this into account, the Commission's projections for the deficit were revised down to 2.7% of GDP for 2012 and to 1.8% for 2013, resulting in a safety margin of 0.3% to hedge against implementation risks. Therefore, the Commission concluded that the Cypriot authorities had taken effective action to correct the excessive budget deficit in a timely and sustainable manner.

[7] Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus COM (2013) 284 Final, 7.5.2013.

On 25th June 2012, the Government of the Republic of Cyprus submitted to euro-area Member States an official request for external financial assistance from the EFSF/ESM, to contain the risks to the Cyprus economy, notably those arising from vulnerabilities in the financial sector. In parallel to the above, a similar request was also submitted to the Managing Director of the International Monetary Fund (IMF). Following the request, the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) agreed an Economic Adjustment Programme with the Cyprus Authorities on 2 April 2013. The Programme was agreed by the euro area Member States on 24 April 2013 and by the IMF Board on 15 May 2013. It covered the period 2013-2016. The financial package covered up to EUR 10 billion with the ESM providing up to EUR 9 billion, and the International Monetary Fund (IMF) contributing around EUR 1 billion. The economic adjustment programme outlining the economic and financial policies that the Cyprus Authorities would implement during the programming period was reflected in the Memorandum of Understanding signed by the Cyprus Authorities and the European Commission, acting on behalf of the ESM, on 26th April 2013. Similarly, a Memorandum of Economic and Financial Policies (MEFP), which has been approved by the Council of Ministers on April 3rd, has been submitted to the IMF.

In view of the above developments and the deterioration in the budgetary position of the government resulting from the weaker overall position of the economy, the significant fiscal consolidation undertaken in 2011-2012 did not correct the excessive deficit of Cyprus by the deadline established in the Council Recommendation of 13th July 2010. Therefore, by a Council decision in May 2013, the original deadline for the correction of the excessive deficit was extended by an additional four years and deficit targets, excluding recapitalisation costs of the banking sector, were set at 6.5% of GDP for 2013, 8.4% of GDP for 2014, 6.3% of GDP for 2015, and 2.9% of GDP in 2016.

3.4 GENERAL GOVERNMENT BALANCE FOR 2015

Public finance policy in 2015 was reflecting the neutral fiscal stance adopted by the government thus allowing automatic stabilizers to operate freely. The budget deficit in 2015 amounted to 1.0% of GDP, owning to an exceptional item of €175 million for the recapitalization of the cooperative sector. Excluding this item, the budget balance of 2015 was in balance and compares favourably with an estimated deficit, excluding the recapitalisation costs of the cooperative sector amounting to 8.7 per cent of GDP, amounting to merely 0.2% of GDP in 2014.

Revenue

In 2015, total revenue amounted to 39.0% of GDP in comparison to 39.8% in 2014. In value terms, total revenue decreased by 1.8%. Tax revenue decreased by 1.7%, reflecting mostly a decrease in current taxes on income and wealth. In more detail, taxes on production and imports decreased by 0.8% due to the implementation of the EU VAT directive on e-services. Revenue from taxes on income and wealth decreased by 3.1%, due to a reduction in income from deemed dividend with 2013 as the reference year resulting to reduced profitability of corporations as well as from withholding tax on interest attributed to the reduction in interest rates and deposit levels.

Concerning the rest of the revenue components, revenue from social contributions increased by 2.4%, reflecting the improved conditions in the labour market namely employment development and income in the economy. On the other hand, revenue from property income decreased by 13.4%, mainly due to a lower dividend from the Central Bank of Cyprus (CBC) by about €50 million compared to the dividend received the year before. At the same, however, a higher dividend was received from the Cyprus Telecommunications Authority (CYTA), mitigating thus the impact from the reduction of dividend income from CBC. Finally, revenue from other sources, which consists of non-tax revenue, decreased by 5.4%, reflecting, in part, a decrease in the rate of absorption of EU funds.

Expenditure

Total expenditure in 2015 amounted to 40.1% of GDP, recording a decrease compared to 48.7% in 2014, mainly due to the fact that 2014 values were affected by the extraordinary expenditure of €1.5 billion for the recapitalization of the cooperative sector or 8.7% as a percentage of GDP, whereas the subsequent recapitalization for the cooperative sector in 2015 amounted to just €175mln or 1% as a percentage of GDP. In value terms, total expenditure decreased by 17.5%, and excluding the impact of the recapitalization of the cooperatives, the decrease is reduced to 2.3%.

The compensation of employees exhibited a decline of 2.9% and is attributed to the reduction in employment through natural attrition in conjunction with a policy freeze on employment growth. Pension outlays including lump sum payments remained broadly stable in 2015 vis-à-vis 2014.

Intermediate consumption declined at a rate of 1.4% due to lower expenditures for energy and energy products linked to the effects of declining oil prices.

Social transfers other than in kind remain broadly unchanged as increases in pension outlays of the social security funds were offset by reductions in unemployment and redundancy benefits o the order of 16.6% and 43.5% respectively due to the improved conditions in the labour market.

Interest expenditure recorded a marginal decrease of 0.4% in 2015, compared to 2014 levels due to a reduction in the weighted average interest rate on debt. As a percentage to GDP interest expenditure declined to about 2.8% in 2015 from 2.9% the year before.

Gross fixed capital formation increased at a rate of 5% rising as a percentage to GDP to 1.9% in 2015 from 1.8% the year before.

3.5 BUDGET FOR 2016

The 2016 Budget, as well as, the MTBF 2016-2018 encompass a major part of the measures identified through the Public Financial Management (PFM) reform process which aim at increasing flexibility and accountability in the management of budgetary appropriations and focusing in achieving targets set. An important part of the PFM reforms is the transformation of the budget from an input based and bottom-up budget to an output based top-down budget. Towards this direction, an activity based budget has been prepared, on a pilot basis, by all line ministries (except by the Ministry of Defense) and two independent agencies (General Directorate European Projects Coordination and Development and the Treasury) in parallel with the existing budget. The total replacement of the traditional budgetary process with the activities based budgetary process will be completed with the introduction of the appropriate IT system that supports activity based budgeting.

The Budget for 2016 reflects the continuation of the policy of the government for a broadly neutral fiscal stance, allowing automatic stabilizers to operate freely, in order to support the return of the economy to sustainable growth. In this context, the Budget also reflects a continuation in the employment policies adopted by the government over the past few years and continues to place emphasis on the reallocation of government expenditure towards growth-enhancing activities and other policy priorities.

A more detailed analysis on the revenue and expenditure components of the 2016 Budget is presented below.

Revenue

In accordance with the central macroeconomic scenario, total revenue in 2016 will decline to about 38.4% of GDP compared with 39% of GDP the year before, anticipated to record zero growth compared to 2015.

Total tax revenue in value terms is expected to exhibit an anemic growth of about 0.4% compared to 2015 values, albeit declining as a percentage to GDP to 24.3% in 2016 from 24.6% the year before. This is attributed to increases in revenues from taxes on production and imports by 1.0%, in accordance with the improved economic conditions and despite the full-year effect of the VAT directive on e-services which, partly offset by an anticipated decline in taxes on income and wealth estimated to decrease by about 0.5%, mainly due to a continuation of the effects from decreasing interest rates, and as consequence, reduced revenue from withholding tax on interest. As a percentage of GDP, taxes on production and imports and taxes on income and wealth are estimated to decline by about 0.2 percentage points to 14.6% and 9.7%, respectively, in 2016.

Revenue from social contributions is estimated to increase by about 2.2%, in line with real growth stagnating as a percentage to GDP to about 8.5% in 2016 reflecting improving labour market conditions.

Revenue from property income is estimated to drop by 29.5% and declining as a percentage of GDP to about 1% in 2016 from 1.4% the year before, attributes to reduced dividend revenue from the Central Bank of Cyprus, as a result of the reduction in the level of Emergency Liquidity Assistance (ELA).

Finally, "other revenue", is estimated to record an increase of 2.9% in 2016, rising as a percentage of GDP by about 0.1 percentage point to 4.6% in 2016 as a result of the improved economic activity.

Expenditure

Total expenditure will continue on a downward path, as a percentage of GDP, coming down to 38.7% in 2016 from 40.1% the year before. This corresponds to a decrease in total expenditure by 1.7% in 2016, compared to 2015 levels.

In more detail, compensation of employees is estimated to increase by 0.4%. In more detail, a drop of 1.3% is estimated for wages and salaries due to further decreases in employment through natural attrition, whereas an increase is estimated for pensions and gratuities by 5%. It should be noted at this point that employment policy for 2016 as provided in the Budget Law for 2016, foresees zero replacement rates, except from exceptions in specific sectors, mainly referring to the health sector. This is complemented by a wage freeze that continues to apply for the fifth year in a row across the public and broader public sector. Therefore, any changes in wages and salaries reflect developments in public sector employment. In percent of GDP, compensation of employees is estimated to decline to about 12.6% in 2016 from 12.8% the year before.

An additional note concerns the recent decisions of the government on the employment of additional personnel in the security and defense functions of the government, in conjunction with the reduction in the compulsory army service. This decision will impact once off the levels of compensation of employees from 2017 onwards.

Intermediate consumption is estimated to decrease by 0.7% due to further decreases estimated in energy prices for 2016 which, in turn, reduce government expenditure on electricity and fuel. In percent of GDP, intermediate consumption is estimated to decline by about 0.1 percentage point of GDP to 3.6% in 2016.

Regarding social transfers other than in kind, these are estimated to increase by 1.7%, despite a combined drop of 14.2% estimated to be recorded in unemployment and redundancy payments, in accordance to further improvements in the labour market envisaged in the central macroeconomic scenario of this Programme. The increase in social transfers other than in kind is attributed to increased payments in pensions and other benefits for the year by about 3.6%. As a percentage to GDP, social transfers other than in kind are estimated to remain broadly unchanged at 14.1% of GDP.

