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Country Report Cyprus 2017
Including an In-Depth Review and the prevention and correction of macroeconomic imbalances

Accompanying the document

**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK AND THE
EUROGROUP**

**2017 European Semester: Assessment of progress on structural reforms,
prevention and correction of macroeconomic imbalances, and results of in-depth reviews
under Regulation (EU) No 1176/2011**

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EXECUTIVE SUMMARY

This report assesses Cyprus' economy in light of the European Commission's Annual Growth Survey published on 16 November 2016. In the survey the Commission calls on EU Member States to redouble their efforts on the three elements of the virtuous triangle of economic policy – boosting investment, pursuing structural reforms and ensuring responsible fiscal policies. In so doing, Member States should put the focus on enhancing social fairness in order to deliver more inclusive growth. At the same time, the Commission published the Alert Mechanism Report (AMR) that initiated the sixth round of the macroeconomic imbalance procedure. The in-depth review, which the 2017 AMR concluded should be undertaken for the Cypriot economy, is presented in this report.

Cyprus' economic recovery continues, but the social situation is fragile and potential growth remains subdued. Real GDP growth was robust in 2016 at 2.8 %, driven by the tourism sector and domestic demand, and is forecast to slow down to 2.3 % in 2018. Inflation remained negative in 2016 and is forecast to turn positive but remain low. Unemployment decreased, but remains high, at 13.3 % at end-2016. The economic crisis led to a rise in inequality, risk of poverty and social exclusion, and this still has a bearing on key social indicators. Potential growth remains weak, due to stagnant productivity growth, subdued investment, and high level of non-performing loans which constrains credit supply.

Macroeconomic imbalances have started to unwind but remain considerable. Imbalances are still above the indicative thresholds provided by the macroeconomic imbalance procedure. They affect most sectors of the economy and therefore make the unwinding process more reliant on productivity increases and external demand. Strong real GDP growth in 2016 and valuation effects have helped to reduce private and public debt relative to GDP and to improve the net international investment position. However, modest nominal growth prospects are likely to make deleveraging more challenging. Non-performing loans have started to decrease but still account for about half of total loans and remain one of the main challenges for the economy.

Overall, Cyprus has made limited progress with implementing the 2016 country-specific

recommendations. After three years of ambitious reforms during the economic adjustment programme, 2016 saw a loss of reform momentum and the stalling of some measures, reflecting a more complex political context. Limited progress was made on the implementation of fiscal structural measures, despite the completion of the fiscal framework. Progress was also limited with regard to measures to help decrease the high private sector debt, notably concerning insolvency, foreclosure, title deeds and judicial reform. Some progress was made on the recommendation to reduce the level of non-performing loans, with enhancements to the credit register and measures to accelerate loan restructuring. There was also some progress with regard to the recommendation on investment promotion. The action plan for growth is gradually being implemented and some measures to improve access to finance were announced, yet, privatisation efforts and measures to facilitate strategic investments are facing delays. Finally, progress remained limited with regard to the recommendation on employment services and healthcare reform. Planned measures to increase the capacity of public employment services have not been implemented yet. And impacts of active labour market policies remain unassessed. Legislative proposals for the reform of the healthcare system are still under discussion in the House of Representatives.

Regarding progress in reaching the national targets under the Europe 2020 strategy, Cyprus has either reached or is making progress towards its objectives for reducing greenhouse gas emissions, increasing the share of renewable energy, improving energy efficiency, reducing early school leaving and increasing higher education attainment levels. However, progress on targets regarding employment rate, investment in research and development and reduction of poverty and social exclusion remains limited.

The main findings of the in-depth review contained in this report, and the related policy challenges, are as follows:

- **Potential growth remains weak, constrained by limited implementation of structural reforms to support investment.** Growth-enhancing initiatives are being implemented, albeit rather slowly. This includes measures presented in the action plan for growth to

stimulate investment, promote entrepreneurship and innovation, and facilitate access to finance. The latter remains challenging for many companies, in particular small and medium sized enterprises. Shortcomings in the business environment and banking sector discourage productivity-enhancing investment, as reflected by the low rate of private investment, notably in innovation. Inefficiencies in the justice system hamper the swift resolution of civil and commercial cases, in particular regarding contract enforcement, insolvency and foreclosure. Administrative burden remains high, notably for licensing and export procedures.

- **Private sector indebtedness has only recently started to decline and remains very high.** The debt of non-financial corporations and households remains among the highest in the EU at around 280% of GDP (excluding special-purpose entities). The balance sheet adjustment of households and non-financial corporations accelerated in 2016, mainly as a result of debt write-offs and debt-to-asset swaps. Repayment of debt has been modest, notably due to weak contract enforcement and the limited use of the insolvency and foreclosure frameworks.
- **The housing market shows signs of stabilisation, which might contribute to deleveraging.** Housing investment has recently picked up and the decline in housing prices has moderated, pointing to some recovery in the housing market. However, demand is held back by subdued income prospects, tight credit conditions and the lack of an effective system for the issuance and transfer of title deeds. A rising supply of properties for sale may also slow down the housing market recovery, as debtors attempt to liquidate collateral to repay their loans and banks try to sell properties acquired through debt-to-asset swaps.
- **The functioning of the banking sector remains hampered by a high, though declining, level of non-performing loans.** Low asset quality weighs on profitability and capital generation, and hinders the resumption of wholesale and interbank funding. Better insolvency and foreclosure tools were introduced to help reduce unviable debt,

incentivising banks and debtors to agree on restructuring solutions. Yet, the effectiveness of such tools is impaired by i.a weak administrative capacity, the cost of procedures and inefficiencies in the court system. In addition, re-default rates remain high, pointing to potential deficiencies in loan restructuring solutions. Risk provisioning levels increased but remain below euro area average, while the lack of a secondary market for loans and a loan securitisation framework limit the scope to accelerate deleveraging and move non-performing loans off banks' balance sheets.

- **Risk tolerance in the financial sector appears on the rise, while supervision of insurance and pension funds remains weak.** Banks have repaid emergency liquidity while accumulating solid liquidity buffers. Negative central bank deposit rates are adding to the pressure to improve asset quality and profitability. Banks increasingly try to reduce non-performing loans through debt-to-asset swaps, and appear to be seeking alternative and more profitable investments. This might lead to increased direct exposure to the housing market and to high-risk assets. In addition, the governance and administrative capacity of insurance and pension funds supervision remain weak.
- **Public debt is on a downward trajectory but its sustainability remains subject to sizeable risks.** A number of recent fiscal measures as well as delays in the implementation of key structural reforms (e.g. on the public administration and public sector wages), are expected to lead to a deterioration of the structural balance and risk reducing the scope for growth-enhancing public investments. This might make sustainable reduction of public debt more challenging. In addition, in the medium to long-term, international initiatives in the fight against tax avoidance could have an impact on Cyprus' tax revenues and fiscal position.
- **The net international investment position remains among the most negative in the EU.** This reflects the presence of special purpose entities in Cyprus and the large proportion of debt that is foreign-owned. Foreign deposits in

the financial sector remain high, at 110% of GDP, exposing Cyprus to changes in depositor confidence and adverse capital flows. The reduction of the current-account deficit falls short of what is required to bring the net international investment position to sustainable levels in the medium term.

Other key economic issues analysed in this report which point to particular challenges facing Cyprus' economy are as follows:

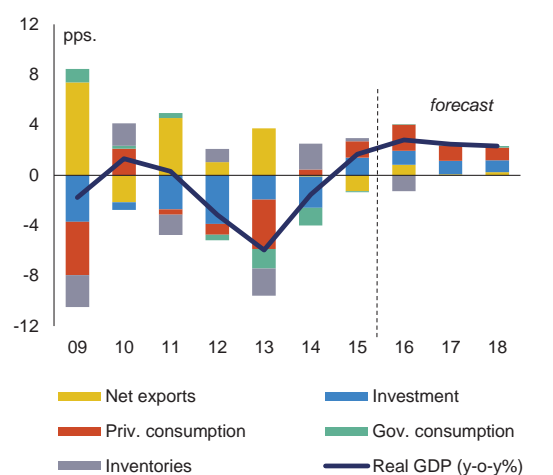
- **Unemployment is decreasing but remains high, especially amongst young people and long-term unemployed.** The reduction of unemployment accelerated in 2016, despite the weak capacity of the public employment services and the limited outreach of active labour market policies. A reform of wage indexation was agreed for state-owned entities linking wage growth to nominal economic growth. However, for the private sector an agreement among social partners is still pending. A temporary arrangement was agreed with social partners to avoid reinstating of the old system of wage indexation in 2017, which would have led to nominal wage cuts.
- **Weak labour productivity growth and inadequate skills development continue to weight on potential growth.** Low business dynamism and skills mismatches in the labour market limit job creation. While spending on education is above the EU average, education outcomes are relatively poor and participation in vocational education and training is low. The higher education attainment rate is very high, but there is a relatively low proportion of graduates in fields most related to innovation.
- **Indicators on risk of poverty or social exclusion deteriorated, reflecting a worsening of social conditions during the crisis.** Following an almost stable path between 2012 and 2014, social indicators worsened in 2015 due to a rising proportion of people at risk of poverty and living in low-work intensity households, in particular people with disabilities. This data does not yet reflect the recent recovery in the labour market. In-work poverty also rose, reflecting the worsening of working conditions during the economic crisis.
- **Pending reforms, the healthcare sector remains characterised by inefficiencies, constraining access to adequate and effective care.** Low public funding and inefficient use of resources result in inadequate access to care and ineffective care delivery in the public sector. The high proportion of private expenditure in total health expenditure is mostly directed towards unregulated private healthcare providers. Measures for public hospitals autonomy and the creation of a national health system aiming to improve the adequacy and cost-effectiveness of healthcare, are still awaiting parliamentary adoption.
- **Enforcement of environmental and climate legislations remains poor and the related green growth potential remains untapped.** Despite high environmental investment in some areas, compliance with environmental regulations is weak and Cyprus lacks framework policies to become more energy and resource efficient. There are major challenges as regards waste and water management, while policy instruments to reduce greenhouse gas emissions seem insufficient. The energy sector reform has made little progress, as Cyprus remains heavily dependent on fossil fuels.
- **Inefficiencies in the public sector and the judiciary remain a matter of concern.** Efforts are made to expand e-government services and improve regulatory quality, but public sector efficiency indicators remain average despite a comparatively high wage bill. Critical inefficiencies in the justice system persist but have started to be addressed by a series of reforms. The supervision of state-owned entities does not allow for adequate assessment of risks, while efforts to attract investors in public utilities are facing major obstacles.

1. ECONOMIC SITUATION AND OUTLOOK

GDP growth

Real GDP growth accelerated and is expected to have reached 2.8 % in 2016. A dynamic tourism sector and robust domestic demand, supported by low inflation, provided significant impetus to growth. Tourism benefited from several factors: a depreciation of the real effective exchange rate, downward price adjustments to attract more demand, measures to extend the season, better air connectivity, and geopolitical tensions in competing destinations.

Graph 1.1: Gross value added and contribution to growth



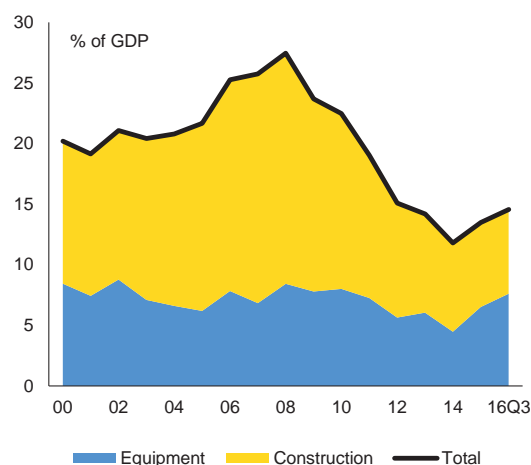
Source: Eurostat

Real private consumption expanded rapidly in 2016. In 2015, despite stagnating labour income, real consumption increased as a result of a drop in consumer prices, while nominal private consumption remained rather stable. Meanwhile in 2016 increasing labour income has played a more important role in supporting private consumption. Households have also used accumulated wealth to finance consumption, as reflected by a negative savings rate. Real private consumption is expected to have expanded by 3.0 % in 2016.

Real investment growth in 2015 and 2016 was driven by sizeable transfers of transport equipment to Cyprus (see Graph 1.2). Besides these transfers, equipment investment appeared to be subdued. Survey indicators suggest that credit demand, although weak, still exceeds supply. Weak gross operating surplus combined with a

lack of credit, contributed to holding back investment.

Graph 1.2: Investment



Source: Cystat

Inflation

Harmonised index of consumer prices (HICP) inflation rates remain negative, averaging -1.2 % in 2016. The decline in consumer prices reflects both the slack in the economy and declining energy prices. Headline inflation, excluding unprocessed food and energy, remained also negative at -0.7 % in 2016. Other indicators for core inflation, such as trimmed mean and weighted median, suggest that domestic cost pressure is mounting, albeit from negative territory. The decline in consumer prices was also observed in the GDP deflator, which is estimated to have fallen by 0.8 % in 2016.

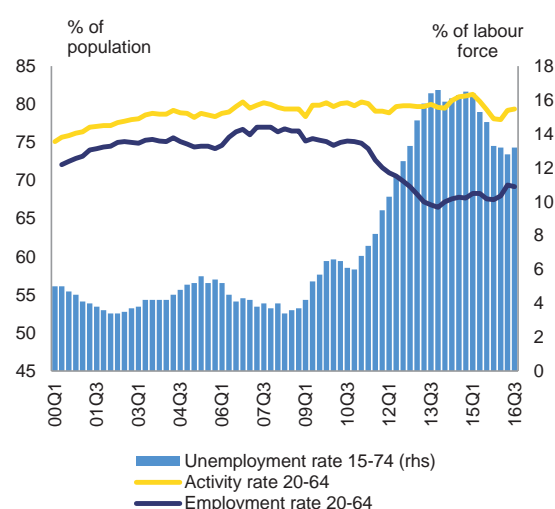
Profit margins have started to narrow. The downward adjustment in consumer prices has, up to 2016, been limited compared to the drop in unit labour costs. This suggests that companies have increased their profit margins instead of passing the entire decline in unit labour costs and energy prices on to consumers. In 2016 profit margins have narrowed, although they still remain high compared to the past.