Interest expenditure is estimated to drop by 7.9% in 2016 declining as a percentage of GDP to 2.6% in 2016 from 2.8% the year before. This development is attributed to further reductions in the weighted average interest rate on debt.

Gross fixed capital formation is estimated to increase at a rate of 4%, remaining broadly unchanged as a percentage to GDP to 1.9% in 2016.

Developments in other expenditure are influence by one-off factors materialized in 2015 and refer mainly to the costs associated with the winding down of the state owned airline company as well as the capital injection provided to the cooperative sector. In view of this, other expenditure is estimated to exhibit a decrease of about 18.6%, excluding these one-off factors, other expenditure is estimated to exhibit an increase of about 6% attributed to the provisioning of possible calling of guarantees.

3.6 MEDIUM TERM BUDGET BALANCE 2017-2019

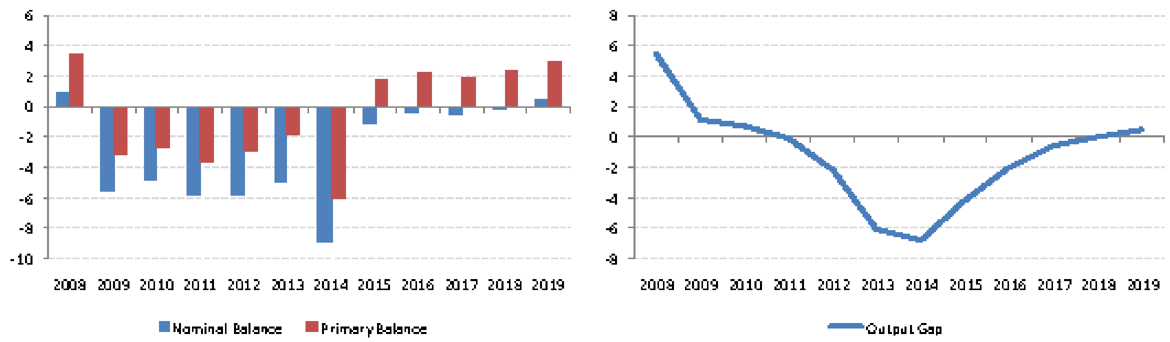
As outlined in the Policy Strategy part of this Chapter, taking stock of the upfront fiscal adjustment that has been achieved, the government aims at continuing with the implementation of a broadly neutral fiscal stance for the period 2016-2019 and allowing automatic stabilizers to operate freely. This will result in the maintenance of high primary surpluses for the period 2016-2019, in order for the debt-to-GDP ratio to follow a decreasing path over the horizon of the Programme. Overall nominal budget balance will average at -0.1% of GDP for the programming period 2016-2019, whereas primary surpluses will average at 2.4% of GDP over the same period.

It should be pointed out that despite the gradual close of the output gap, the nominal balance does not exhibit a bigger correction due to the fact that in 2017 the temporary contributions on the emoluments of employees of the private and public sector terminate, the phasing in of the application of the VAT on e-services Directive as well as the inclusion of forecast for possible guarantees called. The overall impact of these measures is estimated at about 1 per cent of GDP.

Following a period of recession during 2012-2014, output gap, according to the commonly-agreed methodology of the European Commission, turned negative to -2.2%, -6.0% and -6.8% of GDP in 2012, 2013 and 2014 respectively. Under the central macroeconomic scenario adopted for this Programme, the Ministry of Finance estimates the output gap still in negative territory in 2015 at -4.1% of GDP, while the assumption that the output gap will gradually decrease and close by 2020 is maintained.

The estimations for the output gap adopted in this Stability Programme, as mentioned previously, differ from the estimations stemming from the commonly-agreed methodology of the European Commission, mainly due to the different macroeconomic projections adopted in this Programme, compared to the Winter Forecast of the European Commission. The higher real growth rates anticipated and incorporated in the central macroeconomic scenario implies a more gradual elimination of the output gap by 2020.

Figure 9: Nominal Balance, Primary Balance and Output Gap (% GDP)



Structural Balance and Fiscal Stance

One-off and temporary measures 2014-2015

In 2014, the General Government budget balance (GGBB) was burdened with the amount of €1.5 billion, which refers to the initial capital injection deemed necessary for the recapitalization of the cooperative credit institutions; this corresponded to a decrease in the GGBB of the order of 8.7 percentage points of GDP.

With the introduction of the European System of National and Regional Accounts (ESA 2010) in 2014, Cyprus' GDP levels recorded the highest increase across Member States (+9.5% in 2010). The impact of this change reflected an upward revision of the GNI based and VAT own resources contributions to the EU budget. Therefore, in 2014 Cyprus' budget was burdened by a one-off burden on the GGBB amounting to €42.9 million as a contribution to EU budget's own resources, based on the revised GDP levels.

Another one-off measure with regard to 2014 was the guarantees called by the Cooperative Central Bank on obligations of third parties guaranteed by the government, of the order of €80 million, which increased the component of capital transfers.

Overall, the one-off deficit increasing measures materialized in 2014 are estimated at €1.623 million or 9.3 percentage points of GDP.

During 2015, an additional one-off temporary amount of the order of €175 million was also recorded in the GGBB as capital transfer, for the recapitalization of the cooperative credit institutions. In 2015, €55 million were recorded as expenditure in the GGBB for the liquidation of Cyprus Airways which included the calling of government guarantees provided on loans granted to the company, as well as, providing for the compensation of employees of the company. Overall, the one-off deficit increasing measures materialized in 2015 are estimated at €230 million or 1.3 percentage points of GDP. In addition to this one-off expenditure in 2015, the GGBB was burdened with the costs associated with the liquidation of the state owned airline company. These costs are estimated at 0.4% of GDP.

The cyclically-adjusted balance and structural balance

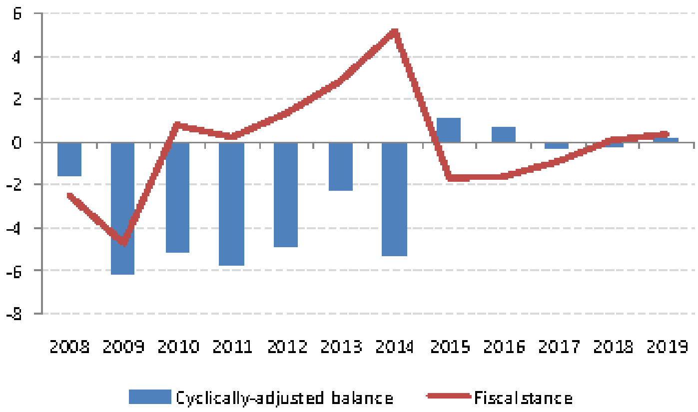
The cyclically-adjusted budget balance is estimated at a surplus of 1.1% of GDP in 2015, compared to a deficit of 5.3% in 2014. Given the broadly neutral fiscal position, the cyclically-adjusted budget balance is projected to remain close to balance over the programming period, and at around 0.2% of GDP by 2019 as the output gap closes. Structural balance, which accounts for one-off measures, is estimated at a surplus of 2.4% and 0.7% of GDP in 2015 and 2016 respectively.

Table X: Cyclical developments

in percentage of GDP	2014	2015	2016	2017	2018	2019
Real GDP growth (%)	-2.5	1.6	2.2	2.5	2.5	2.5
Net lending of general government	-8.9	-1.0	-0.4	-0.5	-0.2	0.4
Interest expenditure	2.9	2.8	2.6	2.4	2.5	2.6
One-off and other temporary measures[1]	-9.3	-1.3	0.0	0.0	0.0	0.0
Potential GDP growth (%)	-1.7	-1.3	0.0	1.0	2.0	2.0
Output gap	-6.8	-4.1	-2.0	-0.5	0.0	0.5
Cyclical budgetary component	-3.6	-2.1	-1.0	-0.3	0.0	0.2
Cyclically-adjusted balance	-5.3	1.1	0.7	-0.2	-0.1	0.2
Cyclically-adjusted primary balance	-2.4	3.9	3.3	2.2	2.4	2.8
Structural balance	4.0	2.4	0.7	-0.2	-0.1	0.2

[1]*Negative sign corresponds to deficit increasing measures*

Figure 10: Cyclically-adjusted balance and fiscal stance (% of GDP)



34

Following the strong fiscal consolidation adopted during the 2012-2014 period, fiscal stance turned positive, reaching 5.2% of GDP in 2014. In 2015, fiscal stance turned negative due to the absence of extraordinary one-off measures, compared to 2014. As fiscal policy adjusts to a path that is broadly neutral over the period 2016-2019, fiscal stance will gradually increase and average at about -0.5%.

3.7 DEBT MANAGEMENT

Financing actions in 2015

The Public Debt Management Office (PDMO) of the Ministry of Finance developed a Medium Term Debt Management Strategy (MTDS) covering the five-year period 2015-2019. This strategy was intended to operate as a bridge strategy between the official funding (IMF/ESM) period and the post-programme period, commencing in April 2016. It is worth-noting that the drafting of the said strategy has benefited both from the IMF-World Bank Revised Public Debt Management Guidelines, as well as, from the ESM concerning the aspects of internal organization, IT infrastructure of the PDMO and establishment of a market intelligence function.

The main guidelines of the MTDS 2015-2019 were the following:

- smoothening of maturity profile of public debt and extension of maturity of marketable debt;
- risk mitigation through increased cash reserves and management of foreign exchange and interest rate risk;
- development of the government securities markets;
- minimisation of marketable debt borrowing costs.

Following two EMTN issuances of €0.8bln in 2014, a year after the commencement of the Economic Adjustment Programme and the significant drop of the secondary market bond yields in 2015, the Cyprus Authorities proceeded with another two EMTN issuances in the international markets of €2bln in the said year increasing the nominal amount of EMTN issuances during the Economic Adjustment Programme to €2.8bln. It is noted that the latest issuance of the Republic of Cyprus of €1bln at a coupon and yield of 4.25% was done simultaneously with a switch of older bonds maturing in 2019 and 2020 with the newly issued bond. The proceeds from the above issuances were used: (a) for the renewal and redemption of the recapitalization bond of the Bank of Cyprus; (b) for the repurchase of shorter maturity bonds in order to smooth the maturity profile of public debt and (c) to enhance cash accumulation.

The Republic of Cyprus issued three bonds to the domestic market (2 to 10 years) for a nominal amount of €448 million, as well as retail bonds in monthly series with a tenor of 6 years. The total amount of retail bonds raised in 2015 was €205 million.

The disbursements from the ESM and the IMF in 2015 totaled €1.003 million which, resulted from €403 million and €600 million respectively. Also, the European Investment Bank disbursed amounts of €62 million for project financing of the Public Works Department and the University of Cyprus.

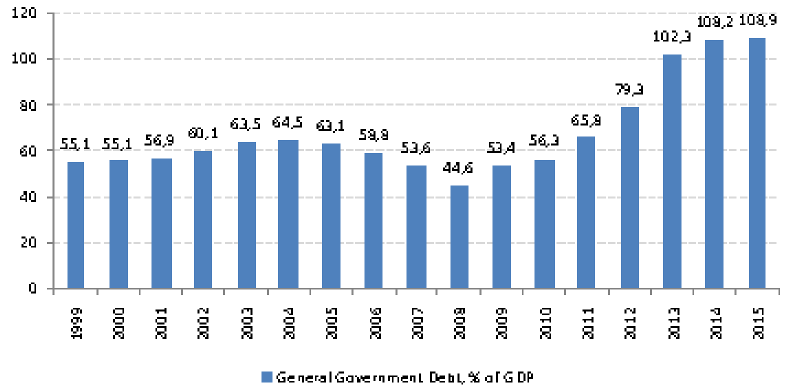
Short term securities of 1 to 12 months were re-introduced in the domestic market through auctions in February 2015 and rolled-over throughout the entire year reaching to about €0.4bln representing approximately 2 percent of the total general government debt as at end 2015. The weighted average yield in the 13-week Treasury Bills auctions marked a significant decline by 2.3 percentage points declining to 0.65% at the end of 2015 from 2.96% in February 2015.

Overall, Cyprus secondary market bond yields dropped significantly in 2015 and exhibited noticeable stability during that year. Despite the significant volatility in core and periphery yields in the period May –August 2015 attributed to Eurozone inflation/growth expectations and the uncertainty related to the Greek programme, Cyprus bonds outperformed the market for most of that period. Furthermore, despite the volatility in the international markets in September – November 2015, Cyprus bonds yields continued to exhibit a downward trend. The main reasons for the reduction of Cyprus secondary market bond yields are the continuous outperformance of programme targets, the ever increasing acknowledgement by investors of the economic over-performance of Cyprus, the European Central Bank's quantitative easing programme, as well as the upgrades issued by Credit Rating Agencies in September-October 2015.

All of the above actions which materialized in 2015 had positively contributed towards year end targets set in the MTDS 2015-2019.

As presented in Figure 11 below, the general government debt to GDP ratio marked an increase from 108.2% in 2014 to 108.9% in 2015. In levels, general government debt remained broadly unchanged in the last two years reaching to about €18.9bln at the end of 2015 which is marginally above the debt level at the end of 2014 of €18.8bln.

Figure 11: Debt ratio



By the end of 2015, the composition of the general government debt was as follows:

- Short-term public debt comprised 2% of total debt;
- 69% of total debt comprises of loans, whereas 31% comprises of securities;
- Public debt with fixed interest rates comprised 53% of the total debt;
- Public debt denominated in euro was 95%.

The developments in 2015 had positively contributed to the Cyprus' debt portfolio risks. The weighted average maturity of total debt improved significantly in years 2013-2015 reaching 8.5 years compared to 4.7 years which was at the average maturity at the end of 2012. This improvement was mainly due to the long-term official funding by the ESM loans with the average maturity of the said loans set at 15 years, as well as to the longer term bond issuances. Indeed, the weighted average maturity of marketable debt was 4.8 years at the end of 2015 in relation to 2.7 years at the end of 2012. The weighted average cost of outstanding debt was 2.7% at the end of 2015 compared to 4.2% which was at the end of 2012. The cost has benefited significantly from the low interest rates of ESM/IMF loans and the low base rates of the Euribor. The share of debt that falls due within 1 year and 5 years improved significantly indicating the reduction of the refinancing risk. By the end of 2015, the debt that falls due within 1 year and 5 years reduced to 6.1% and 34% respectively, compared to 21% and 76% at the end of 2012. This outcome was due to the asset liability management transactions undertaken during the last two years.

The interest rate distribution of debt has changed significantly since 2013 due to the financing provided by the ESM and IMF at floating interest rates. By the end of 2015 the fixed-rate debt was 53% and the floating-rate debt was 47% compared to 88% and 12% respectively at the end of 2012. Although, floating-rate debt followed an upward trend since 2013, taking into consideration that the vast majority of the floating-rate debt (82%) relates to official lending by the ESM and IMF for which interest rates are indexed at low levels, the interest rate risk is projected to be at low levels.

Financing 2015

As presented in the Table below, the net annual financing by source in 2015 was €79 mn.

Table XI: Net annual financing by source in 2015

	€mln
Government Securities	**-789**
Treasury Bills and ECPs	-336
Retail bonds	202
Domestic bonds	-1,359
EMTNs	704
Loans by ESM and IMF	**868**
Total net annual financing	**79**

Source: PDMO

Financing 2016

The total financing needs, as well as, the total financing sources for the current year was estimated at €1.2bln, as at the end of 2015 of which 92% concerns debt redemptions and 8% relates to fiscal needs. The main source of financing is the issuances of domestic short-term Treasury Bills and domestic bonds amounting €0.4bln and €0.3bln respectively. Other sources of financing are the issuance of retail bonds and loan disbursements by the European Investment Bank (EIB). It is noted that in case the total amount of loans by EIB will be higher than expected, the Republic of Cyprus will adjust the amount of Treasury Bills in order to avoid over financing and increase public debt levels. Although, the financing needs for the current year were prefunded, the Republic of Cyprus intends to maintain its presence in international markets over 2016 with one benchmark new bond subject to market conditions in order to avoid running down its cash reserves. The syndicated international bond issuance will aim mainly at strategic medium-term objectives such as the reduction of refinancing risk in future years, as well as the expansion of international bond yield curve. Also, the said issuance will aim at the exchange of domestic and international bonds due in 2019-2020 with new bonds in an attempt to smooth out the current debt maturity profile.

An overview of the financing plan for 2016 is presented in Table XII below.

Table XII: Financing plan for 2016

Financing needs	**€bln**
Domestic Short term Treasury Bills	0.4
Domestic long-term bonds & loans	0.4
Foreign long-term bonds & loans	0.3
Fiscal needs	0.1
Total	**1.2**
Financing sources	**€bln**
Treasury Bills rollover	0.4
Domestic bonds	0.3
Other sources (Retail bonds, EIB loans)	0.2
EMTN (Net amount)	0.2
IMF Programme Financing	0.1
Intra-year cash use	0.0
Total	**1.2**

Source: PDMO

Debt developments

General government debt is projected at €18,720.1mln or 105.6% of GDP at the end of 2016. The improvement in the debt ratio in 2016 is 3.2 percentage points. Over the period 2016-2019, debt-to-GDP ratio is projected to exhibit a downward trend declining to about 105.6 in 2016, 101.7% in 2017, 97.8% in 2018 and 90.5% in 2019. The reduction in the debt-to-GDP ratio satisfies the debt criterion of the Stability and Growth Pact (SGP) which states that for Member States that breach the 60% limit on the debt-GDP-ratio, an annual debt-to-GDP ratio deduction should be recorded of at least 5% of the part of the benchmark value being in excess of the 60% limit (averaged over three years).

Table XIII: General government debt 2015-2019

in percentage of GDP	2015	2016	2017	2018	2019
Gross debt ratio	108.9	105.6	101.7	97.8	90.5
Change in debt ratio	0.7	-3.2	-3.9	-3.8	-7.3
Primary balance	1.8	2.2	1.9	2.3	3.0
Interest expenditure	2.8	2.6	2.5	2.5	2.6
Stock-flow adjustment	0.8	-1.7	-1.4	0.0	-2.4

The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called "snow ball" effect. The positive stock flow adjustment in 2015, equivalent to 0.8% of GDP, reflects financial transactions undertaken by government in the form of currency and deposits accumulation as well as developments in transactions in loans to third parties. In 2016, the stock flow adjustment turns negative to -1.7% of GDP owing primarily to the "snow ball" effect and secondarily the decumulation of financial assets in the form of currency and deposits as well as developments in transactions in loans to third parties.

The contribution of SFA is projected to remain negative in 2017 at around -1.7% and falling to 0.0% of GDP in 2017 and 2018 respectively, and subsequently turning again negative reaching 2.4% of GDP in 2019. The developments in SFA is mainly influence by the developments in the nominal GDP growth contributing to a negative SFA for the period under consideration of 0.7%, 1.5% and 1.9% respectively.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

This chapter sets out the sensitivity analysis for the projected general government balance and debt, in respect to risks that could impact macroeconomic and fiscal performance over the short- to medium-term.