Labour market

Labour market conditions have improved, although youth and long-term unemployment

remain very high. Unemployment fell from a peak of 16.5 % in 2014 to 13.2 % in the third quarter of 2016 (see Graph 1.3). This was driven by a gradual improvement in the job finding rate and a drop in the job separation rate ⁽¹⁾. Youth and long-term unemployment rates have declined but remain high, at 29.9 % and 5.8 % respectively. Long-term unemployment accounts for almost half of the total unemployment. This continues to be source of concern, also because one third of the unemployed have been so for more than two years. Even if the recent fall in unemployment could be partly attributed to a decreasing activity rate, more recent data show that activity rates are also recovering. .

Graph 1.3: **Unemployment and activity rates**



Source: Eurostat

Productivity growth remains weak, forecast at around 0.2 % in the first three quarters of 2016. This, combined with increasing compensation per employee, is expected to lead to an increase of unit labour costs as of 2017, after four years of negative adjustment (see Section 4.3).

Social developments

The risk of poverty or social exclusion rose in 2015 and is one of the highest in the EU. The recent recovery in the labour market is not yet reflected in social indicators, with an increase of the risk of poverty or social exclusion of 1.5 pps. to 28.9 % in 2015. While the poverty or social

⁽¹⁾ The job separation rate measures the probability that employed people will lose their job.

exclusion rate for elderly people has decreased considerably (from 27.2 % in 2014 to 20.8 % in 2015), the rate for children has increased (from 24.6 % in 2014 to 29.2 % in 2015) together with the number of jobless households. In-work poverty has grown due to the precariousness of the labour market (see Section 4.3).

Inequality has been rapidly increasing in recent years, and remains a source of concern.

The ratio of incomes between the richest 20 % and the poorest 20 % of the Cypriot population increased to 5.4 in 2014 (from 4.4 in 2009), before falling slightly in 2015, back to the EU average of 5.2. The widening inequality has been caused by faster income growth among the richest. The share of total income of the richest 10 % of households rose by 15 % from 2006 to 2015, while the income share of the poorest 10 % over the same period slightly declined. The tax-benefit system in Cyprus is among the least effective in the EU in reducing inequality.⁽²⁾ and its effectiveness may deteriorate even further following the abolition of the property tax in 2017. The worsening of working conditions during the crisis, especially as involuntary temporary and part-time employment were increasing and wages were adjusted significantly downwards, seem to be the main factors driving increased inequality. Net wealth ⁽³⁾ inequality was among the highest in the EU (ECB 2016). Going forward, an expected fall in unemployment and the return to positive wage growth (see Section 4.3) are likely to reduce inequality and minimise its possible adverse effects on economic growth.

External position

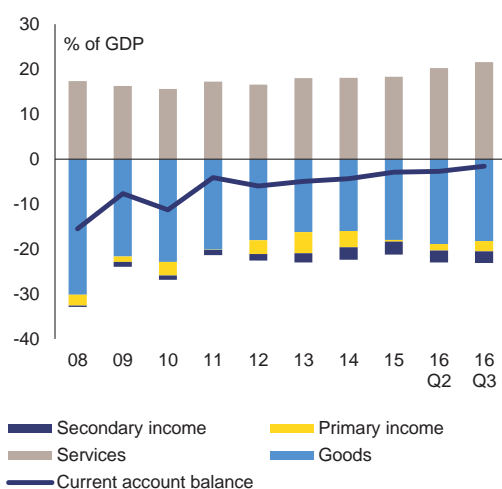
The current account deficit is expected to have narrowed to 1.6 % of GDP in 2016 from 3.0 % in 2015. Higher net export of services helped further to rebalance the current account. This more than offset the deterioration of the goods balance, due to stronger imports as a result of stronger domestic demand and imports of transport equipment. The negative secondary income

⁽²⁾ According to Eurostat 2014 data and Commission's calculations in 2014 the gap between the Gini coefficient before taxes and benefits ('market income inequality') and the Gini after taxes and benefits was only 10, as compared to an EU average of 19.7. Note that the Gini coefficient is an indicator with value between 0 and 1. Lower values indicate higher equality.

⁽³⁾ Difference between total assets and total liabilities.

account is expected to have lessened to around -2.5 % of GDP. This deficit is related to sizeable remittances, but also to marketing costs incurred by Cypriot investment firms trying to attract new customers. The primary income account has worsened, estimated at -2.3 % of GDP in 2016, mainly due to higher interest payments to non-residents.

Graph 1.4: Current account balance



Source: Eurostat

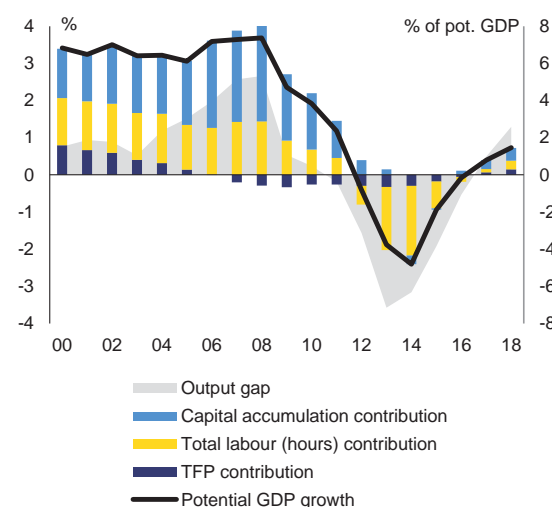
The net international investment position (NIIP) has remained negative. Nevertheless, it improved from the trough of -147 % of GDP in 2014 to -118 % of GDP in the third quarter of 2016. While special purpose entities ⁽⁴⁾ account for more than half of the negative NIIP (Central Bank of Cyprus, 2016), the public and private sectors had a NIIP of -79 % and -30 % of GDP, respectively (see Section 4.4.1).

Real GDP growth is expected to moderate to 2.5 % in 2017 and slow down to 2.3 % in 2018, due to slowing growth in the tourism sector, fading support from the negative inflation and depreciation of the real effective exchange rate.

⁽⁴⁾ Special purpose entities (SPEs) are legal entities that have limited operations. They relate to corporations, often subsidiaries, that are typically located in other jurisdictions. In Cyprus there are three major types: (i) financial companies, mainly financing and holding companies that channel funds within a worldwide group on behalf of a non-resident parent company, (ii) ship-owning companies (non-financial companies), and (iii) factoring and invoicing companies that are invoicing the sales of the worldwide group on behalf of the parent.

Moreover, higher debt servicing and continued loan restructuring efforts by banks are also projected to weigh on domestic private demand. Consumer prices are expected to increase moderately alongside gradually declining unemployment.

Graph 1.5: Potential output



Source: European Commission

Potential growth

Potential growth is expected to increase over the medium term. Gradually expanding investment is forecast to support total factor productivity growth and capital deepening. This in turn should support potential growth. Despite the higher investment growth rates, the investment-to-GDP ratio is expected to remain below its long term average since 1995. Improving labour market conditions should lower the structural unemployment rate and hence support potential growth, which is estimated at 0.5 % in 2018.

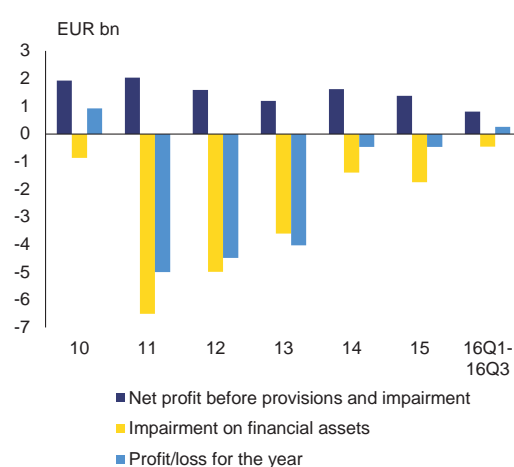
Financial sector

The financial sector is still heavily burdened with non-performing loans (NPLs), which account for half of the overall loan portfolio. Since the end of 2014, the proportions of NPLs in corporate and household loan portfolios have remained at levels of around 57 % of gross loans. Efforts for restructuring NPLs have increased since the end of 2015, as reflected by a declining share of loans more than 90 days past due. NPLs are to large extent concentrated in construction and real

estate sectors and banks are increasingly resorting to debt-to-asset swaps in loan restructuring transactions. This leads to an accumulation of real estate assets in their balance sheets, which in turn increases their vulnerability to property price developments (see Section 4.2.1).

The real estate market shows signs of stabilisation. The Cypriot housing market has undergone a sizeable price correction since 2008. The decline in house prices moderated markedly in 2016, after having fallen by 32 % from the 2008 peak. The number of building permits increased, albeit from low levels, and supported residential investment, pointing to some stabilisation in the short term. While it remains weak, housing demand improved slightly, as reflected by the Bank Lending Survey indicators and the increased number of property transactions (see Section 4.2.5).

Graph 1.6: Profits for the aggregate banking sector



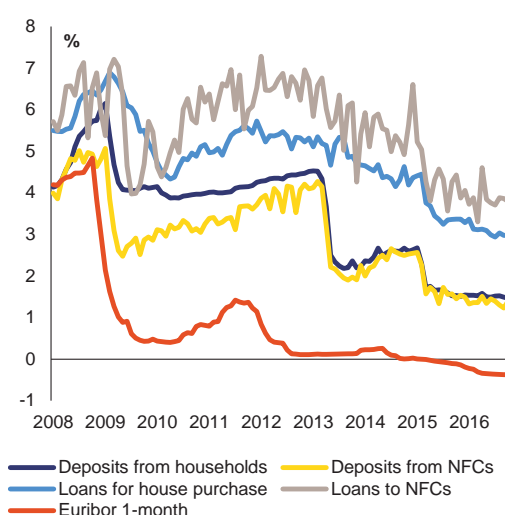
Source: European Commission

Risk provisioning improved in 2016 but remains below euro area average. Higher risk provisioning increases the cost of holding NPLs on a bank's balance sheet, and therefore provides additional incentives to restructure loans. Following the supervisory review and evaluation process in 2015 loan loss reserves increased from about 33 % to 38 % of the non-performing exposure. The coverage rate remains somewhat lower than the average of significant banks in the euro area. This is mostly due to banks' relatively optimistic assumptions regarding cost of recovery, valuation of recovered collateral and time to

recover collateral, combined with a high level of loan collateralisation.

Banks' return to profitability in the short term is challenged by provisioning and impairment costs. Cypriot banks recorded overall losses in 2015, despite a relatively moderate cost-to-income ratio. During the first nine months of 2016, Cypriot banks returned to profitability due to a decline in provisioning and despite the lower net operating income. In 2015, the Central Bank of Cyprus narrowed the maximum authorised spread between Euribor and deposit interest rates. Lending rates eventually declined faster than deposit rates, weakening the net interest margin, although the latter remains above the euro area average.

Graph 1.7: Interest rates developments



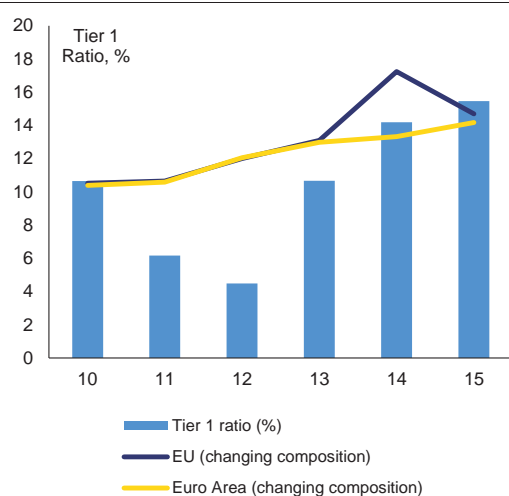
Source: Central Bank of Cyprus and European Central Bank.

Overall, the banks' capacity to generate profits remains under pressure (see Graph 1.6) in a context of very low and negative interest rates and further balance sheet deleveraging. Higher provisions would have a negative short-term impact on bank profits both directly and indirectly via the recording of accrued interest on the non-provisioned part of NPLs. In addition, the low interest rate environment's impact on profitability could lead to increasing risk-taking by banks (see Graph 1.7 and Section 4.2).

The Common Equity Tier 1 (CET1) capital ratio of all banks stood at 16 % in September 2016, about 0.7 pp. higher than a year before. The

higher CET1 ratio came from a further reduction in the aggregate risk-weighted assets, as the deleveraging process continued. Preserving the banking sector's sufficient capital levels is highly dependent on the successful reduction of NPLs and the associated provisioning for losses on non-performing borrowers.

Graph 1.8: Tier 1 ratio of Cypriot banks



Source: European Commission

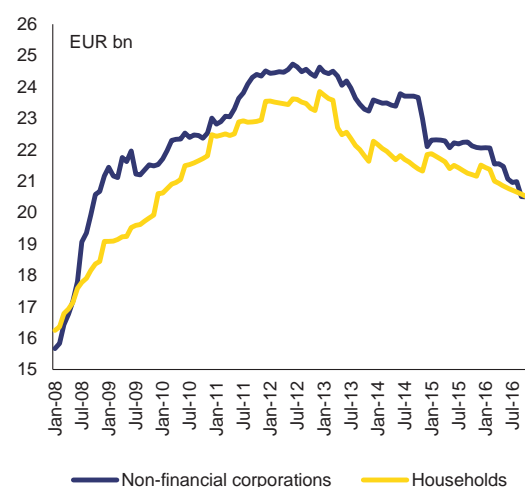
Banks' deleveraging continues. The gross stock of loans to domestic households and non-financial corporations contracted respectively by EUR 0.8 billion and EUR 1.9 billion year-on-year as of December 2016 (see Graph 1.9). All sectors included, the total stock of loans of Cypriot banks decreased by 11 % year-on-year as of December 2016. This contraction results mainly from the growing use of debt-to-asset swaps and debt write-offs by banks in order to restructure their non-performing exposures. This is also due, to a lesser extent, to the repayment of loans, while new lending activity is slowly picking up.