Macroeconomic risks

The evolution in oil prices were a positive gain for households and businesses, strengthening domestic demand and lowering input costs, increasing the competitiveness of firms. The risk potential is associated with the evolution in oil prices, and specifically if oil prices rebound faster than the central scenario assumption. The high indebtedness of the private sector is also a risk on the downside for domestic demand, especially if the trend in debt restructuring picks up and households spend the higher disposable income on debt reduction rather than consumption.

A positive gain relates to the geopolitical tensions in the eastern Mediterranean, which reflects positively in terms of tourist arrivals. This is expected to represent an upside risk.

From the perspective of the external macroeconomic environment, risks are on the negative side and related to the developments in Greece, although the contagion risk is very low for Cyprus, the developments in the UK economy, especially concerning the uncertainty surrounding the upcoming referendum for Brexit as well as the developments regarding Russia-Ukraine relations with the repercussions they could have on the euro-ruble exchange rate.

In view of the above, risks to the central macroeconomic projections are overall balanced from a domestic perspective, but tilted on the negative on the external risks front.

Fiscal Risks

Fiscal outcomes are correlated to the macroeconomic outcomes, which in turn affect primary balances, and are also affected by the evolution in interest rates.

The evolution of primary revenues and expenditure forms the basis for the primary balance forecast, along with the evolution of GDP. Risks to the primary balance forecast can arise especially from a different than expected outcome in tax revenues, or from unanticipated outcomes in primary expenditure.

The forecast on interest expenditure is based on both the existing stock of debt and projected debt issuance over the forecast horizon. Any unanticipated increase in the cost of borrowing represents a downside risk to the public finance forecast.

In addition, the reaction of the international markets towards government bonds following the exit of Cyprus from the macroeconomic adjustment programme is an uncertain factor that, apart from global movements in interest rates, highly depends on the economic performance and the evolution in Non-Performing Loans which are currently at high levels. It is thus regarded as a downside risk for the purposes of the sensitivity analysis.

Contingent Liabilities

Government guarantees at the end of 2015 amounted to around €3.1bln, representing almost 18% of GDP. Out of these, an amount of €0.3bln, or 2% of GDP, is already accounted for in the general government debt; the remaining amount of €2.7bln represents contingent liabilities, €1bln of which accounts for liabilities connected with the financial sector (Bank of Cyprus issuing of bonds) and €0.3bln for liabilities connected to the European Financial Stability Facility. Net of these, guarantees at the end of 2015 amount to about €1.5 bln, representing 9% of GDP.

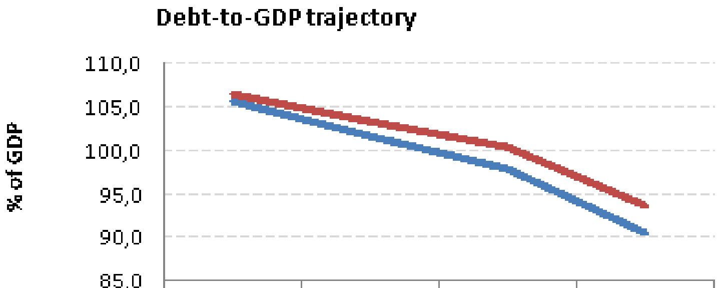
Sensitivity analysis

In order to address the sensitivity of the projected general government balance and debt ratios, alternative assumptions for real GDP growth rates, interest rates and primary balances have been incorporated in three distinct scenarios. In line with the approach taken in the rest of this Programme, all simulations assume unchanged policies but free operation of automatic stabilisers.

Scenario 1: Higher interest rate by 50 basis points annually

The first scenario assumes higher interest rates than the baseline scenario for each year over the programming period. In particular, the real interest rate increases by half of the 10-year historical standard deviation. Under this scenario, only the trajectory of general government public debt is affected which, however, continues to present a downward trend, falling to around 93.7% in 2019, compared to 90.5% under the baseline scenario.

Figure 12: Debt to GDP trajectory under the higher interest rate sensitivity scenario

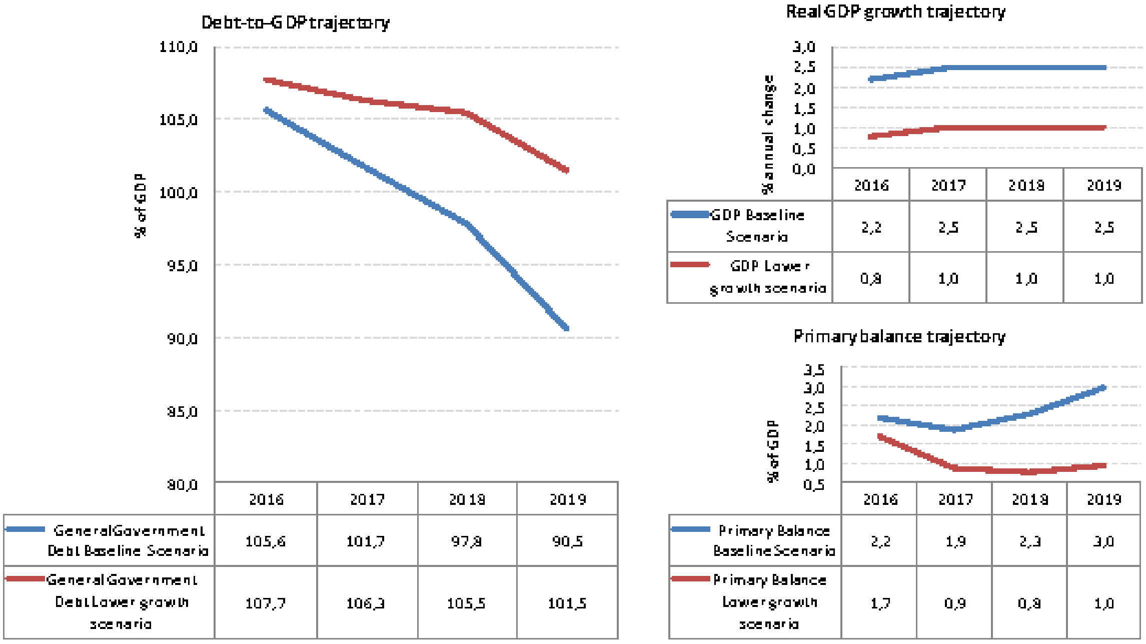


	2016	2017	2018	2019
General Government Debt Baseline Scenario	105,6	101,7	97,8	90,5
General Government Debt Higher interest rates scenario	106,5	103,3	100,3	93,7

Scenario 2: Lower real GDP growth by half of the 10-year historical standard deviation

Under this scenario, real growth in GDP is assumed to be lower by half of the 10-year standard deviation, for each year over the programming period, compared with the baseline scenario. Along with the real growth trajectory, Figure 13 below presents the trajectories for debt-to-GDP ratio and primary balance as percentage of GDP for the period 2016-2019. The debt ratio still projects a sustainable downward path over the medium term, falling down to 101.5% in 2019.

Figure 13: Debt to GDP, real GDP growth and primary balance as % of GDP trajectories under the lower real growth rate sensitivity scenario



	2016	2017	2018	2019
General Government Debt Baseline Scenario	105,6	101,7	97,8	90,5
General Government Debt Lower growth scenario	107,7	106,3	105,5	101,5

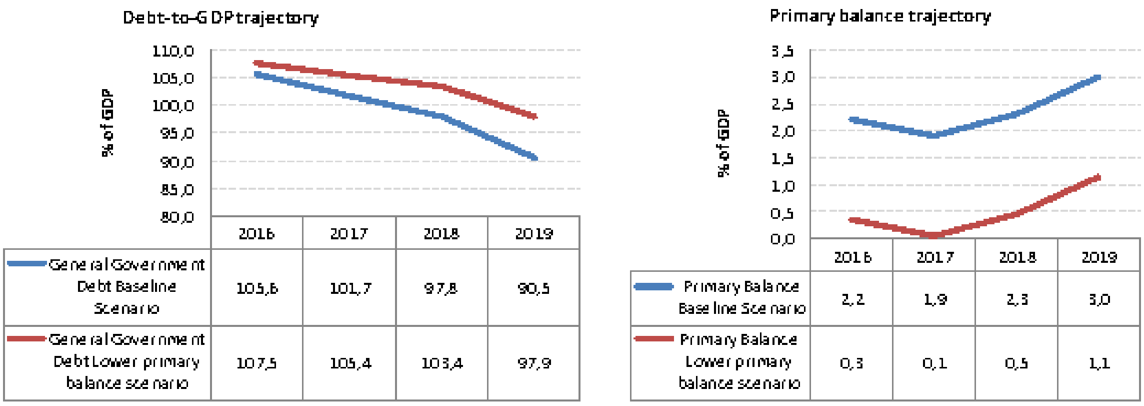
	2016	2017	2018	2019
GDP Baseline Scenario	2,2	2,5	2,5	2,5
GDP Lower growth scenario	0,8	1,0	1,0	1,0

	2016	2017	2018	2019
Primary Balance Baseline Scenario	2,2	1,9	2,3	3,0
Primary Balance Lower growth scenario	1,7	0,9	0,8	1,0

<u>*Scenario 3: Lower primary balance by half of the 10-year historical standard deviation*</u>

In the third scenario, primary balance as a percentage of GDP is reduced by half of the 10-year historical standard deviation for each year over the programming period. Under this scenario, even though the debt to GDP in 2019 is expected to be higher than the baseline, there is still a downward trend, where debt ratio falls down to 97.9% in 2019.

Figure 14: General government debt and primary balance trajectories under the lower primary balance sensitivity scenario (% of GDP)



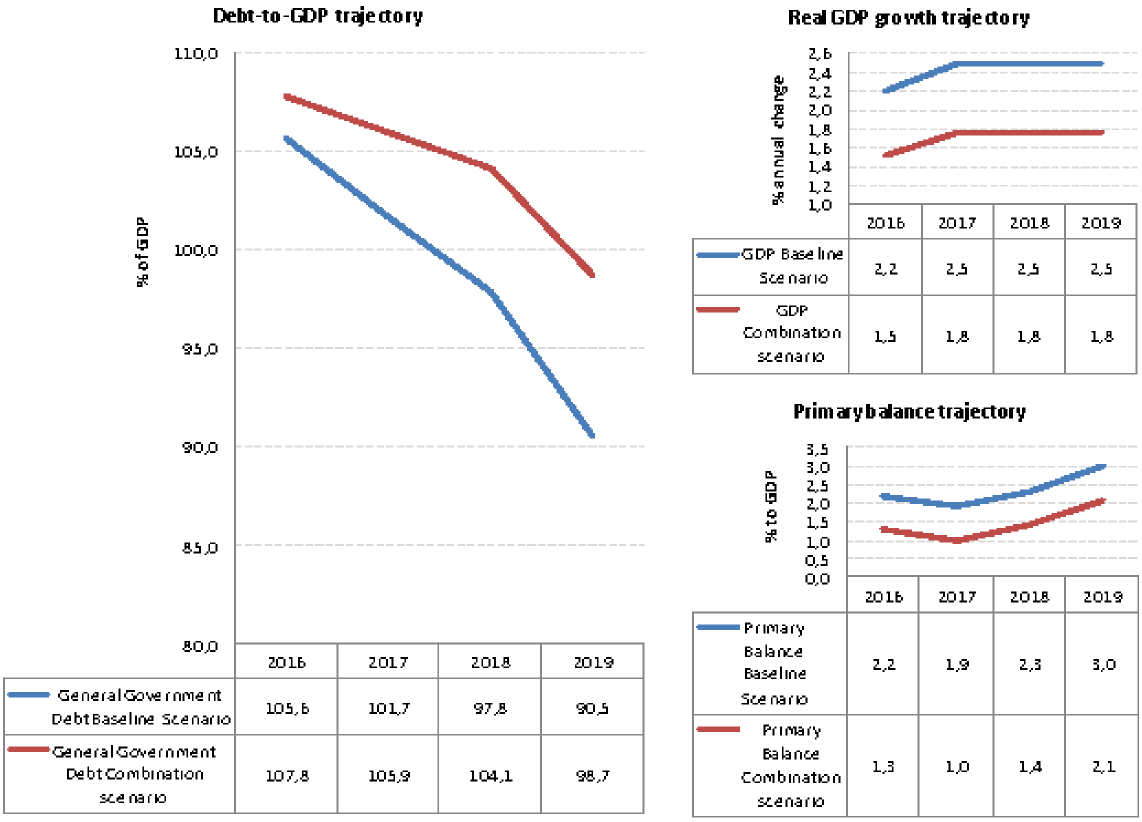
	2016	2017	2018	2019
General Government Debt Baseline Scenario	105,6	101,7	97,8	90,5
General Government Debt Lower primary balance scenario	107,5	105,4	103,4	97,9

	2016	2017	2018	2019
Primary Balance Baseline Scenario	2,2	1,9	2,3	3,0
Primary Balance Lower primary balance scenario	0,3	0,1	0,5	1,1

Scenario 4: Combination scenario

The combination scenario assumed that shocks occur simultaneously on real interest rates, real growth and in primary balance, of the order of 1/4 of their 10-year historical standard deviation. Under this scenario, even though the debt to GDP in 2019 is expected to be higher than the baseline, there is still a downward trend, falling to 98.7% in 2019.

Figure 15: Debt to GDP, real GDP growth and primary balance as % of GDP trajectories under the combination sensitivity scenario



	2016	2017	2018	2019
General Government Debt Baseline Scenario	105,6	101,7	97,8	90,5
General Government Debt Combination scenario	107,8	105,9	104,1	98,7

	2016	2017	2018	2019
GDP Baseline Scenario	2,2	2,5	2,5	2,5
GDP Combination scenario	1,5	1,8	1,8	1,8

	2016	2017	2018	2019
Primary Balance Baseline Scenario	2,2	1,9	2,3	3,0
Primary Balance Combination scenario	1,3	1,0	1,4	2,1

5. SUSTAINABILITY OF PUBLIC FINANCES

Chapter 5 illustrates the overall situation as regards to the sustainability of public finances. In this chapter a more detailed analysis is performed on the projected development of the General Social Insurance Scheme (GSIS) and other public age-related expenditures, as well as the future evolution of the general government expenditures and revenues. For the purposes of this analysis, it is assumed that the budgetary situation evolves in line with the Stability Programme targets for 2016-2019. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2019 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government deficit.

The pension projections incorporate the December 2012 reform measures of the following two public pension schemes, the General Social Insurance Scheme (GSIS) and the Government Employees Pension Scheme (GEPS).

The amendment to the Social Insurance Law N.193(I)/ 2012, which was enacted on December 21st , 2012, introduced the following reform measures that were to be phased in gradually and aim to secure the long-term viability of the GSIS:

- As of January 1st 2013, actuarial reduction of pension entitlements from the GSIS by 0.5% per month for retirements earlier than the statutory retirement age in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;
- Freeze of pensions (all types) under the GSIS for the period 2013-2016;
- Abolishment of the increase of pensions for a working dependent spouse under the GSIS as of 1 January 2013 (this applies only to new pensioners);
- Stricter eligibility conditions to old-age pension - as of 1 April, 2013 gradual extension of the minimum contributory period (one year per year) from the current 10 to 15 years over the period 2013-17;
- Increase of contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point (p.p.) of the increase which was legislated to take effect in 2014 as per 2009 GSIS reform – the above increase is apparitional as follows: 0.5 p.p. from salaried employees and 0.5 p.p. from employers and 1 p.p. in the case of self-employed persons; and
- Introduction of an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy, to be applied for the first time in 2018 and the first revision will cover the period 2018-2023.

The pension projections incorporate a series of GEPS amendments as a result of the enactment of the amendment to the Pension Law N.216(I)/ 2012 in December, 2012 which refer to the following reform measures aiming in the containment of the future increase in the GEPS:

- Closing of the scheme for newcomers after October 2011;
- Pension Benefit - the pension calculated for any service after the 1st of January 2013, will be based on the career average salary, revalued based on the changes of the Basic Insurable Earnings under the GSIS;
- Lump Sum Benefit - the factor for calculating the lump sum benefit for service after the 1st of January 2013, will be based on a factor of 14/3, irrespective of the total period of service;

- Normal Retirement Ages - early and normal retirement ages are gradually increased. Normal retirement age is gradually extended by 2 years;
- Early Retirement Reduction Factors - early retirement pensions are actuarially reduced by certain factors, but only the part that corresponds to the service after 1.1.2013 is affected;
- Taxation of Lump Sum Benefit - the portion of the lump sum benefit which corresponds to the service after 1.1.2013 is taxable; and
- Commutation of Lump Sum Benefit - members have the option to commute part or all of their lump sum benefit into an annuity.

Furthermore, as it is currently stipulated in the Budget Law, future increases of the level of GEPS pensions may be granted the rate of increase of the COLA indexation over the previous year capped at 5%. This adjustment of pensions is suspended during periods of recessions during the 2nd and 3rd quarter of the previous year.

Note that public pension projections as included in this Stability Programme cover the pension expenditure of the GSIS, GEPS and Social Pension Scheme (SPS), which in total represent approximately the total public pension expenditure as defined by Eurostat (ESSPROS).

Table 7 in the Appendix includes an analysis of the long-term fiscal sustainability taking into account the impact of age-related changes in expenditure over the period 2013-2060. The main elements of the analysis are the long-term projections for public pensions, health long-term care and education expenditures. The base year for the projections is 2015[8] and therefore, the figures for the subsequent years are projections. In addition, the projections undertaken for the purposes of the present Stability Programme exercise are primarily based on the latest available commonly agreed assumptions of the EPC-Ageing Working Group (AWG).

Table XIII, presents the key demographic and labour market assumptions used for the purposes of this year's Stability Programme exercise. These assumptions[9] are in line with those used in the 2015 Ageing Report: Underlying Assumptions and Projection Methodologies (published in November 2014) with certain adjustments made to reflect the recent experience.

Table XIII: Basic Demographic and Labour Market assumptions 2013-2060

	2015	2020	2030	2040	2050	2060
Total Fertility Rate	**1.33**	**1.39**	**1.46**	**1.51**	**1.56**	**1.59**
Life Expectancy at birth						
Males	79.4	80.1	81.5	82.8	84.1	85.2
Females	83.6	84.3	85.5	86.7	87.8	88.9
Participation Rates (15-64)	**74.5**	**77.6**	**77.7**	**77.9**	**78.8**	**78.6**
Males (15-64)	80.8	83.2	82.7	82.7	83.3	83.0
Females (15-64)	68.5	72.3	72.9	73.1	74.1	74.1
Net migration (thousand)	**-10.4**	**-0.3**	**2.8**	**6.0**	**8.8**	**7.9**

[8] For pensions, health care and education the base year is 2014 and for long-term care the base year is 2013 since no data are yet available until 2015.
[9] The projection period from the 2015 AWG report is 2013-2060.