High private sector debt limits the scope for stronger expansion of lending. In 2015, debt of non-financial corporations stood at around 150 % of GDP, excluding special purpose entities debt (75 % of GDP). Debt of households stood close to 130 % of GDP (see Section 4.2.4). This restricts the pool of borrowers able to take on additional debt.

Deposits increased in 2016, on the back of strengthened confidence. Total deposits in

Cyprus increased by about EUR 3.0 billion (or 6.2 %) as of December 2016. By June 2016 the Greek subsidiaries had already recovered the liquidity that was shed in 2015, i.e. more than EUR 600 million. By depositor types, the highest annual growth rates were recorded for households from the rest of the world and Cypriot non-financial corporations.

Graph 1.9: Outstanding loans to domestic residents



Source: Central Bank of Cyprus

The reliance on central bank funding was reduced significantly, with emergency liquidity fully repaid. This was mainly achieved thanks to the broadening of the deposit base and the successful downsizing of the bank assets. As of November 2016, total reliance on central bank funding by Cypriot banks stood at EUR 1.2 billion, down from EUR 4.7 billion at end-2015. The Eurosystem emergency liquidity assistance was fully repaid in January 2017.

Public finances

The primary surplus is expected to have improved to 2.5 % of GDP in 2016, up from 1.7 % of GDP in 2015. As of November 2016, the general government headline and primary surpluses stood at 0.8 % and 2.9 % of GDP respectively. Revenue increased by 0.7 % year-on-year, driven by the increases recorded for taxes on income and wealth, social security contributions and taxes on production and imports. This is due to a stronger cyclical position, better labour market conditions and higher imports. On the expenditure side, general government expenditure decreased slightly by 0.3 % year-on-year. This is due, in particular, to lower intermediate consumption and compensation of employees, partly offset by rising social transfers, subsidies and gross fixed capital formation.

The primary surplus is forecast to deteriorate to 2.2 % for 2017 amid growing pressures for fiscal relaxation. In 2017, the non-compensation of the abolition of the immovable property tax is expected to lower revenues, while the partial change to professional army will weigh on expenditure.

The headline balance should stabilise in 2017 at -0.2 % of GDP. In 2018, it is expected to improve to a balanced position thanks to economic growth. Public debt is expected to decrease both as a proportion of GDP and in absolute numbers. It is still expected to fall to 83 % of GDP by 2027.

Table 1.1: Key Economic, Social and Financial indicators - Cyprus

	2004-2008	2009	2010	2011	2012	2013	2014	2015	forecast		
									2016	2017	2018
Real GDP (y-o-y)	4.3	-1.8	1.3	0.3	-3.2	-6.0	-1.5	1.7	2.8	2.5	2.3
Private consumption (y-o-y)	6.6	-6.4	3.3	-0.7	-1.3	-5.9	0.7	1.9	3.0	1.7	1.4
Public consumption (y-o-y)	4.0	6.4	1.2	2.1	-2.3	-8.2	-7.9	-0.6	0.3	0.7	0.8
Gross fixed capital formation (y-o-y)	9.9	-13.6	-2.6	-12.1	-20.5	-12.9	-17.5	12.0	8.3	7.4	6.3
Exports of goods and services (y-o-y)	2.1	-4.1	4.5	5.6	-2.7	2.1	4.2	0.0	6.5	4.6	3.8
Imports of goods and services (y-o-y)	7.4	-15.0	8.0	-3.0	-4.4	-4.8	4.6	2.1	5.1	4.7	3.6
Output gap	4.0	1.1	0.5	-0.4	-3.1	-7.2	-6.3	-3.8	-1.1	1.0	2.6
Potential growth (y-o-y)	3.4	2.4	1.9	1.2	-0.4	-1.9	-2.4	-0.9	-0.1	0.4	0.7
Contribution to GDP growth:											
Domestic demand (y-o-y)	7.0	-6.9	1.7	-2.7	-5.2	-7.4	-3.4	2.6	3.2	2.4	2.1
Inventories (y-o-y)	0.4	-2.5	1.8	-1.6	1.1	-2.2	2.1	0.3	-1.3	0.0	0.0
Net exports (y-o-y)	-3.1	7.4	-2.1	4.6	1.0	3.7	-0.1	-1.3	0.8	0.1	0.2
Contribution to potential GDP growth:											
Total Labour (hours) (y-o-y)	1.3	0.9	0.7	0.5	-0.5	-1.7	-1.9	-0.7	-0.1	0.1	0.2
Capital accumulation (y-o-y)	2.1	1.8	1.5	1.0	0.4	0.2	-0.2	0.0	0.1	0.2	0.3
Total factor productivity (y-o-y)	0.0	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.1	0.1	0.1
Current account balance (% of GDP), balance of payments	.	-7.7	-11.3	-4.1	-6.0	-4.9	-4.3	-2.9	.	.	.
Trade balance (% of GDP), balance of payments	.	-5.4	-7.3	-2.9	-1.5	1.8	2.1	0.3	.	.	.
Terms of trade of goods and services (y-o-y)	.	0.2	0.2	-0.4	0.9	-1.1	0.5	-0.7	3.3	-0.6	0.0
Capital account balance (% of GDP)	.	0.3	0.3	0.4	0.2	1.4	0.8	0.3	.	.	.
Net international investment position (% of GDP)	.	-100.3	-111.2	-129.9	-129.2	-138.9	-147.3	-130.3	.	.	.
Net marketable external debt (% of GDP) (1)	.	-56.5	-113.4	-109.0	-103.2	-111.1	-113.4	-131.6	.	.	.
Gross marketable external debt (% of GDP) (1)	.	620.2	594.4	557.7	536.5	485.5	464.2	470.1	.	.	.
Export performance vs. advanced countries (% change over 5 years)	.	-1.5	-9.0	-3.5	-12.8	-7.1	-18.0	-15.02	.	.	.
Export market share, goods and services (y-o-y)	.	12.9	-14.7	-4.9	-8.9	2.3	0.9	-7.0	.	.	.
Net FDI flows (% of GDP)	.	-7.5	12.9	-15.2	10.2	-1.7	-8.0	48.4	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	2.8	3.2	0.8	0.6	-2.4	-10.8	-16.2	-13.7	.	.	.
Private credit flow, consolidated (% of GDP)	22.9	7.9	13.2	13.0	15.5	-11.7	0.2	4.4	.	.	.
Private sector debt, consolidated (% of GDP)(5)	264.8	306.1	315.5	321.7	327.4	340.9	354.2	353.8	.	.	.
of which household debt, consolidated (% of GDP)	90.3	112.5	118.3	121.3	126.5	127.5	131.0	129.2	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)(5)	174.5	193.6	197.2	200.4	200.9	213.4	223.2	224.6	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-10.6	2.2	-1.7	4.8	3.6	7.7	14.3	7.1	4.3	3.6	3.0
Corporations, gross operating surplus (% of GDP)	23.1	19.9	20.2	20.7	20.3	22.5	21.9	21.7	20.5	20.4	20.6
Households, net lending (+) or net borrowing (-) (% of GDP)	-6.6	-4.3	-4.2	-2.6	-3.3	-6.8	-9.5	-8.8	-7.0	-6.6	-6.5
Deflated house price index (y-o-y)	5.7	-6.6	-7.6	-4.5	-5.4	-4.1	-1.3	0.2	.	.	.
Residential investment (% of GDP)	11.1	9.8	8.1	6.2	4.9	4.1	4.1	4.3	.	.	.
GDP deflator (y-o-y)	3.7	0.0	2.0	1.9	1.9	-1.0	-1.5	-1.3	-1.0	1.0	1.2
Harmonised index of consumer prices (HICP, y-o-y)	2.5	0.2	2.6	3.5	3.1	0.4	-0.3	-1.5	-1.2	1.2	1.1
Nominal compensation per employee (y-o-y)	3.6	5.7	0.7	2.1	1.5	-5.4	-3.6	-0.5	0.1	0.9	1.5
Labour productivity (real, person employed, y-o-y)	0.8	-1.8	0.8	0.3	0.0	0.0	0.4	0.9	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2.8	7.7	-0.2	1.8	1.5	-5.4	-4.0	-1.5	0.0	0.6	0.9
Real unit labour costs (y-o-y)	-0.8	7.6	-2.1	-0.1	-0.4	-4.4	-2.5	-0.2	1.0	-0.4	-0.3
Real effective exchange rate (ULC, y-o-y)	1.2	4.7	-2.8	1.5	-1.7	-2.3	-4.2	-5.7	0.3	0.1	-0.8
Real effective exchange rate (HICP, y-o-y)	0.5	1.0	-4.1	0.1	-2.0	1.1	-0.8	-6.5	0.6	-1.1	.
Tax rate for a single person earning the average wage (%)	7.9	.	.	.	.	.	.	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	.	.	.	.	.	.	.	.	.	.	.
Total Financial sector liabilities, non-consolidated (y-o-y)	50.1	7.3	8.5	-8.2	15.1	-15.3	-3.8	2.3	.	.	.
Tier 1 ratio (%) (2)	.	9.3	10.7	6.2	4.5	10.7	14.2	15.5	.	.	.
Return on equity (%) (3)	.	6.8	6.7	-102.8	-164.9	-145.5	-8.6	-9.0	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (4)	.	4.3	5.6	11.9	18.7	37.1	35.6	34.7	.	.	.
Unemployment rate	4.4	5.4	6.3	7.9	11.9	15.9	16.1	15.0	13.3	12.0	11.0
Long-term unemployment rate (% of active population)	0.9	0.6	1.3	1.6	3.6	6.1	7.7	6.8	.	.	.
Youth unemployment rate (% of active population in the same age group)	10.7	13.8	16.6	22.4	27.7	38.9	36.0	32.8	30.1	.	.
Activity rate (15-64 year-olds)	73.1	73.0	73.6	73.5	73.5	73.6	74.3	73.9	.	.	.
People at risk of poverty or social exclusion (% total population)	24.8	23.5	24.6	24.6	27.1	27.8	27.4	28.9	.	.	.
Persons living in households with very low work intensity (% of total population aged below 60)	4.1	4.0	4.9	4.9	6.5	7.9	9.7	10.9	.	.	.
General government balance (% of GDP)	-0.6	-5.4	-4.7	-5.7	-5.8	-4.9	-8.8	-1.1	0.0	-0.2	0.4
Tax-to-GDP ratio (%)	32.7	31.8	31.9	31.9	31.6	31.5	33.2	32.7	32.7	31.9	32.1
Structural budget balance (% of GDP)	.	.	-5.0	-5.3	-4.5	-0.9	3.0	1.7	0.6	-0.7	-0.9
General government gross debt (% of GDP)	56.8	53.4	55.8	65.2	79.3	102.2	107.1	107.5	107.4	103.2	99.6

(1) Sum of portfolio debt instruments, other investment and reserve assets

(2,3) domestic banking groups and stand-alone banks

(4) domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches

(5) These figures include Special Purpose Entities

(*) Indicates BPM5 and/or ESA95

Source: European Commission, ECB

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Progress made on recommendations addressed to Cyprus in 2016 ⁽⁵⁾ has to be seen as part of a longer process which started with the introduction of the European Semester in 2011. In March 2016, Cyprus completed a three-year EU-IMF economic adjustment programme whereby it adopted a wide range of financial, fiscal and structural reforms. The programme allowed Cyprus to make progress in implementing most of the recommendations made in 2011 and 2012.

The public financial management and budgetary framework was strengthened, with the adoption of the Financial Responsibility and Budget Framework Law.

The financial sector regulations underwent significant reforms, notably through the harmonisation and integration of the supervision of banks and cooperative credit institutions.

The recommendation related to the services sector was successfully implemented, as most sector-specific obstacles to the establishment and free provision of services have been removed.

Recommendations related to the pension system and social benefits were addressed through the reform of the pension system, which ensured its long term sustainability, and the introduction of the guaranteed minimum income (GMI) which allows for more efficient and targeted social benefits.

Recommendations related to the labour market were implemented through reforming wage indexation, measures to promote youth employment and improvements to the vocational education system.

Measures were introduced to promote renewable energy source and achieve a diversification of the energy mix as recommended in 2011. However, Cyprus is still heavily dependent on fossil fuels for energy production.

Finally, the past recommendation regarding the reform of the national healthcare system has not yet been implemented, with key reform bills still

awaiting adoption by the House of Representatives.

Overall, Cyprus has made limited ⁽⁶⁾ progress in the implementation of the 2016 country-specific recommendations. Limited progress was made on the implementation of fiscal structural measures, despite completion of the fiscal framework. Progress was also limited with regard to measures to help decrease the high private sector debt, notably concerning insolvency, foreclosure, title deeds and judicial reform. Some progress was made on the recommendation to reduce the level of non-performing loans, with enhancements to the credit register and measures to accelerate loan restructuring. There was also some progress with regard to the recommendation to promote investments. The action plan for growth is gradually being implemented although with delays and some measures were announced to improve access to finance, but privatisation efforts and measures to facilitate strategic investments are facing delays. Finally, progress remained limited with regard to the recommendation on employment services and healthcare reform. Planned measures to increase the capacity of public employment services have not been implemented yet, while the impact of active labour market policies has not been assessed. As mentioned above, legislative proposals for the reform of the healthcare system are still awaiting adoption by the House of Representatives.

Cyprus is benefiting from technical support provided by the Commission to help implement structural reforms in various areas including public administration and justice, growth and the business environment, healthcare, education, public financial management, taxation, and the financial sector.

⁽⁵⁾ For the assessment of other reforms implemented in the past, see Section 4 in particular

⁽⁶⁾ Information on the level of progress and actions taken to address the policy advice in each subpart of a country-specific recommendation is presented in the overview table in the Annex. This overall assessment of recommendation 1 does not include an assessment of compliance with the Stability and Growth Pact. Source: European Commission.