Regarding the population projections, the population growth is projected at around 24% in the time period 2015-2060, which is among the strongest population increase among the EU countries. Fertility rates, which have decreased between 2000 and 2014, are now projected to increase over the projection period from 1.33 in 2015 to 1.59 in 2060. Life expectancy also increases significantly. Gains in life expectancies over this period are for males 5.8 years and for females 5.3 years.

On the labour market, the total participation rate (15-64) is expected to increase by 4.1 p.p. between 2015-2060, mainly due to the increase in female participation rates (2.2 p.p. for males and 5.6 p.p. for females). Unemployment rate is expected to decline and stabilize at a low rate as from 2039. Table XIV presents the aggregate results of the projections for the public pension expenditure and the contributions over the period 2010-2060.

Table XIV: Projected public pension expenditure, contributions and reserves

in per cent of GDP	2010	2020	2030	2040	2050	2060
Total Expenditure[1]	6.9	9.3	9.8	10.0	9.5	9.6
Total Amount of Contributions[2]	5.9	7.1	8.3	9.3	9.3	9.0
Reserves of the GSIS	36.5	38.9	36.2	37.1	40.4	38.3

[1] *Expenditure represents pension spending under GSIS, GEPS and SPS.*
[2] *Contributions arising from GSIS legislated schedule of contribution rates and GEPS employee contribution rate.*

Results indicate a moderate increase in public pension spending of about 0.3% of GDP during 2020-2060. By 2040 contributions as a percent of GDP increase by 2 p.p. with the excess of expenditure over contributions contained at relatively low level up to 2050.

In particular, total public pension expenditures are projected to increase from 6.9% of GDP in 2010 to 10.0% of GDP in 2040 and decline to 9.6% of GDP by 2060. At the same time, contributions increase from 5.9% of GDP in 2010 to 9.3% of GDP over the period 2040-2050 and decline to about 9% GDP by 2060. The low increase in public pension expenditures as a percentage of GDP over the period 2020-2060 is explained mainly by the 2012 pension reform, the demographics and the improved macroeconomic assumptions.

The accumulated reserve of the GSIS, peaked in 2015 reaching about 42.7% of GDP. From 2015 onwards, the GSIS reserves are expected to exhibit a gradual decline falling to about 38.3% of GDP by 2060.

In total, all age-related expenditure including spending on healthcare and education – which are based on the projection methodologies and assumptions of the EPC-AWG as adopted in 2014 for the purposes of the 2015 Ageing Report – are projected to increase from 18.3% in 2010 and then remain relatively stable over the period 2020-2060, hovering at around 20% of GDP.

Health care expenditure is projected to marginally increase by 0.3 p.p. between 2013-2060, increasing from 3% of GDP in 2013 to about 3.3% in 2060. Long-term care expenditure is also projected to marginally increase from 0.3% of GDP in 2013 to 0.5% in 2060. This marginal increase is due to demographic factors and ageing population.

In contrast, education expenditure are projected to decrease by 1.2 p.p. of GDP during the period 2013-2060 from about 7.3% in 2013 to about 6.1% by 2060. This decrease is also due to demographic factors and the change in the age structure of the population.

Other age-related expenditures are expected to remain stable at 1% of GDP across the projection period as it was during the last years with available information, 2014-2015.

On the revenue side, property income is expected to remain stable at 0.9% of GDP across the projection period as it is projected to be in 2018-2019. In contrast, pension contributions are expected to increase by 1% of GDP each decade between 2010-2040, then remain stable in 2050 and finally decrease by 0.3 p.p. of GDP in 2060.

As a result of the above, total general government expenditure will decrease from 42.2% of GDP in 2010 to 37% of GDP by 2060. General government revenue is projected to increase from 37.5% of GDP in 2010 to around 39.6% of GDP in 2060.

6. QUALITY OF PUBLIC FINANCES

The quality of public finances in Cyprus has been significantly improved during the period 2013-2015. From an institutional point of view, the radical reform of the procedure followed for the compilation of the Budget and the Medium Term Budgetary Framework is the main point of focus. The centre point of the reform concerns the Fiscal Responsibility and Budget Systems Law (FRBSL), a pivotal point in the Public Financial Management reform (PFM). The FRBSL, described in more detail in Chapter 7, has introduced a framework for a transparent management of public finance, in sustainable and efficient manner which contributes in an effective way towards fulfilling the obligations stemming from the European governance framework.

In accordance with the FRBSL, line Ministries are invited to prepare, on an annual basis, Strategic Plans and Activity Based Budgets, in line with the Government's Strategy Statement, which is prepared at the central Government level. The Strategy Statement determines the key strategic objectives and policy priorities of the Government for the next three years, within the forecast fiscal framework. The Strategy Statement consists of the following pillars:

- The "Government Strategy Statement", which analyzes the broader framework of the government's growth policy in the medium term and indicates the economic sectors for which priority should be given. The Government Strategy Statement, which is prepared by the DG EPCD, provides the policy direction for the preparation of the sectoral Strategic Plans by line Ministries.
- The "Fiscal Strategy Statement", which is prepared by the Ministry of Finance and sets the maximum expenditure ceilings for each line ministry including inter alia independent services, with the aim to safeguard the achievement of budgetary targets.
- The "Human Resources Policy Statement", prepared by the Public Administration and Personnel Department, sets out the government's policy in relation to the overall employment policy, personnel and terms of employment issues.

Public Investment Management (PIM) framework

The FRBSL also provides for the selection process for the identification and inclusion of projects in the budgetary framework as well as for their implementation and monitoring, through the standardization of their appraisal using common methodology and parameters, with the aim at promoting those projects that are considered to be viable, affordable and beneficial in the long run. More specifically, the Law provides for the following

The full implementation of the new project selection process for inclusion in the State Budget is expected to take place in the 2018-2020 Budget. Aiming at the smooth transition to the new PIM system, the new process will be implemented on a pilot basis for a limited number of projects per line ministry, during the preparation of the 2017-2019 Budget. The pilot implementation of the new process on a limited number of projects will be used as a learning experience aiming at identifying potential problems/shortages to the implementation of the whole process and consequently at the adoption of suitable measures for overcoming these, in time for the full implementation of the process in the 2018-2020 budget.

Tax administration reform

In order to maintain fiscal consolidation over the medium term and converging towards Cyprus' medium-term budgetary objective, structural reforms have been put into trajectory including, inter alia, the improvement of the overall tax regulatory and administrative framework. In this respect, a tax administration integration plan has been approved with a view to reinforce efficiency and effectiveness of revenue collection and fight against tax fraud and evasion. The integration is reflected in an enabling Law that puts in place the integration of the former Inland Revenue Department and the VAT Service into a single Tax Department. The integration aims in achieving enhanced efficiency levels by making full use of existing human resources, skills and systems.

Furthermore, the integration is designed to introduce self-assessment and risk management policies, improve voluntary compliance by taxpayers, to streamline and modernize processes and procedures and to optimize the use of automation in favor of the increased efficiency of tax administration.

Reallocation of expenditure

In line with the objective of the government to direct public expenditure to growth-enhancing categories, the structure of expenditures over time, exhibits a continued reallocation towards high priority functions such as Environmental Protection, Housing and Community Amenities, Health and Social Protection. At the same time, there is a reduction in government expenditure on functions such as Defense, Public Order and Safety and Economic Affairs.

Table XIII: Functional classification of expenditure

% of GDP	2010	2011	2012	2013	2014	2019f.
General public services	9.7	10.2	11.4	10.1	10.1	9.2
Defence	2.1	1.8	1.8	1.6	1.4	1.3
Public order and safety	2.2	2.1	2.0	2.1	1.7	1.6
Economic affairs	3.7	3.6	3.0	2.9	2.8	2.4
Environmental protection	0.3	0.3	0.3	0.4	0.3	0.5
Housing and community amenities	2.6	2.5	2.1	1.9	2.2	2.1
Health	3.0	3.1	3.0	3.1	2.7	2.9
Recreation, culture and religion	1.2	1.2	1.0	0.9	0.9	0.8
Education	6.8	6.6	6.1	6.5	5.8	5.2
Social protection	10.6	11.1	11.3	11.9	12.2	11.4
Total expenditure	**42.2**	**42.5**	**41.9**	**41.4**	**40.1**	**37.4**

Revenue side

In general, the government's policy following the economic downturn is to promote the return to sustainable growth, while supporting investment and employment and promoting social cohesion. In this context, the immovable property reform recently introduced is very relevant. In particular, in order to improve the fairness of the tax burden on immovable property and to increase the efficiency of the tax administration, the Cypriot Authorities have conducted a General Valuation for all immovable properties based on January 1st, 2013 prices, with a view to adopting legislation introducing a revamped immovable property tax framework based on the consolidation of property taxes, at all levels of government broadening the tax base, applying flat not progressive taxation in conjunction with a reduction in transfer fees for title deeds issuance. These reforms entail the reallocation of the tax burden from transacting in properties to the use of properties, thus removing impediments for investment and development. More specifically the Immovable Property Tax is envisaged to be applied on a wider tax base, thus allowing for the reduction of the tax burden on households and business. The relevant legislation is pending before the House of Representatives for consideration. In tandem, the framework specifies the frequency of the mandatory update of the cadastral values to three years.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The framework governing the process for the budget and the medium-term budgetary framework has been radically transformed in Cyprus with the introduction of the Fiscal Responsibilities and Budget Systems Law (FRBSL), voted by Parliament in February 2014. Overall, the new framework that has been introduced has greatly strengthened fiscal transparency, accountability and awareness, which are three essential features every modern Public Financial Strategy (PFM) should cover.