Table 2.1: Summary table on 2016 CSR assessment

2016 CSRs to Cyprus	Overall assessment of progress with the 2016 CSRs: Limited Progress ¹
CSR1: <i>By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public employees. By the end of 2016, adopt the horizontal reform of the public administration and the law on the governance of state-owned entities, and implement the reform of local governments. By the end of 2016, adopt the secondary legislation to complete the new budgetary framework. (MIP Relevant)</i>	Limited progress*: <ul style="list-style-type: none"> • Substantial progress on the secondary legislation completing the new budgetary framework. • Limited progress regarding the binding mechanism containing the growth rate of the compensation of public employees. • No progress regarding the horizontal reform of the public administration. • No progress regarding the law on the governance of state-owned entities. • No progress regarding the reform of local governments.
CSR2: <i>By June 2017, eliminate impediments to the full implementation of the insolvency and foreclosure frameworks and ensure adequate resources for the Insolvency Service. Ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. Increase the efficiency and capacity of the court system. Reform the civil procedure law. (MIP Relevant)</i>	Limited progress: <ul style="list-style-type: none"> • Some progress in eliminating impediments to the full implementation of the insolvency and foreclosure frameworks and in ensuring adequate resources for the Insolvency Service. • Limited progress on ensuring reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. • Limited progress on increasing the efficiency and capacity of the court system and reforming the civil procedure law.
CSR3: <i>By the end of 2016, take measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. Increase the range of information available for creditors to make the credit registry fully operational. (MIP Relevant)</i>	Some progress: <ul style="list-style-type: none"> • Some progress on taking measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. • Some progress in increasing the range of information available for creditors through the credit registry.
CSR4: <i>Remove impediments to investment, notably by implementing the action plan for growth, pursuing the privatisation plan and strengthening the national regulatory authorities. Take measures to increase access to finance for small and medium-sized enterprises. (MIP Relevant)</i>	Some progress: <ul style="list-style-type: none"> • Some progress in implementing the action plan for growth. • Limited progress in pursuing the privatisation plan. • Some progress in strengthening national regulatory authorities. • Limited progress in increasing access to finance.
CSR5: <i>Enhance the capacity of the public employment services and their provision to the long-term unemployed; improve outreach to the non-registered unemployed. Adopt legislation for a hospital reform and advance with the planned implementation of universal health care coverage. (MIP Relevant)</i>	Limited progress: <ul style="list-style-type: none"> • Limited progress in enhancing the capacity of the public employment services and their provision to the long-term unemployed; and some progress in improving outreach to the non-registered unemployed.

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Table (continued)

<p>CSR5: <i>Enhance the capacity of the public employment services and their provision to the long-term unemployed; improve outreach to the non-registered unemployed. Adopt legislation for a hospital reform and advance with the planned implementation of universal health care coverage. (MIP Relevant)</i></p>	<p>Limited progress:</p> <ul style="list-style-type: none"> • Limited progress in enhancing the capacity of the public employment services and their provision to the long-term unemployed; and some progress in improving outreach to the non-registered unemployed. • Limited progress in adopting legislation for a hospital reform and advancing with the planned implementation of universal health care coverage.
<p>* This overall assessment of CSR1 does not include an assessment of compliance with the Stability and growth Pact</p>	
<p>Source: European Commission</p>	

Box 2.1: Contribution of the EU budget to structural change in Cyprus

The total allocation of the European Structural and Investment Funds (ESIF) in Cyprus amounts to EUR 874 million under the current financial framework 2014-2020. This is equivalent to around 0.9 % of GDP annually (at 2014-2017) and 24 % of national public investment¹. By 31 December 2016, an estimated EUR 49 million, which represent about 6 % of the total allocation for ESI Funds, have already been allocated to concrete projects. However, the set-up of financial instruments for maximising the effects of ESI Funds support and facilitating access to finance is still pending².

Financing approved by the EIB Group under the European Fund for Strategic Investments (EFSI), Horizon 2020, the Connecting Europe Facility and other directly managed EU funds is additional to the ESI Funds. By end 2016, Cyprus had signed agreements for EUR 5 million for projects under the Connecting Europe Facility. In addition, the EIB Group approved financing under EFSI amounting to EUR 5 million, which is expected to trigger nearly EUR 14 million in total investments (as of end 2016).

ESI Funds helped progress on a number of structural reforms in 2015 and 2016 via ex-ante conditionalities³ and targeted investment. Examples include enhancing competitiveness and innovation, promoting Cyprus' digital strategy, improving ecosystems and biodiversity, supporting the shift towards a low-carbon economy, reducing youth unemployment, encouraging active inclusion and vocational education and training. These reforms have laid the ground for better implementation of public investment projects in general, including those financed from national sources and from the other EU instruments mentioned above. Fulfilment of the remaining ex-ante conditionalities is on track. Support to administrative reforms is available through targeted financing under the European Social Fund as well as advice and technical assistance from the European Commission's Structural Reform Support Service. Only one environmental conditionality on solid waste remains to be fulfilled, while the fulfilment of the conditionality on water is currently under assessment.

The Country-specific recommendations focusing on structural issues were taken into account when designing the 2014-2020 programmes for the funds. Particular attention was granted to challenges identified in the context of the 2013-2016 economic adjustment programme. These include boosting competitiveness (including for the agro-food sector and aquaculture enterprises) and economic growth through support to entrepreneurship and innovation. The 2014-2020 programmes also aim to promote a more efficient public administration and to support the reform of the Common Fisheries Policy (CFP). With regard to social issues the programmes seek to contribute to the reduction and prevention of poverty, promote vocational education and training, support public employment services and employment, especially youth employment and the activation of long term unemployed as well as that of vulnerable groups. To date, over 1 700 young people have been supported under Youth Employment Initiative-financed measures, of whom 443 were in employment, education or training as of end-2016.

In addition to the aforementioned challenges, ESI Funds address wider structural obstacles to growth and competitiveness. The funds will help Cyprus meet EU standards in a number of areas. On energy, the funds will support the objective of reducing the annual primary energy consumption of public buildings by 3.000.000 kW. On digital policy, they will help Cyprus reach its objective to ensure high-speed broadband coverage for 50% of households. The funds will also support the objective to increase waste treatment and recycling by 50% and promote the improvement of waste water treatment. On agriculture, they will support the achievement of at least 5% of savings in water used for agriculture by investing in more efficient

¹ National public investment is defined as gross capital formation + investment grants + national expenditure on agriculture and fisheries

² The necessary ex-ante assessment on the basis of which the appropriate financial instruments will be set up is expected to be delivered by June 2017.

³ Before programmes are adopted, Member States are required to comply with a number of ex-ante conditionalities, which aim at improving framework and conditions for the majority of public investments areas. For Member States that did not fulfil all the ex-ante conditionalities by the end 2016, the Commission has the possibility to propose the temporary suspension of all or part of interim payments.

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Box (continued)

irrigation systems on 41% of the irrigated agricultural land. They will contribute to support 300 young farmers to create viable rural businesses.

For more information, please visit: <https://cohesiondata.ec.europa.eu/countries/CY>

3. SUMMARY OF THE MAIN FINDINGS FROM THE MIP IN-DEPTH REVIEW

The 2017 Alert Mechanism Report called for further in-depth analysis to monitor progress in the unwinding of the excessive imbalances identified in the 2016 MIP cycle. On the basis of the in-depth review of spring 2016, the excessive macroeconomic imbalances identified in Cyprus take the form of large private, government and external debt. Major weaknesses were also identified in the financial sector, burdened with a non-performing loans ratio close to 50 %. The analysis also identified subdued potential growth and relatively high unemployment as important adjustment issues.

This report provides an in-depth review of how the identified imbalances have developed. In particular, the in-depth review is found in the following sections: excessive government debt is analysed in Sections 4.1.1 and 4.1.2; financial sector imbalances are discussed in Section 4.2.1; developments in private indebtedness in Section 4.2.4; and external imbalances in Section 4.4.1. Investment is analysed in Section 4.4.2, given its links to private indebtedness and growth.

3.1 Imbalances and their gravity

Cyprus has a large negative net international investment position (NIIP) of around 118 % of GDP combined with a current-account deficit of around 1.6 % of GDP in the third quarter of 2016. Even excluding special purpose entities (SPEs) registered in Cyprus ⁽⁷⁾, which distort the liability position, the NIIP remained at -40 % of GDP. The persisting negative current-account of -1.6 % of GDP reflects low domestic savings, rather than a high level of investment. Although a booming tourism sector and a depreciation of the real exchange rate helped to reduce the current-account deficit, this was partially offset by higher imports and income transfers to non-residents.

Public debt is high, standing at 108 % of GDP at end-2015. This makes the country vulnerable to financial or economic shocks, which could increase its financing costs. The pace of downward adjustment depends, inter alia, on the ability of the authorities to ensure responsible fiscal policies in an increasingly challenging political environment.

Fiscal policy is turning pro-cyclical and is expected to lead to a deterioration in the structural balance in 2017-2018.

Private sector indebtedness remains among the highest in EU, above 350 % of GDP in 2015. Private sector debt is very high both for households (close to 130 %) and for non-financial corporations (nearly 230 %). Even excluding ship-owning SPEs, the debt of non-financial corporations still remains high at around 150 % of GDP. This limits the non-financial private sector's ability to increase its currently low level of investment.

Almost half of the financial sector's loan book is currently non-performing. The deep recession triggered a surge in non-performing loans, fuelled by the high level of indebtedness and weak contract enforcement. The high stock of NPLs continues to raise concerns for financial stability, as it weighs on banks' profitability and limits their ability to generate capital and increase credit supply.

Low potential growth is making the unwinding of accumulated stock imbalances particularly challenging. The extent of the imbalances suggests that the adjustment process will need years of sustained economic growth. However, the drivers of Cyprus' growth potential are currently weak, due in particular to low investment and subdued productivity growth.

The depressed housing market has deterred the selling of assets, thereby slowing down debt reduction and incentivising strategic defaults. A large proportion of loans have real estate property as collateral. However, asset disposals, namely asset sales, remain unattractive due to declining housing prices. In addition, the difficulties in issuing and transferring title deeds have deterred demand for housing and weighed on the liquidity of property markets.

3.2 Evolution, prospects and policy responses

The current-account balance improved, helped by a significant depreciation of the real effective exchange rate. The current-account balance

⁽⁷⁾ See Section 1, p. 7.

improved from -4.3 % in 2014 to -1.6 % of GDP in the third quarter of 2016. Tourism exports benefitted from structural reforms but also from external factors, such as geopolitical tensions and safety concerns in competing tourist destinations. A current-account close to balance and a trade balance of close to 10 % would allow Cyprus to reduce its NIIP to the MIP threshold of -35 % of GDP by 2026.

The NIIP has been improving in parallel with a decline of the current-account deficit. The NIIP adjusted from its trough of -147 % of GDP in 2014 to -118 % of GDP in the third quarter of 2016, mainly due to valuation effects. The financial liabilities of SPEs still weigh on the NIIP and external liabilities of banks remain high. This exposes the financial sector and the economy to volatility risks in cases of shifts in investor and depositor confidence.

Government debt is projected to fall to 83 % of GDP by 2027, but recent changes in fiscal policy have slowed down the pace of public debt reduction. Long term risks are moderate, mainly due to favourable projected costs of ageing. Yet, as the economy recovers, fiscal policy has become increasingly pro-cyclical, narrowing the tax base and reducing the scope for growth-enhancing expenditures over investment. The Commission winter 2017 forecast envisages a deterioration in the structural fiscal position in the medium term. It would take a cumulative improvement in the structural primary balance of 1.7 % of GDP over five years (from 2019 to 2023) for Cyprus to reach the debt reference value of 60 % of GDP by 2031.

Further reduction of public debt depends on ensuring a responsible fiscal policy stance. A sound fiscal policy, including a reduction of the public sector wage bill, and a reform of the public administration and local governments remain key to safeguarding the long-term sustainability of public finances. Public expenditure could also better support potential growth by shifting towards more long-term productivity-enhancing projects, including investment in R&D, in a fiscally neutral manner.

Private sector deleveraging gained traction in 2016, despite the limited use of the new insolvency tools. Households and non-financial corporations had reduced their loans from the

domestic banks by 14 pps. of GDP in September 2016 compared to September 2015. The debt reduction was supported by economic recovery and adjustments caused by valuation effects (i.e. debt write-offs and debt-to-asset swaps), rather than actual loan repayments. The new insolvency framework has been used only scarcely to date, due to obstacles to its effective application (inadequate court rules, capacity limitations, impediments in the law) and inefficiencies in the judicial system.

Continued efforts at loan restructuring have helped to start a reduction of NPLs. Banks have intensified their restructuring efforts, leading to positive results in the performance of restructured loans. In absolute terms, NPLs have declined by about EUR 2.5 billion since end-2015. However, the ratio of NPLs to gross loans has remained stable at levels slightly below 50 % since 2014, due to a corresponding reduction in gross loans. This stability is also due to a regulatory lag effect, since restructured NPLs must show full compliance with repayment terms for at least one year before being classified as "performing loans".

Policy measures have had limited effectiveness in substantially reducing debt levels and NPL ratios. Weak contract enforcement incentivises slow repayment of debt, which continues to hamper private sector deleveraging. The effectiveness of the policy measures introduced so far remains limited. Weak contract enforcement stems from inefficiencies in the judicial system, bottlenecks in implementing the foreclosure and insolvency frameworks and remaining information gaps regarding borrowers. Little progress was made in addressing the significant shortcomings of the system of issuance and transfer of property title deeds.

A key challenge is to avoid the build-up of new financial sector imbalances in the short term. Banks' profitability is expected to remain challenged by risk provisioning and impairment needs, and a constrained pool of eligible borrowers. Liquidity buffers continue to increase since banks limit new credit to the economy. Low investment returns combined with abundant liquidity might lead to higher risk-taking. In addition, banks are increasingly resorting to debt-to-assets swaps. Banks are therefore engaged in a balancing act, trying to maximise recovery values

while limiting the increase of housing supply, as the latter could exert downward pressure on housing prices and collateral values. In addition, it has been recognised that more measures are needed to align the regulation and supervision of financial institutions, including pension and insurance companies, with international best practices, thus further safeguarding financial stability.

Signs of stabilisation have emerged in the housing market, yet remaining inefficiencies slow down the deleveraging process. The housing market remains fragile. There are still significant backlogs and delays with issuing title deeds and major obstacles to transferring title deeds from property sellers to final buyers. This, together with deleveraging pressure on households and a rather subdued outlook for labour income, weigh on housing demand. Restructuring solutions based on debt-to-assets swaps, involving the acquisition and sale of real estate pledged as collateral, may bolster the supply of houses for sale over the medium term and slow down the recovery in housing prices.

Labour productivity and potential growth remain low, slowing down the unwinding of the macroeconomic imbalances. Total fixed investment, at 13 % of GDP, is among the lowest in the EU and productivity has broadly stagnated since 2008. In the medium term, emerging upward cost pressures could erode competitiveness if productivity does not improve. Low business dynamism weighs on productivity and skills mismatches in the labour market are still largely unaddressed. As a result potential growth estimates for Cyprus remain subdued. This hampers the balance sheet adjustment of most sectors of the economy.

Structural reforms to improve the business environment are slowly being implemented. The action plan for growth aims to improve the business environment, tackle the lack of alternative financing sources and boost investment and employment in key sectors of the economy, including tourism and shipping. In addition, the government intends to lighten the regulatory burden by making existing procedures more efficient, developing digital public services and improving the quality of regulation. However, the privatisation plan adopted to attract investment and

foster efficiency in public utilities has largely been put on hold.

3.3 Overall assessment

Cyprus still faces important challenges in the form of very high NPLs burdening the financial sector, combined with large stocks of private, government, and external debt. The current-account remains negative, which does not support a sustainable correction of the NIIP. Government debt is on a downward path, although fiscal relaxation measures might slow-down debt reduction in a context of low potential growth and inflation. Private sector debt and its ratio of NPLs remain high. The surge in NPLs has dried up credit supply, and is weighing on investment and harming the growth potential of the economy. Aggregate savings increased somewhat in 2015 but still remain insufficient to improve the saving-investment balance. All in all, low savings and depressed potential growth make the deleveraging process rather difficult.

Successful implementation of policy measures to address macroeconomic imbalances remains a challenge. The measures taken to reduce the proportion of NPLs, such as the revised insolvency framework and a strengthened supervisory and regulatory framework face obstacles to their effective application. Other reforms regarding public administration, justice, title deeds, and privatisation plan have lost momentum, while improvements to the business environment are being implemented only slowly.

Table 3.1: MIP assessment matrix for Cyprus

This MIP Assessment Matrix summarises the main findings of the in-depth review in the country report. It focuses on imbalances and adjustment issues relevant for the MIP.			
	Gravity of the challenge	Evolution and prospects	Policy response
<i>Imbalances (unsustainable trends, vulnerabilities and associated risks)</i>			
External Balance	<p>The NIIP stood at -118 % of GDP in the third quarter of 2016. The current account balance amounted to -1.6 % of GDP in 2016, falling short of what is required for a swift external rebalancing.</p> <p>There is a significant real exchange rate depreciation of -6.2 % over three years and 6.5 % y-o-y, beyond the MIP threshold of 5 %. Cyprus continues to lose export market shares.</p>	<p>The NIIP has adjusted from its trough of -147 % of GDP in 2014 to around -118 % of GDP in 2016. This was mainly due to valuation effects and improving current account balance, supported by booming tourism exports.</p> <p>The real exchange depreciation, which contributed to improved current account, is a by-product of lower unit labour costs and negative inflation (see Section 1.1).</p>	<p>Tourism exports have been stimulated by structural reforms aimed at extending the tourism season and improving air connectivity, but less has been done in other areas.</p> <p>Price competitiveness gains have been a key factor to current account developments in Cyprus. This highlights the importance of stronger productivity and non-price competitiveness gains, as well as contained wage inflation (see Section 4.4).</p>
Private debt	<p>Non-financial private sector debt in Cyprus climbed to above 350 % of GDP, among the highest level in the EU (see Section 1).</p> <p>A large proportion of debt stocks are non-performing due to poor contract enforcement, low nominal income growth and high unemployment.</p>	<p>Households' debt declined from 131 % of GDP in 2014 to 129 % of GDP in 2015, while for non-financial corporations (excluding ship-owning special purpose entities) the ratio remained at around 149 %.</p> <p>The use of the new insolvency framework has been very limited, while depressed property prices make asset disposal less attractive for debt reduction (see Section 4.2)</p>	<p>Debt-to-asset swaps have been used as a deleveraging tool, but deficiencies in the insolvency service and the judicial system constrain the effectiveness of the new insolvency tools.</p> <p>Reforms of land registry regulations to enhance the definition of property rights have been delayed (see Section 4.2).</p> <p>New Rules of Court for insolvency are being adopted. Amendments to the Civil Procedure Law have been proposed to improve the enforcement of contracts and court decisions (see Section 4.6).</p>
Public debt	<p>General government debt stood at 108 % of GDP in 2015, exposing Cyprus to changes in financial or economic conditions that might increase financing costs (see Section 1).</p>	<p>The debt-to-GDP ratio is projected to decline at a slower pace than what was envisaged during the macroeconomic adjustment programme.</p> <p>Cyprus' sovereign credit ratings have improved significantly since mid-2013, but remain below investment grade (see Section 4.1).</p>	<p>Fiscal relaxation and stalling implementation of fiscal-structural reforms have contributed to slowing down of adjustment (see Sections 4.1 and 4.6).</p> <p>Abolishing the property tax at national level reduces the range of tax instruments and increases the weight of less growth-friendly forms of taxation.</p> <p>High current expenditures may crowd out public investment (see Section 4.1).</p>
Financial Sector	<p>NPLs in the Cypriot banking sector comprise around 50 % of all loans, among the highest ratio in the euro area.</p> <p>Depressed housing prices affect a large proportion of loans, which are backed by property collateral.</p> <p>Banks' weak profitability challenges their ability to ensure adequate capitalisation in the long term.</p>	<p>The ratio of NPLs was virtually stable at around 48 % of gross loans between 2014 and 2016. NPLs declined only from 57 % to 56 % of loans to non-financial corporations over the same period, while for households' loans the NPL ratio increased from 52 % to 55 %.</p> <p>The high level of collateralised lending poses challenges regarding the perception of credit risk. Relatively mild estimates of expected losses on collateralised loans have kept provisions at levels below the EA average (see Section 1).</p> <p>Capacity to build up further capital buffers is still hampered by low profitability and high NPLs. The flow of credit to the economy is still limited (see Section 4.2).</p>	<p>More information has been made available to creditors through the credit and company registry but the quality and breadth of available information can be improved.</p> <p>Targets for loan restructuring and early arrears management have been set and regularly updated, but are not fully met.</p> <p>Despite increased capacity, there are still impediments to implement the reformed foreclosure framework.</p> <p>Legislation allowing the sale of NPLs has been enacted but is not leading to any transaction, notably due to adverse market conditions.</p> <p>Provisioning requirements have been enhanced but provisions remain below the EA average (see Section 4.2).</p>
<i>Adjustment issues</i>			

(Continued on the next page)

Table (continued)

Potential growth	Potential growth is estimated at around 0 %, while inflation is also low. Low nominal income growth prevents deleveraging from picking up (see Section 1).	Low investment and stable productivity levels constrain potential growth. At 13 %, the investment-to-GDP ratio remains one of the lowest in the EU (see Section 1).	An Action Plan for Growth is in place to improve the business environment and help develop key sectors of the economy, but implementation is slow (see Section 4.4). The implementation of the privatisation plan has been largely put on hold (see Section 4.6).
Unemployment	Unemployment was high at around 13 % at end 2016. Long-term and youth unemployment were also high at 6 % and 30 %, respectively.	Unemployment declined but remains high. The capacity of the public employment services to provide services to the unemployed, reach out to NEETs, and help reduce welfare dependency remains sub-optimal. Participation in Vocational and Education Training remains low and there is a growing evidence of skill-mismatches in the economy (see Section 4.3).	The reform of the public employment services has been delayed and the impact of ALMPs implemented is still to be evaluated. Measures are being undertaken to enhance vocational training and the quality of higher education, but the implementation is slow (see Section 4.3).
Conclusions from IDR analysis			
<ul style="list-style-type: none"> Cyprus faces excessive imbalances in the form of a weak financial sector and large stocks of private, public, and external debt. The very high ratio of NPLs in the domestic banking system weighs on banks' profitability and constrains new credit to the economy. Low credit and high private debt depress domestic investment, constrain the growth potential and maintain unemployment relatively high. Despite a major restructuring of the banking sector and improved capital positions, the ratio of non-performing loans as a share of GDP remains at very high levels and does not show a clear downward trend. Poor contract enforcement, inefficiencies in the judicial system, bottlenecks in the implementation of the foreclosure and insolvency legislation and incomplete information on borrowers hamper private sector deleveraging and the reduction of non-performing loans. Delays in reforming the system of issuance and transfer of title deeds negatively affect the property market. A current account position still in deficit implies that a large negative NIIP is not yet under correction. The major deleveraging process has affected potential growth and unemployment.. A decrease in government savings might slow down public debt reduction. Measures have been taken to increase loan restructuring, implement foreclosure and insolvency frameworks, make the judiciary more efficient, and allow for the sale of loans. However, efforts are still needed to remove bottlenecks in the foreclosure and insolvency frameworks, improve contract enforcement, ensure well-defined property rights, and help banks resume a healthy flow of credit to the economy. Ensuring fiscal discipline is also crucial for debt-reduction. Measures are also needed to raise potential growth, including by improving the business environment, increasing productivity-enhancing investment and making the public administration more efficient. 			
<p>(*) The first column summarises 'gravity' issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the 'evolution and prospects' of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment issue. The final three paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.</p>			

Source: European Commission

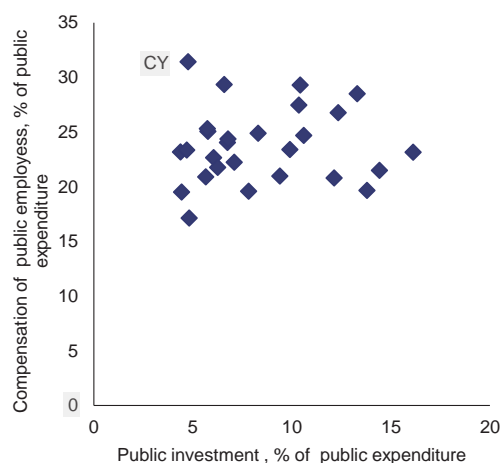
4. REFORM PRIORITIES

4.1. PUBLIC FINANCES AND TAXATION

4.1.1. PUBLIC EXPENDITURE * ⁽⁸⁾

Low public investment, in particular in R&D and infrastructure, continues to weigh on potential growth. Public investment in Cyprus was among the lowest in the EU in 2016, a clear deterioration compared to past performance (European Commission, 2014a). Public spending on R&D (0.4 % of GDP) remains one of the lowest in the EU. Low investment has limited progress in terms of the quality and sustainability of basic public services, such as waste and water management or public transport (see Section 4.5). Similarly, the low level of public spending on healthcare may have contributed to lower than EU average health system performance outcomes (see Section 4.3).

Graph 4.1.1: **Public investment and compensation of public employees, EU Member States, 2015**



Source: Eurostat.

Compensation of public employees accounts for a large share of public expenditure. The latter ⁽⁹⁾ has gradually declined from 42.1 % of GDP in 2011 to 38.3 % of GDP in 2016. At the same time, compensation of employees also decreased from 14.6% of GDP in 2011 to 12.4% in 2016.

⁽⁸⁾ An asterisk indicates that the analysis in the section contributes to the in-depth review under the MIP (see Section 3 for an overall summary of main findings).

⁽⁹⁾ General government expenditure net of one-off exceptional items.

Although public expenditure in Cyprus is below the EU average, compensation of employees is a major expenditure component. Cyprus is the Member State with the highest proportion of compensation of public sector employees relative to total public expenditure (see Graph 4.1.1). Although several measures have been introduced since 2012, the high wage bill continues to reflect one of the largest public sector wage premiums in the EU ⁽¹⁰⁾ in the EU. In 2016 the House of Representatives rejected a legislative proposal to reform the public sector wage-setting mechanism. This reform aimed to link permanently the evolution of public sector compensation to nominal economic growth. Although the application of the mechanism foreseen by the reform will be implemented until 2018 via collective agreements with public sector unions, the lack of a permanent mechanism increases the risk of further crowding out of growth-enhancing public investment in the medium to long term.

The effective interest rate on public debt declined to 2.6 % in 2015, down from 4.4 % in 2012. This is due to the increase in lending from the **European Stability Mechanism (ESM)** and International Monetary Fund (IMF) and lower yields on the secondary market for Cypriot government securities. The yield for three-month T-bills fell gradually to 0.02 % in January 2017, notably due to the regular frequency of T-bill auctions. Yields on longer-term debt displayed similar developments, declining to 3.8 % at the seven-year bond issuance in July 2016.

4.1.2. FINANCING NEEDS AND PUBLIC DEBT SUSTAINABILITY*

Public debt appears to have peaked in 2015, at 107.5 % of GDP. According to the Commission winter 2016 analysis, public debt is expected to decline steadily to 83 % of GDP in 2027. The declining debt path going forward is mainly driven by primary surpluses and relies on a number of

⁽¹⁰⁾ Difference in average wage between the public and the private sector after controlling for experience, educational attainment, gender, etc. (European Commission, 2016b, p.56)

assumptions⁽¹¹⁾. The high stock of debt and the assumed gradual normalisation of the interest rates are expected to bring about a higher interest bill. This will offset the positive impact from nominal growth. The debt trajectory will be dependent on the development of both the structural fiscal position and potential growth.

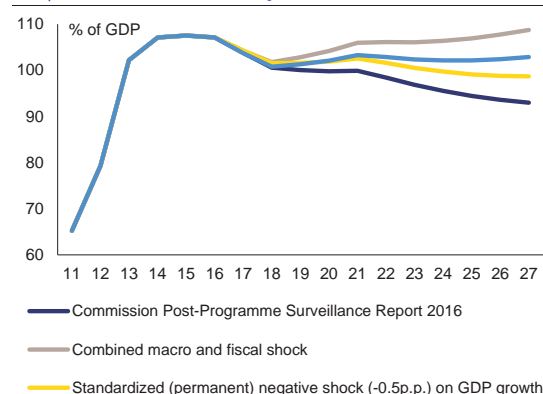
Total debt redemptions and fiscal needs are contained until end-2017 and remain lower than the existing cash buffer. In 2017, debt repayments and fiscal needs are estimated at EUR 0.4 billion and EUR 0.1 billion, respectively. However, medium-term financing needs for 2019 and 2020 remain high, estimated at around 10 % of GDP in each year.