The Management of Public Finances (PFM) in Cyprus is governed by the FRBSL, which fully transposed the provisions of the Medium Term Budgetary Framework Law introduced in 2013. The FRBSL has brought the budget process in line with best practices in the EU, and enforce the fiscal rules and fiscal discipline that are necessary in order to comply with the obligations at EU level as they arise from the adoption of the legislative proposals of the new Economic Governance and the new Treaty on Stability, Coordination and Governance in the EMU.

The FRBSL is also known as the Umbrella Law, and has replaced the previous fragmented PFM framework, providing the necessary legal basis for the main principles, including defining the main processes and roles and responsibilities of the main stakeholders. The law also encompasses "new" topics, such as the selection and evaluation of public investment projects, including the management of risks from public-private partnerships, while other features include the management of revenues from hydrocarbons via a National Investment Fund.

It should also be noted that, the FRBSL covers the responsibilities of local authorities, along with general government entities and state organizations, increasing transparency and accountability over a medium-term budgeting horizon.

The PFM process is conducted through a rolling 3-year multiannual framework, replacing the previous one-year short-term view, with a focus on controlling inputs over the medium-term and achieving policy objectives by delivering high value added outputs and services.

The process itself is a top-down budgeting line by line format with binding expenditure ceilings, numerical and fiscal rules and an automatic correction mechanism. Under this framework, the government publishes the Fiscal Strategy Statement (FSS) at the beginning of the budget process in the spring of each year. The FSS, along with the medium-term expenditure ceilings, includes, inter alia, an overview of the recent macroeconomic and financial developments, the medium-term macroeconomic and budgetary forecasts of the government and forecasts on the key fiscal indicators and objectives for the medium-term, including indicators for the fiscal balance of the general government, public debt and public expenditure.

The expenditure ceilings under the Fiscal Strategy Statement are consistent with the fiscal rules which include: (a) the rule for the budgetary position which establishes that the general government structural budget balance is in balance or in surplus in the medium term, (b) the corrective adjustment rule which ensures that the annual structural balance of the general government converges towards the medium-term budgetary objective, according to the timetable set out by the provisions of Regulation (EC) No 1466/97 and (c) the public debt rule, which is essentially a debt-brake rule which stipulates that when the ratio of public debt to the Gross Domestic Product at market prices exceeds the reference rate of sixty percent (60%), the ratio is reduced under the provisions of Regulation (EC) No 1467/97.

Following the publication of the FSS, the Minister of Finance issues the Circular for the Budget and Medium Budgetary Framework providing the general instruction guidelines to line ministries and, thereafter, line ministries and independent services submit their multiannual proposals to the Minister of Finance in accordance with the set ceilings. The objective of this process was to reallocate tasks and responsibilities between the Ministry of Finance and line ministries and other public entities. The Ministry of Finance focuses on its responsibility to ensure overall fiscal sustainability, extending its focus in the medium term, as well as, the long term. Line Ministries and other public entities have the sole responsibility for developing their strategies in line with the government's policy objectives and for implementing their policies within the available ceilings set. The implied decentralization of decision making process provides autonomy to line ministries, while increasing accountability and transparency.

The Minister of Finance prepares the MTBF and presents it to the Council of Ministers for approval in the fall of each year and then the Minister of Finance presents it to Parliament for discussion and approval. The expenditure ceilings are set on at least a 3-year horizon, with binding ceilings for the first year, which essentially sets the ceilings in next year's government Budget. The ceilings set for the following year are binding only for the overall government expenditure, whereas the third year ceilings are indicative and can be adjusted according to macroeconomic developments.

No new or additional expenditures can be made or committed to in excess of the relevant budgetary allocation, except with the approval of the Minister for Finance and as long as adherence to the fiscal rules is ensured. An important aspect to note is the provision governing the submission of Supplementary budgets, where Minister of Finance may submit supplementary budgets only after June 15th in any given Budget year and not more than twice a year.

Fiscal Council

The macroeconomic and budgetary forecasts of the government are evaluated by the Fiscal Council (hereby the Council), an independent public body, established in 2014 according to the provisions of the FRBSL. The evaluation by the Council of the forecasts included in the FSS is provided a priori, i.e. before the publication of the FSS, and the Council either endorses the forecasts, or provides a recommendation to the Minister, in case of a deviating views. The Minister reviews the evaluation of the Council and, in case the Council is of a different opinion and either adopts the recommendation of the Council for a correction of the macroeconomic and budgetary forecasts, or provides an explanation for not adopting the recommendations (comply or explain rule).

The Council is also entrusted with providing an ex-ante and ex-post evaluation of the public fiscal policy, which is made public in real time. In addition, the Council provides assessments, which are also published in real time, regarding the numerical fiscal rules.

The Council consists of three members, appointed by the Council of Ministers after consultation the Parliamentary Committee on Finance and the Budget of the House of Representatives, one of which acts as full-time Chairman. The term of office of the member appointed as Chairman is six years from the date of entry into force of this Law, whereas, for the remaining two members, the term of office is part-time and lasts five and four years respectively. The tenure framework for the Council ensures that the tenure of the members of the Council is not the same as the tenure of the government, while the tenure of each member of the Council is not the same to safeguard that any government in the future will not appoint all the Council's members at once.

Table 1a. Macroeconomic prospects

		2015	2015	2016	2017	2018	2019
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	15,176.0	1.6	2.2	2.5	2.5	2.5
2. Nominal GDP	B1*g	17,420.6	0.2	1.7	3.0	4.0	4.6
Components of real GDP							
3. Private consumption expenditure	P.3	10,396.7	1.9	1.9	1.9	2.4	2.6
4. Government consumption expenditure	P.3	2,550.3	1.1	0.6	1.3	0.5	0.1
5. Gross fixed capital formation	P.51	2,112.9	14.0	5.0	4.7	3.5	3.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	255.3	-0.3	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	9,286.7	1.9	2.7	3.2	3.4	3.6
8. Imports of goods and services	P.7	9,426.0	4.0	2.4	2.6	3.0	3.2
Contributions to real GDP growth							
9. Final domestic demand		15,060.0	3.2	2.1	2.2	2.2	2.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	255.3	-0.3	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-139.3	-1.3	0.2	0.3	0.3	0.2

Table 1b. Price developments

	ESA Code	2015 Level	2015 rate of change	2016 rate of change	2017 rate of change	2018 rate of change	2019 rate of change
1. GDP deflator		114.8	-1.4	-0.5	0.5	1.5	2.0
2. Private consumption deflator		117.6	-1.9	-1.0	0.0	1.5	2.0
3. HICP[1] [2015=100]		100.0	-1.5	-0.7	0.5	1.6	2.0
4. Public consumption deflator		108.0	-0.7	-0.6	1.2	1.5	2.2
5. Investment deflator (GFCF)		110.2	2.0	0.6	2.8	3.0	3.0
6. Export price deflator (goods and services)		112.4	-1.9	-1.0	0.0	1.5	2.0
7. Import price deflator (goods and services)		113.3	-0.5	-1.4	0.2	1.8	2.2

53

Table 1c. Labour market developments

	ESA Code	2015 Level	2015 rate of change	2016 rate of change	2017 rate of change	2018 rate of change	2019 rate of change
1. Employment, persons (thousands)[1]		361.7	0.9	1.2	1.5	1.5	1.5
2. Employment, hours worked[2] (thousands)		648.6	0.7	1.2	1.5	1.5	1.5
3. Unemployment rate (%)[3]		63.7	15.0	13.5	12.5	11.5	10.0
4. Labour productivity, persons[4]			0.7	1.0	1.0	1.0	1.0
5. Labour productivity, hours worked[5]			0.9	1.0	1.0	1.0	1.0
6. Compensation of employees (€ million)	D.1	7,689.5	-0.2	1.2	2.0	2.5	3.0
7. Compensation per employee		24,235	-1.0	0.0	0.5	1.0	1.5

[1]Persons with occupation, domestic concept, national accounts definition.
[2]National accounts definition.
[3]Harmonised definition, Eurostat; levels.
[4]Real GDP per person employed.
[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2015	2016	2017	2018	2019
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-3.6	-3.4	-3.2	-3.0	-3.0
of which:						
- Balance on goods and services		*-1.4*	*-1.2*	*-0.9*	*-0.8*	*-0.8*
- Balance of primary incomes and transfers		*-2.2*	*-2.3*	*-2.3*	*-2.2*	*-2.2*
2. Net lending/borrowing of the private sector	B.9	-2.6	-3.0	-2.7	-2.8	-3.4
3. Net lending/borrowing of general government	EDP B.9	-1.0	-0.4	-0.5	-0.2	0.4
4. Statistical discrepancy		0.0	-	-	-	-