Cyprus' sovereign credit rating has continued to increase. Cyprus' ratings by all four major rating agencies remain below investment grade despite several rating upgrades over the past year. The most favourable rating, by Standard & Poor's, remains two notches below investment grade at 'BB'. Better-than-expected macroeconomic, public debt and fiscal budgetary developments were the main drivers for the recent upgrades. However, according to the rating agencies, weaknesses related mainly to the high level of NPLs in the financial sector and the still high public debt could hold back further upgrades.

The high public debt still poses risks to medium-term debt sustainability, leaving limited room for further fiscal relaxation. Overall, the economic recovery remains supportive for the evolution of the debt trajectory. However, the situation proves challenging, due to still-low potential growth and inflation, and an expected deterioration of the structural balance (European

Commission, 2016a). Efforts to improve the structural balance would help placing debt on a sustainable downward trajectory (see Graph 4.1.2). Sensitivity analyses suggest that reducing real GDP growth by one standard deviation over the horizon would trigger an upward revision of the debt trajectory, leading to a stabilisation in the debt ratio. Assuming an additional effect of lower real GDP growth on the primary balance would put debt on an upward path. Medium-term debt developments are also sensitive to changes in market access terms, vulnerabilities in the financial system and fiscal performance (IMF, 2016; European Commission, 2017a).

Graph 4.1.2: **Public debt trajectories**



Source: European Commission.

4.1.3. FISCAL FRAMEWORK

The budgetary framework has been reformed and should be fully implemented as of 2018. Beyond laying down the key blocks of the domestic fiscal framework, such as the independent Fiscal Council, the 2014 Fiscal Responsibility and Budgetary Framework Law (FRBFL) has introduced a more strategic approach to budget preparation, notably based on project evaluation and more rigorous selection processes. It also set out procedures improving the monitoring of fiscal risks stemming from guarantees, payment arrears and state owned enterprises. The FRBFL secondary legislation was adopted by the House of Representatives in 2016, setting out procedures for budget preparation, within-year budgetary adjustments, and the responsibilities of commitment control officers. Practical steps remain necessary to make the budgetary framework fully functional, such as new

⁽¹¹⁾ The starting point for the baseline debt projection is the Commission's 2016 autumn forecast. After 2018, the debt projection is based on the following technical assumptions; (i) the structural primary fiscal balance remains at a surplus of 0.8 % of GDP under the no-fiscal policy change assumption, (ii) inflation converges to 2.0 % by 2021 (year of output gap closure) and remains stable thereafter; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5 % by the end of the 10-year projection horizon in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group (AWG), (iv) real GDP grows at the rate projected by the EPC's Output Gap Working Group until t+10 and thereafter according to the AWG's projections (level of around 1.5 %); and (v) ageing costs develop according to the Commission and EPC's 2015 Ageing Report.

implementation circulars and upgrades of IT systems. The budgetary framework is expected to be fully implemented as of January 2018.

The modernisation of public investment management is still at the early stages. New guidelines for public investment projects were issued in July 2015. There has been some progress with their implementation, notably on strengthening project selection processes. Investment projects will need a pre-selection screening before qualifying for a general project pool. Projects will eventually be prioritised based on political choices and available resources. It is likely to take several years to fully implement this reform. Current efforts focus on building the necessary administrative capacity by providing training and acquiring related IT management systems.

The public accounting and information management systems still lack comprehensive coverage and adequate internal control mechanisms. Cyprus' public accounting information system does not cover all government levels and is not in line with the latest accounting and financial reporting standards. The authorities intend to gradually adopt a new enterprise resource planning (ERP) system to tackle this issue and improve the quality and reliability of financial information. With support from technical assistance, the chart of public accounts will be updated, in line with the new ERP which will be selected by tender. The ERP implementation aims at three main objectives, i.e. modernisation of the treasury, shift from cash to accrual accounting, and improvement of the public procurement system.

4.1.4. TAXATION

The current tax administration reforms aim to improve the efficiency of the tax system. A comprehensive compliance strategy for risk identification and analysis was developed to address collectible and unencumbered debt, but it has not been fully implemented. The single registration process for existing tax payers is being prepared but lacks an online registration programme. The integration of the VAT service and the Inland Revenue Department into a single tax department has not been completed, as key functions such as audit, risk management and debt

collection remain separated. Delays are also observed in the integration of regional tax offices. A project for developing an integrated IT system for the new tax department has started. The tax procedure code is being drafted and its adoption is not planned before mid-2017.

The abolition of the immovable property tax (IPT) leads to a revenue shortfall and risk negatively affecting the quality of the tax base. The reform of the IPT was a key commitment under the economic adjustment programme expected to be adopted in 2016. The tax was instead reduced by 75 % for 2016 fully abolished as of 2017. In the absence of compensatory measures, this will result in a shortfall of public revenues. It also risks negatively affecting the quality of the tax base, as property taxation is widely considered as one of the least distortionary and most growth-friendly taxes. The abrogation of the IPT tends to favour property owners and therefore goes against efforts towards more progressive taxation. Revenues from recurrent property taxation, as a proportion of GDP, were lower in Cyprus (1.1%) than the EU average (1.6%) in 2014. This indicates that there could be scope to increase this kind of taxation while diversifying the tax base.

Tax transparency and tax information exchange continue to improve. In 2014 the US-Cyprus Foreign Accounts Tax Compliance Act (FATCA) agreement was signed. This was followed by the signing of the US-Cyprus Competent Authority Agreement in 2016, which allows FATCA to be implemented. Cyprus also committed to the early implementation of the OECD's new common reporting standard for the automatic exchange of financial account information. The first exchange of information under this new standard will take place in 2017. In the area of transparency of rulings, Cyprus has issued a circular which sets out the procedure to be followed for issuing advance cross-border tax rulings. This stems from the revision of the Directive on Administrative Cooperation (DAC-3) on the automatic exchange of cross border rulings.

Some of Cyprus's tax rules may be used in structures of aggressive tax planning⁽¹²⁾ ⁽¹³⁾.

⁽¹²⁾ For an overview of the most common structures of aggressive tax planning and the provisions (or lack thereof)

The absence of certain anti-abuse rules (European Commission, 2016b) and the absence of withholding taxes on dividend, interest and royalty⁽¹⁴⁾ payments vis-à-vis third countries are features of the tax system which may facilitate aggressive tax planning. Moreover, the minimum fixed margins approved by Cyprus for the remuneration of intragroup back-to-back financing activities can narrow the taxable base (European Commission, 2016c), and has the potential to facilitate aggressive tax planning. However, Cyprus has taken steps to terminate the current tax treatment on back to back loans within the first semester of 2017 and is currently drafting a new transfer pricing framework covering back-to-back financing activities. In that respect, the very high level of inward and outward foreign direct investments (FDI) positions, but also the high level of dividend and interest payments⁽¹⁵⁾ as percentage of GDP would suggest that the country's tax rules are used by companies that engage in aggressive tax planning. Within this context however, it is important to note that corporate tax initiatives (for example the Anti-Tax Avoidance Directive) will strengthen Member States' anti-abuse framework and boost tax transparency (for example through the automatic exchange of information on tax rulings or on country-by-country reports). It should be noted that the anti-hybrid rule introduced by Cyprus with effect from January 2016, applied to dividend income flows from within or from outside the EU and irrespective of the level of holding.

Cyprus has taken steps to adjust some of its tax rules facilitating aggressive tax planning. The patent box regime (see European Commission,

2016b) has been amended in order to bring it in line with Action 5 of the Base Erosion and Profit Shifting project (see OECD, 2015), as endorsed by the Code of Conduct for Business Taxation. This means that a stronger link between profits registered in Cyprus and the underlying R&D will have to be proven in order for profits to qualify for the reduced patent box rate.

necessary for these structures to work, see Ramboll Management Consulting and Corit Advisory (2016), Study on Structures of Aggressive Tax Planning and Indicators, European Commission Taxation Paper n°61. It should be noted that country-specific information provided in the study gives the state of play by May/June 2015.

⁽¹³⁾ Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. – source: Commission Recommendation of 6 December 2012 on aggressive tax planning (2012/772/EU)

⁽¹⁴⁾ There is a withholding tax on royalties if intellectual property rights are used locally.

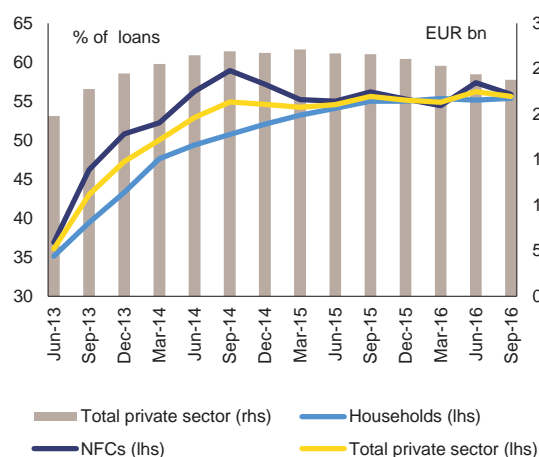
⁽¹⁵⁾ In 2015, the level of inward and outward foreign direct investment amounted respectively to 905 % and 906 % of GDP. The flows of dividends and interests paid amounted respectively to 9.3 % and 0.9 % of GDP.

4.2. FINANCIAL SECTOR

4.2.1. BANKING SECTOR *

The financing of the Cypriot economy remains at a standstill as it is largely dependent on the banking sector. Bank lending accounts for almost all credit supply in Cyprus. Monetary and Financial Institutions (MFI) loans accounted for about 470 % of GDP at end 2015, about four times higher than the EU average. On the other hand, non-bank financing via equity markets, debt issuance and venture capital is relatively underdeveloped and remains well below the EU average. The self-financing rate of Cypriot businesses is close to the EU average. Credit conditions (availability and cost) improved gradually in 2016 for all types of clients, including SMEs, and a slow pick-up in credit supply can be observed. However, due to banks' still high risk perception and low risk tolerance, but also subdued solvent demand, the decline of the credit stock continues.

Graph 4.2.1: **Non-performing loans, Non-financial private sector**



Source: Central Bank of Cyprus

Despite an absolute reduction in the stock of NPLs, it remained stable in 2016 as a proportion of total loans. In absolute terms, the amount of NPLs for the non-financial private sector fell by approximately 12 %, from EUR 28.1 billion in October 2015 to EUR 24.6 billion in October 2016. However, since total loans decreased by a similar proportion, the NPL ratio as a whole remained broadly constant at about 48 %. For the non-financial private sector, the NPL ratio

remained constant at about 55% as of October 2016 (see Graph 4.2.1).

NPLs ratios remain high but uneven across corporate sectors. The distribution of NPLs shows that, although the root of the problem lies in the construction and property sectors, the broad spectrum of businesses is burdened with a high level of NPLs. The construction sector accounts for the largest part of total NPLs, and is also the sector with the highest NPL ratio, followed by real estate activities (see Table 4.2.1). SMEs had a NPL ratio of 59 % of total loans in October 2016.

Table 4.2.1: **Non-financial corporations- Sectors most affected by NPLs - September 2016**

	Share of total NPLs	Sector NPL ratio	Provisioning coverage ratio
Construction	17%	72%	39%
Real estate activities	9%	54%	41%
Wholesale and retail trade	8%	46%	45%
Accommodation and food service activities	4%	53%	31%
Manufacturing	3%	50%	42%

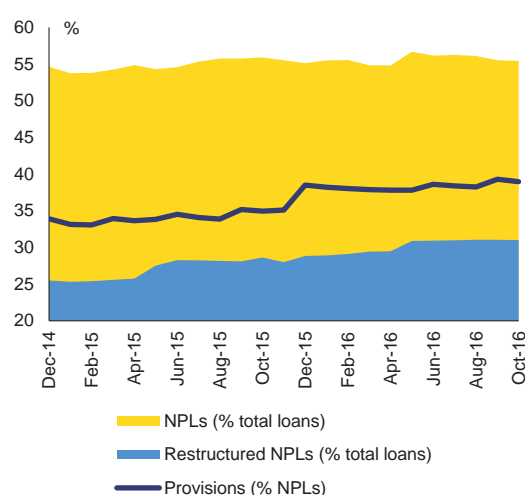
Source: Central Bank of Cyprus

Debt restructuring continues, leading to positive results in terms of performing restructured loans. In October 2016, compared to a year before, the proportion of restructured loans (performing and non-performing) increased both for non-financial corporations and for households. The proportion of restructured loans for non-financial corporations is higher than for households, as banks firstly focused their efforts on larger exposures. This could also explain the fact that the proportion of performing restructured loans to total loans increased for non-financial corporations but slightly dropped for households over the same period. The proportion of private sector loans in arrears over 90 days slightly decreased to 42 % in October 2016 from 45 % a year earlier. The provisioning rate remained broadly stable since the end of 2015, from 38 % to 39% of NPLs in October 2016 (see Graph 4.2.2), which is lower than the EU average. Despite these developments, the high level of arrears shows that the Cypriot private sector is still excessively leveraged.

Banks are meeting the targets set for the level of loan restructuring activity, but have more difficulties ensuring sustainable results. The Central Bank of Cyprus has set for banks a series of targets in order to better monitor and assess loan

restructuring efforts (European Commission, 2016b, p. 18). As of September 2016, banks over-achieved the targets set for the number of proposed and concluded restructuring solutions. However, the re-default rates of restructured loans turned out slightly higher than the targets envisaged by the Central Bank of Cyprus. This highlights difficulties in designing sustainable restructuring solutions. The increasing recourse to converting amortising loans (loans with scheduled periodic payments) into bullet-repayment loans may weaken the reliability of monitoring statistics, as the debt service burden is lifted in the short term and pushed to the end of the loan maturity.