Table 2a: General government budgetary prospects

% of GDP	ESA Code	2015'	2015	2016	2017	2018	2019
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-180.2	-1.0	-0.4	-0.5	-0.2	0.4
2. Central government	S.1311	-190.8	-1.1	-0.4	-0.5	-0.2	0.4
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	0.3	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	10.3	0.1	0.1	0.1	0.1	0.1
General government (S13)							
6. Total revenue	TR	6,801.6	39.0	38.4	37.9	37.7	37.8
7. Total expenditure	TE[1]	6,981.8	40.1	38.7	38.4	37.9	37.4
8. Net lending/borrowing	EDP B.9	-180.2	-1.0	-0.4	-0.5	-0.2	0.4
9. Interest expenditure	EDP D.41	496.0	2.8	2.6	2.4	2.5	2.6
10. Primary balance[2]		315.8	1.8	2.2	1.9	2.3	3.0
11. One-off and other temporary measures[3]		-230.0	-1.3	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		4,290.8	24.6	24.3	23.9	23.9	23.9
12a. Taxes on production and imports	D.2	2,569.7	14.8	14.6	14.4	14.4	14.4
12b. Current taxes on income, wealth, etc	D.5	1,720.6	9.9	9.7	9.5	9.5	9.5
12c. Capital taxes	D.91	0.5	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1,479.9	8.5	8.5	8.6	8.6	9.1
14. Property income	D.4	240.4	1.4	1.0	1.0	0.9	0.9
15. Other[4]		790.5	4.5	4.6	4.5	4.3	3.9
16=6. Total revenue	TR	6,801.6	39.0	38.4	37.9	37.7	37.8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]							
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2,877.8	16.5	16.3	16.3	16.0	15.6
17a. Compensation of employees	D.1	2,231.7	12.8	12.6	12.7	12.5	12.2
17b. Intermediate consumption	P.2	646.1	3.7	3.6	3.6	3.5	3.4
18. Social payments (18=18a+18b)		2,468.5	14.2	14.2	14.1	14.0	13.7
of which Unemployment benefits[6]		97.3	0.0	0.5	0.4	0.3	0.3
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	4.4	0.0	0.0	0.1	0.1	0.1
18b. Social transfers other than in kind	D.62	2,464.1	14.1	14.1	14.0	13.9	13.7
19=9. Interest expenditure	EDP D.41	496.0	2.8	2.6	2.4	2.5	2.6
20. Subsidies	D.3	71.5	0.4	0.4	0.4	0.4	0.4
21. Gross fixed capital formation	P.51	322.3	1.9	1.9	2.0	2.0	2.0
22. Other[7]		745.7	4.3	3.4	3.2	3.1	3.1
23=7. Total expenditure	TE[1]	6,981.8	40.1	38.7	38.4	37.9	37.4
p.m.: Government consumption (nominal)	P.3	2,759.7	15.8	15.6	15.5	15.2	14.8

' in million of €

[1] TR-TE=B.9.

[2] The primary balance is calculated as B.9 (item 4) plus D.41 (item 5).

[3] A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91).

[5] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] Includes social benefits other than social transfers in kind (D.62) and social transfers in kind via market producers (D.632) related to unemployment benefits.

[7] D.29pay+D4pay (other than D.41pay) + D.5pay+D.7pay+P.52+P.53+NP+D.8.

Table 2b. No-policy change projections[1]

	ESA	2015 Level	2015 % of GDP	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP
1. Total revenue at unchanged policies		6,801.6	39.0	38.4	37.9	37.7	37.8
2. Total expenditure at unchanged policies		7,058.8	40.1	38.7	38.4	37.9	37.4

Table 2c. Amounts to be excluded from benchmark

	2015 Level (€ million)	2015 % of GDP	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	236.1	1.4	1.1	1.0	1.0	0.9
2. Cyclical unemployment benefit expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Effect of discretionary revenue measures	0.0	0.0	0.0	0.0	0.0	0.0
4. Revenue increases mandated by law	0.0	0.0	0.0	0.0	0.0	0.0

Table 3. General Government expenditure by function

% of GDP	**COFOG Code**	**2014**	**2019**
1. General public services	1	10.1	9.2
2. Defence	2	1.4	1.3
3. Public order and safety	3	1.7	1.6
4. Economic affairs	4	11.4	2.4
5. Environmental protection	5	0.3	0.5
6. Housing and community amenities	6	2.2	2.1
7. Health	7	2.7	2.9
8. Recreation, culture and religion	8	0.9	0.8
9. Education	9	5.8	5.2
10. Social protection	10	12.2	11.4
11. Total expenditure (=item 3=22 in Table 2a)	TE	48.7	37.4

2014: including the equity injection to restore the capital base of the Cooperative Central Bank (€1,500.0 mln)

57

Table 4. General government debt developments

% of GDP	ESA Code	2015	2016	2017	2018	2019
1. Gross debt		108,9	105,6	101,7	97,8	90,5
2. Change in gross debt ratio		0,7	-3,2	-3,9	-3,8	-7,3
Contributions to changes in gross debt						
3. Primary balance	B.9+D.41	2.8	2.2	1.9	2.3	3.0
4. Interest expenditure	D.41	2.8	2.6	2.5	2.5	2.6
5. Stock-flow adjustment		0.8	-1.7	-1.4	0.0	-2.4
p.m.: Implicit interest rate on debt		2.6	2.4	2.4	2.6	2.8

Table 5. Cyclical Developments

% of GDP	ESA Code	2015	2016	2017	2018	2019
1. Real GDP growth (%)		1.6	2.2	2.5	2.5	2.5
2. Net lending of general government	B.9	-1.0	-0.4	-0.5	-0.2	0.4
3. Interest expenditure	D.41	2.8	2.6	2.4	2.5	2.6
4. One-off and other temporary measures [1]		-1.3	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		-1.3	0.0	1.0	2.0	2.0
contributions:						
- labour		-0,9	0,5	0,8	1,0	1,2
- capital		-0,1	0,1	0,2	0,2	0,3
- total factor productivity		-0,2	-0,6	0,05	0,8	0,5
6. Output gap		-4.1	-2.0	-0.5	0.0	0.5
7. Cyclical budgetary component		-2.1	-1.0	-0.3	0.0	0.2
8. Cyclically-adjusted balance (2 - 7)		1.1	0.7	-0.2	-0.1	0.2
9. Cyclically-adjusted primary balance (8 + 3)		3.9	3.3	2.2	2.4	2.8
10. Structural balance (8 - 4)		2.4	0.7	-0.2	-0.1	0.2

[1] A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2015	2016	2017	2018	2019
Real GDP growth (%)						
Previous update		n.a.	n.a.	n.a.	n.a.	n.a.
Current update						
Difference		n.a.	n.a.	n.a.	n.a.	n.a.
General government net lending (% of GDP)	B.9					
Previous update		n.a.	n.a.	n.a.	n.a.	n.a.
Current update						
Difference		n.a.	n.a.	n.a.	n.a.	n.a.
General government gross debt (% of GDP)						
Previous update		n.a.	n.a.	n.a.	n.a.	n.a.
Current update						
Difference		n.a.	n.a.	n.a.	n.a.	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	37.7	42.2	37.3	37.0	36.9	36.5	37.0
Of which: **age-related expenditures**	15.4	18.3	20.8	20.5	20.3	20.0	20.5
Pension expenditure	6.0	6.9	9.3	9.8	10.0	9.5	9.6
Social security pension	4.0	4.8	7.1	8.3	8.8	9.1	9.5
Old-age and early pensions	2.9	3.6	*5.4*	*6.4*	*6.9*	*7.2*	*7.8*
Other pensions (disability, survivors)	1.1	1.2	*1.7*	*1.9*	*2.0*	*1.9*	*1.6*
Occupational pensions (if in general government)[1]	2.0	2.1	2.2	1.5	1.2	0.4	0.1
Health care	2.7	3.0	3.2	3.1	3.3	3.4	3.3
Long-term care	0.2	0.2	0.3	0.4	0.4	0.5	0.5
Education expenditure[2]	5.8	6.8	6.9	6.2	5.6	5.7	6.1
Other age-related expenditures	0.8	1.4	1.0	1.0	1.0	1.0	1.0
Interest expenditure[3]	-	-	-	-	-	-	-
Total revenue	40.9	37.5	37.8	38.9	39.9	39.8	39.6
Of which: property income	0.7	1.4	0.9	0.9	0.9	0.9	0.9
Of which: from pensions contributions (or social contributions if appropriate)	5.9	7.1	7.3	8.3	9.3	9.3	9.0
Pension reserve fund assets	33.0	36.5	38.9	36.2	37.1	40.4	38.3
Of which: consolidated public pension fund assets (assets other than government liabilities)	-	-	-	-	-	-	-
Systemic pension reforms							
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	-0.7	1.1	1.7	1.6	1.8	1.7	1.6
Real GDP growth	4.9	1.4	2.5	2.3	2.3	2.3	2.3
Participation rate males (aged 15-64)	82.9	80.4	83.2	82.7	82.7	83.3	83.0
Participation rates females (aged 15-64)	65.4	67.4	72.3	72.9	73.1	74.1	74.1
Total participation rates (aged 15-64)	73.9	73.6	77.6	77.7	77.9	78.8	78.6
Unemployment rate (15+)	3.9	6.3	8.5	7.2	4.8	4.8	4.8
Population aged 65+ over total population	12.4	12.7	16.3	20.5	23.1	25.5	26.8

1Occupational Pension expenditure projection results are extracted from an expert actuarial study and also take into account the lump-sum.
2 National estimates based on EPC-AWG projection methodology and assumptions.
3 Possible interest rate effects were not taken into account.

Table 7a. Contingent liabilities

% of GDP	2015	2016
Public guarantees	**15.7**	-
Of which: linked to the financial sector	5.7	-

61

Table 8. Basic assumptions

	2015	2016	2017	2018	2019
EA: Short-term interest rate (3-months money markets)	-0.02	-0.25	-0.33	-	-
EA: Long-term interest rate (10-year government bonds, Germany)	0.50	0.27	0.44	0.44	0.44
USD/€ exchange rate (annual average)	1.11	1.09	1.09	1.09	1.09
Nominal effective exchange rate of the EU (% change)	-8.21	-0.17	-0.27	-	-
World growth excluding EU (in PPP terms)	3.2	3.4	3.7	3.7	3.7
EU GDP growth	1.9	1.9	2.0	2.0	2.0
Growth of relevant foreign markets [US]	2.4	2.3	2.2	2.2	2.2
World import volumes, excluding EU	0.8	2.2	3.5	3.5	3.5
Oil prices (Brent. USD/barrel)	53.4	39.7	45.3	45.3	45.3