Graph 4.2.2: **Debt restructuring of non-financial private sector**



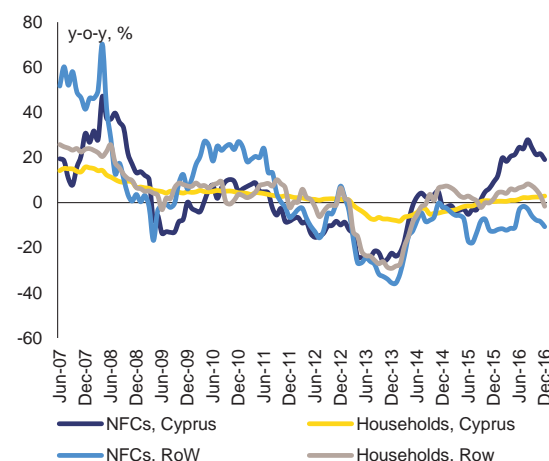
Source: Central Bank of Cyprus

Increased use of debt-to-asset swaps could impact the real estate market and ultimately banks. The use of debt-to-asset swaps in loan restructuring transactions as a cheaper and more expedient alternative to foreclosure is leading banks to book an increasing amount of real estate assets on their balance sheets. Although risks are expected to be contained by exposure limits, the large volume of swapped assets might eventually lead to fire sales or excess supply of properties. In a context of housing market adjustment, a significant increase of supply could negatively affect property prices and therefore drive down loan collateral values. As Cypriot banks' outstanding loans are predominantly collateralised, this could lead to higher provisioning needs and

put additional pressure on profitability and capital adequacy.

Pressure to increase profitability could pose risks to asset quality. The narrowing net interest margin, low interest rates environment and need for risk provisioning are putting pressure on banks' profitability. As Cypriot banks display a cost-to-income ratio below the EU average, the potential for increasing profits substantially by cutting operational costs appears relatively limited. Banks are therefore seeking ways to use the abundant available liquidity (see Section 1.2) to bolster their profitability and generate capital. The scope for expanding domestic credit supply is limited by the scarcity of viable domestic borrowers, more restrictive loan origination requirements and limited capital headroom. The lack of low-risk alternative investments with substantially higher returns prompts banks to place excess liquidity at the European and Cypriot central banks, despite negative deposit rates. This may provide incentives to diversify lending activities towards alternative and riskier asset classes.

Graph 4.2.3: **Evolution of bank deposits**



Source: Central Bank of Cyprus

Banks face challenges in issuing funding instruments with longer maturities. Cypriot banks are mostly reliant on deposits to fund their lending operations. They currently enjoy comfortable liquidity levels (see Section 1.2). However, there are risks in relying exclusively on a broad but potentially volatile deposit base (see Graph 4.2.3), notably concerning the large proportion of non-resident deposits. As of

September 2016, the majority of deposits had a maturity below one month. There is currently no interbank market in Cyprus, while banks are facing difficulties in raising medium to long-term funding on wholesale capital markets, mainly due to weak credit ratings. This is likely to become a more pressing issue as banks seek to prevent maturity mismatches and to contain their loan-to-deposit ratio while expanding credit supply. Debt issuance will also be necessary to deal with regulatory requirements concerning loss-absorption capacity, such as the minimum requirement for own funds and eligible liabilities (MREL), which is meant as a complement to the bail-in mechanism under the Bank Recovery and Resolution Directive. Therefore, improving asset quality is a key challenge, as it will determine the conditions for raising funds in the future.

4.2.2. FINANCIAL REGULATION *

The supervisory and regulatory framework is being improved to allow for the creation of a secondary market for loans. The loan origination directive was simplified in 2016 and clarifies that financial leases and syndicated loans are outside of its scope. To stimulate a secondary market for loans, the authorities are preparing a legal framework for loan securitisation. The legislation on the sale of loans has not yet had tangible impacts: it appears that no loan has been sold so far, which may be explained by the burdensome licensing requirements placed on potential purchasers of those assets. In addition, other factors such as (i) the heterogeneity and granularity of assets, (ii) the impact of loan sales values on the capital position, (iii) the lack of loan servicers in Cyprus and (iv) the poor liquidity in the property market also play an important role. It is possible that the provisions of the securitisation law will remain equally inactive. Thus, the effective functioning of a secondary market for bank loans remains one of the main challenges for the Cypriot financial sector.

Financial information is improving through strengthening the credit register and registrar of companies. The availability of reliable and comprehensive financial information on borrowers is a key condition to promote lending based on the actual repayment ability of borrowers. Therefore the credit register of commercial banks' borrowers

is expected to be fully integrated with the register of the cooperative banks. This is to provide a comprehensive view of a borrower's total liabilities. In addition, the company managing the credit register has been required to develop a scoring system for better appreciation of households' risks. The Central Bank of Cyprus continues to reflect on how to include the credit register's data in its supervisory activity and economic research. It is assessing how to submit more granular data to the ECB AnaCredit database, starting from 2018. The companies' register has been updated and submission of financial statements and other data has been made electronic.

4.2.3. PENSION AND INSURANCE *

The relatively weak governance and administrative capacity of the relevant supervisory authorities pose risks to financial stability. The European Insurance and Occupational Pension Authority (EIOPA) identified in a 2015 report (EIOPA, 2015) the challenges related to maintaining the current supervisory framework of insurance companies and pension funds. These sectors hold assets amounting to about 40 % of GDP. While the insurance sector contains about 30 entities and is highly concentrated, the pension and provident funds sector is fragmented into a large number of small entities. According to EIOPA, the current supervisory authorities framework needs reinforcement with regard to capacity and technical resources, in order to adequately identify weaknesses and promote adequate prudential measures.

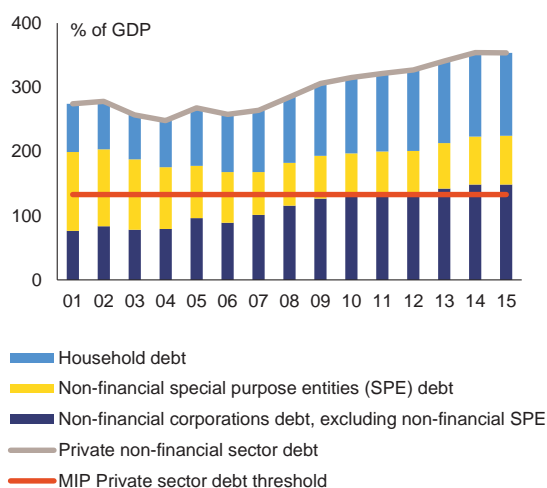
Following the 2015 recommendations of EIOPA, the authorities are taking steps to integrate the regulation and supervision of insurance companies and pension funds into a single supervisory authority. This authority will be able to perform a forward-looking, risk-based supervision, covering not only prudential aspects but also market conduct. While the supervisory integration is not yet in effect, much progress has been achieved in diagnosing the sectors. A technical project management team was set up in September 2016 with a view to implementing the integration of the regulation and supervision of the sectors.

4.2.4. PRIVATE INDEBTEDNESS *

The overall indebtedness of the non-financial private sector remains high at 354 % of GDP, significantly over the MIP threshold of 133 %.

Non-financial private sector debt as a percentage of GDP remained almost unchanged in 2015, being the highest in the EU. While the debt-to-GDP ratio of non-financial corporations (excluding SPEs) remained stable at 149 % in 2015, the debt of households decreased to 129 % of GDP in 2015, from 131 % of GDP in 2014 (see Graph 4.2.4). The debt of SPEs accounted for 75 % of GDP. However, as mentioned in Section 1, SPEs have limited interaction with the domestic economy.

Graph 4.2.4: Private sector indebtedness



Source: Eurostat and Central Bank of Cyprus

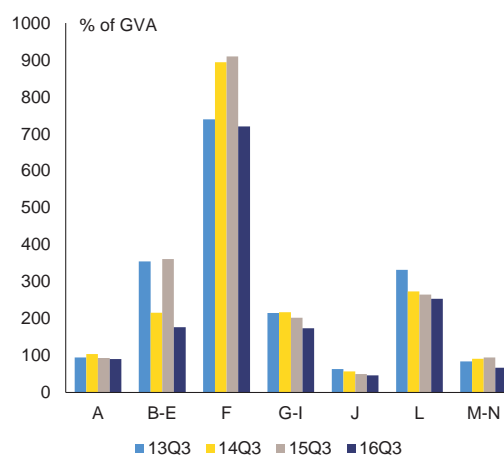
Alternative indebtedness indicators also point to excessive debt and potential solvency problems of the non-financial private sector in Cyprus. Both households and non-financial corporations have high debt to income ratio, indicating a weak capacity to repay debt. Households' debt stood at 198 % of gross disposable income in 2015 (from around 130 % ten years earlier). The debt of non-financial corporations stood at 931 % of gross operating surplus in 2015 (from 435 % in 2005). Furthermore, financial liabilities as a percentage of financial assets decreased marginally. For households, financial liabilities accounted for 56 % of financial assets in the second quarter of 2016. For non-financial corporations, the proportion of financial liabilities was 171 % over the same

period of time, suggesting potential solvency problems. The debt-to-equity ratio of firms, excluding SPEs, increased to 171 % in 2015 from 166 % in the previous year.

The leverage levels are high and above the euro area average across most economic sectors.

Although the majority of sectors deleveraged in 2016, many sectors remain highly indebted, such as real estate activities and industry (see Graph 4.2.5). Construction is the most heavily indebted sector; its ratio of loans to gross value added accounted for approximately 720 % in the third quarter of 2016. The sectors that have deleveraged the most in the third quarter of 2016 are industry (51 %) and construction (21 %).

Graph 4.2.5: Ratio of loans to gross value added across sectors of economic activity



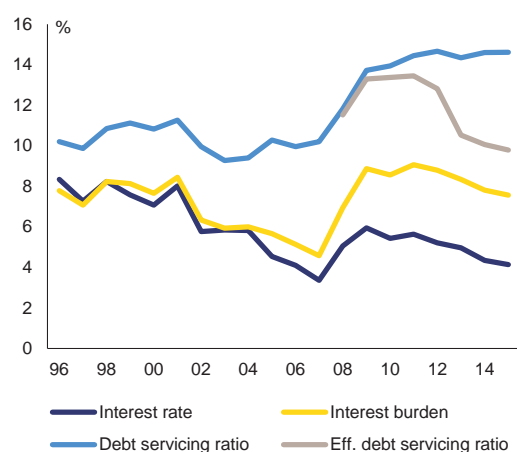
A: Agriculture, forestry and fishing, B-E: Industry (except construction), F: Construction, G-I: Wholesale and retail trade, transport, accommodation and food service activities, J: Information and communication, L: Real estate activities, M-N: Professional, scientific and technical activities; administrative and support service activities K: Financial and insurance activities, O-Q: Public administration, defence, education, human health and social work activities, R-U: Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies

Source: Eurostat

The aggregate effective debt servicing ratio for households has declined since 2011, as a significant proportion of loans have not been served. The debt servicing ratio, which accounts for amortisation of loans and the interest burden (interest paid as a share of disposable income), has remained stable since 2011 (around 14.5 %). However, the ratio adjusted for non-payments (effective debt servicing ratio) has declined sharply

and is increasingly below the unadjusted debt servicing ratio (see Graph 4.2.6). This shows the increasing proportion of income that Cypriot households did not allocate to debt servicing and instead made available for other purposes, for example consumption. This might have contributed to recent economic growth.

Graph 4.2.6: Household debt servicing ratios

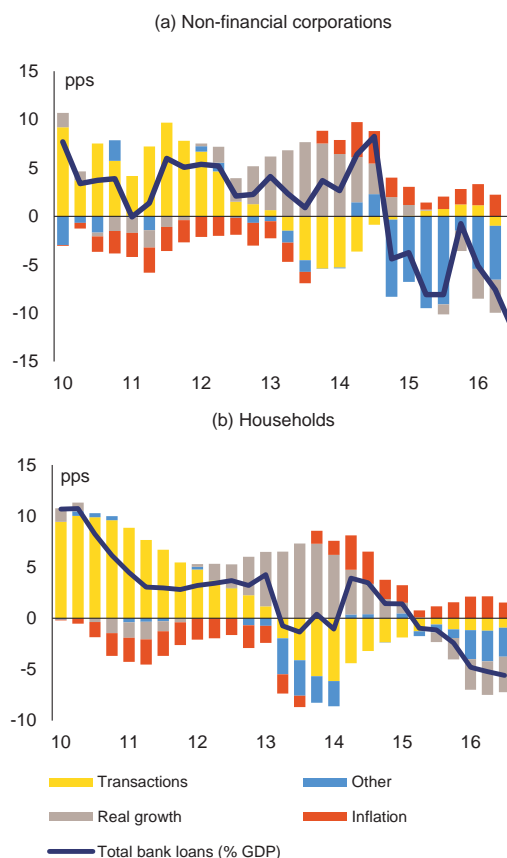


Source: Cystat, Eurostat, IMF, European Commission

The debt of the private non-financial sector decreased in 2016, mostly due to restructuring solutions involving debt write-offs and debt-to-asset swaps. To a lesser extent, it was also due to the servicing of loans and the subdued credit environment. The stock of loans to non-financial corporations and households in Cyprus, relative to GDP, declined by 17 % in the third quarter of 2016 compared to the same quarter in 2015⁽¹⁶⁾. However, the reduction in debt is mainly due to valuation effects (i.e. debt write-offs and debt-to-asset swaps) rather than repayment of debt. The increased use of debt-to-asset swaps allows banks to hold property assets on their balance sheets for up to three years, instead of liquidating them at currently low prices, and suffering losses (see Section 4.2.1) thus not impacting adversely their current profitability.

⁽¹⁶⁾ Given the high reliance on banking loans from the domestic banking system, developments in the stock of loans from the domestic banking system provide an early indication of developments in the scoreboard indicator.

Graph 4.2.7: Bank loans to domestic residents, annual changes



Source: Central Bank of Cyprus, Eurostat and European Commission

The new insolvency and foreclosure schemes have been used only to a limited extent. The corporate and personal insolvency laws and the revised foreclosure legislation are currently in full legal effect, (European Commission, 2016b, pp.32-33) and legal procedures are being modernised too. However, the use of the foreclosure and insolvency processes remains limited due to obstacles to their effective application. This is coupled with still inadequate legal procedures and some deficiencies in the judicial system. As a result, according to the ECB (European Central Bank, 2016, pp. 5-6), debt recovery costs in Cyprus remain very high. This is demonstrated by the high amount of fees to be paid when enforcing a claim through the legal system (e.g. court fees, government levies). Consequently, Cypriot banks tend to use the threat of foreclosure as a way to improve the payment discipline of borrowers to send a signal rather than as a tool to

collect outstanding debt. Envisaged reforms of the justice system (see Section 4.6.2) are expected to facilitate the use of the insolvency and foreclosure frameworks and contribute to accelerating debt reduction in the private sector.

4.2.5. HOUSING MARKET DEVELOPMENTS *

The housing market in Cyprus is experiencing a less prominent but longer price adjustment in comparison to those in Ireland and Spain. The Cypriot, Irish and Spanish housing markets are relevant comparisons as they recently experienced the highest house price inflation in the EU. In these countries, house prices and transactions dropped following the start of the financial crisis. This was because demand for houses reduced due to tight credit conditions, weak economic prospects and increased unemployment.

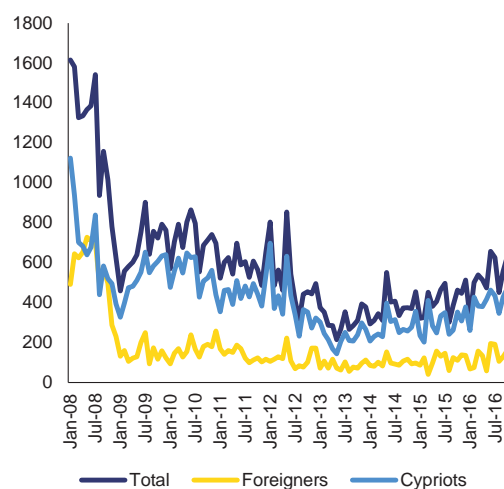
Cypriot house prices appear to be approaching a trough, while the Irish and Spanish troughs were in 2012 and 2013 respectively. When assessing the trough's depth across the three countries, and assuming there is no further decline in house prices in Cyprus, the intensities of the downward price adjustments ⁽¹⁷⁾ show that the decrease in house prices in Cyprus has been less prominent than in Ireland and Spain. The downward price adjustment cycle was also faster in Ireland and Spain than in Cyprus. In Cyprus, it took almost eight years from peak to trough compared to five and six years for Ireland and Spain respectively. In terms of the cumulative decrease in nominal house prices, the decline in Ireland (54 %) was also much stronger than in Spain (37 %) and Cyprus (32 %).

The smoother house price adjustment in Cyprus can be attributed to several factors. The economic situation, with a subdued outlook for labour income, contributed to slower house price growth. Furthermore, although most loans to households and developers are collateralised by real estate property, asset disposal by debtors and banks resorting to debt-to-asset swaps have been limited. The deficiencies of the system for issuing and transferring title deeds hinder debt reduction and affect the housing demand negatively (European Commission, 2016b, pp. 34-35).

⁽¹⁷⁾ The ratio between the cumulative decrease in house prices and the duration of the decline.

The housing market shows early signs of stabilisation. In 2015, house prices in Cyprus still appeared over-valued in terms of price-to-income ratio (European Commission, 2016b, pp. 32-33). However, thanks to a pick-up in housing demand, the decline in nominal house prices had moderated to -1.7 % year-on-year in the second quarter of 2016 according to the Central Bank of Cyprus. This is reflected in the slowly increasing number of housing sales, albeit from a subdued level (see Graph 4.2.8). The foreign segment of the market appears to be recovering more slowly. The supply side of the housing market appears to have bottomed out, with construction confidence becoming less pessimistic and housing investment going up. Looking forward, an improved income outlook could help to increase demand for housing, although credit standards are likely to remain tight in the short-term. Furthermore, the rising use of debt-to-asset swaps, together with a more intense use of asset foreclosure, might increase housing supply.

Graph 4.2.8: Housing sales contracts



Source: Department of Lands and Surveys

Deficiencies in the title deeds system hamper the recovery of the housing market. Cypriot and foreign property buyers are becoming increasingly aware of the delays in issuing and transferring title deeds and the fact that a number of properties sold or available for sale are encumbered by mortgages from other creditors. As household debt in Cyprus is to a large extent backed by real estate assets, obtaining a title deed for a property is a key determinant of households' solvency and banks'

soundness. This enables the enforcement of loan payments and the restructuring of non-performing loans. The lack of progress on reforming the system for transferring title deeds is negatively impacting the recovery of the housing market. It prevents the completion of some mortgage transactions and lowers confidence in the sector. However, reforms of the issuance of title deeds aiming to streamline issuance procedures may ultimately contribute to a further adjustment in the housing market.

4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

4.3.1. LABOUR MARKET

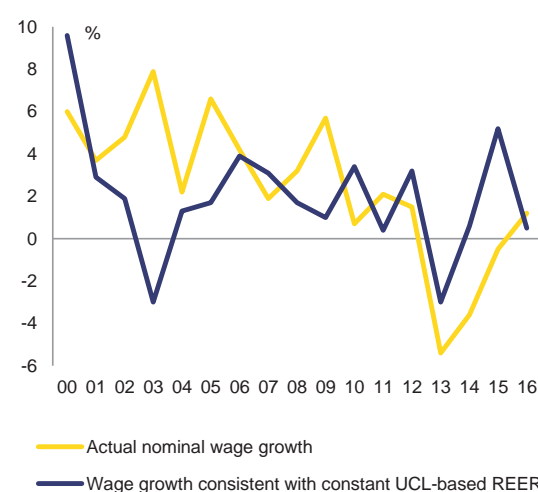
The situation in the labour market is improving, but major challenges remain. As discussed in Section 1, labour market indicators started to improve in 2015, with unemployment decreasing fast in the first quarters of 2016. Unemployment remains however well above the EU average and pre-crisis levels and the reabsorption of the long-term unemployed continue to be an important issue. The labour market recovery has not contributed to reducing the large proportion of underemployed workers⁽¹⁸⁾. In this context, most of the policy challenges identified in the 2016 country report remain valid.

The downward adjustment of wages came to a halt in 2016. Labour costs in Cyprus were on a downward adjustment path between 2012 and 2015. This allowed for a continued alignment of unit labour costs compared to other EU Member States and the international markets. This helped to improve price competitiveness and thus the external position of Cyprus. In 2016, positive wage growth returned for the first time since the crisis, but at a moderate pace. According to current estimations, wage growth converged towards the value consistent with a constant real effective exchange rate (Arpaia and Kiss, 2015), a proxy for (cost-based) external competitiveness (see Graph 4.3.1).

Social dialogue between employees and employers is taking place, aiming to an agreement on wage indexation. As agreed within the economic adjustment programme, indexation to inflation of the cost of living allowance (COLA) in the private sector remained suspended until the end of 2016. After the suspension ended, the application of the previously used wage indexation would have led to a nominal reduction in wages, as the equation is backward-looking and would have taken into account the negative inflation in 2016. Negotiations on COLA in the private sector therefore began in October 2016 in the form of social dialogue. These are expected to lead to a new calculation method that would prevent

automatic nominal wage cuts. Until an agreement is reached, the Ministry of Labour has put forward a temporary arrangement to avoid nominal wage reductions in 2017. For the public and semi-public sector, including the semi-governmental organisations, collective agreements have been signed with the labour unions pegging payroll to nominal growth.

Graph 4.3.1: **Wage growth consistent with constant unit labour cost-based real effective exchange rate**



Source: Eurostat, Cystat, European Commission

Active labour market policies (ALMPs) are launched regularly, but without appropriate follow-up tools. The current list of ALMPs includes measures targeting long-term unemployed and youth (under the National Action Plan for Youth Employment). It also includes measures for other vulnerable groups, including persons with disabilities. However, the effectiveness of the ALMPs in addressing labour market needs is considered to be limited. This is due to their short time frame and frequently narrow scope, including the limited availability of training. Also the lack of a comprehensive continuous monitoring and evaluation tool prevents a more systematic analysis of the full impact of ALMPs and their limitations as tools for getting unemployed people back to work. The availability of such tools would facilitate decision-making and rapid corrective actions.

Public employment services (PES) are not yet equipped to respond effectively in line with their strengthened role. The comprehensive plan

⁽¹⁸⁾ Cyprus presents the highest proportion of underemployed part-time workers (i.e. working part-time, but wish to work additional hours and are available to do so) in the EU, amounting to 8.6 % of total employment in Q3-2016 (against an EU average of 4.3 %).

for reforming PES, including launching a tender for the recruitment of additional staff, has been continuously delayed. Some PES reform measures have already started, e.g. joint actions with private employment services and the training of PES officers, while others are still in the pipeline. These measures are intended to meet labour market demand needs, provide individual counselling and single points of contact, and to assist the welfare reform programme, including activation of Guaranteed Minimum Income (GMI) recipients. The limited specialisation and functionalisation of PES services makes it difficult for them to fulfil all the requirements for implementing the Youth Guarantee and the Long Term Unemployment Initiative recommendations.

The proportion of young people not in employment, education, or training (NEETs) is decreasing but remains high. It amounted to 15.2 % in 2015 (15-24 age group) compared to 17 % in 2014, against an EU average of 12 %. The Ministry of Labour has started efforts to identify and reach out to non-registered unemployed young people and NEETs in coordination with the Ministry of Education and Culture (MoEC) and youth organisations. However, results are not yet available.

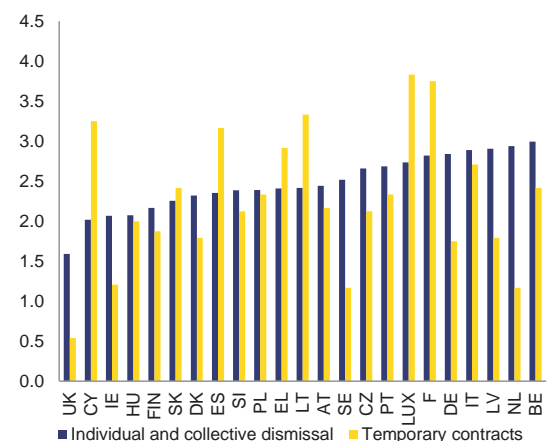
Employment protection legislation (EPL) is relatively flexible in Cyprus, thereby allowing for smooth job transitions. Following the OECD methodology (OECD, 2013) and based on the current labour law in force, the European Commission has calculated EPL indicators for Cyprus for the first time. Results show that the overall legislation for individual and collective dismissals in Cyprus is relatively flexible, especially when comparing with other European countries (see Graph 4.3.2).

However, EPL shows some marked deviations from European practice in some categories. For example, some aspects of EPL for individual dismissals are relatively strict⁽¹⁹⁾, as revealed by three sub-components of the EPL index: (i) relatively high severance payments, which are paid to all dismissed workers except those lay-offs justifiably, (ii) a relatively high compensation

following unfair dismissal and (iii) a reinstatement option. Regarding procedural hurdles and notification periods for individual dismissal, the strictness of the legislation is comparable to the OECD average.

Furthermore, EPL for temporary contracts is quite strict, with Cyprus scoring substantially above the average of EU Member States. This reflects the need for employers always to present an objective reason for a fixed-term employment contract⁽²⁰⁾. In addition, fixed-term employees are considered to have open-ended contracts after 30 months of employment with the same employer (irrespective of the number of contract renewals).

Graph 4.3.2: **Employment protection legislation indicators (2013)**



A low score reflects more flexible employment protection legislation.

Source: OECD and European Commission

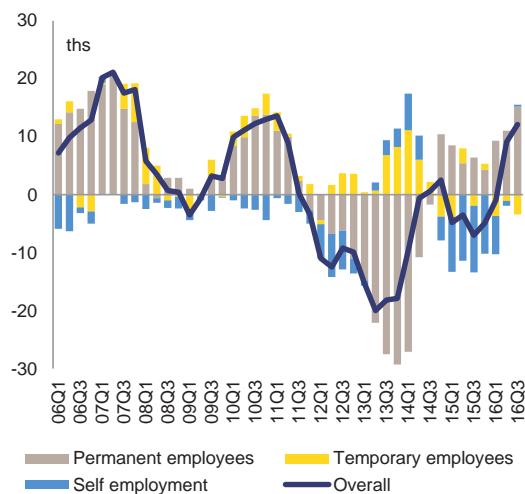
In spite of the restrictive regulation, the proportion of temporary contracts is fairly high. Temporary employees represented 18.4 % of total employees in 2015 (one of the highest rates in the EU), against an EU average of 14.1 %. This proportion increased sharply over the crisis (from 2011 to 2014), also due to a drop in permanent contracts (see Graph 4.3.3). However, it stabilised in 2015 and only slightly decreased in the first three quarters of 2016, along with an improvement in labour market conditions. This improvement was also translated into an increase of the yearly transition rate to permanent contracts, from 17.9 % in 2014 to 27.9 % in 2015 (still among the lowest

⁽¹⁹⁾ For further information, see Termination of Employment Law 24/1967 and subsequent amendments of the Republic of Cyprus.

⁽²⁰⁾ Protection of Employees (Fixed-term Work) Act Section 7(2).

in the EU). However, a large majority of fixed-term employment is involuntary, as 92.9 % of fixed-term employees in 2015 declared that they had to accept a temporary job because they could not find a permanent one. This proportion has not changed significantly compared to the pre-crisis period.

Graph 4.3.3: Employment by type, y-o-y changes



Source: Eurostat (Labour Force Survey)

A relatively high proportion of temporary contracts have long durations, in spite of time limits set in the legislation. There is no evidence of a prevalence of very short-term contracts in Cyprus: those lasting less than three months amount to only 3.4 % of the total in 2015. On the contrary, almost 28 % of total temporary contracts lasted more than 36 months (against an average of 7.5 % in the EU). This evidence conflicts with the duration limits enshrined in the legislation, and suggests cases of potential non-compliance with the legal requirements. However, according to administration sources, only a few complaints were filed.

The Ministry of Labour, Welfare and Social Insurance is currently considering new measures to curb undeclared work. According to the results of labour inspections in the first nine months of 2016, undeclared work stands at around 16 % and is a challenge, especially for low-skilled professions. The reform measures currently taken by the Ministry of Labour, Welfare and Social Insurance include structural changes in the organisation of the Labour Inspectorate. These

include the reinforcement of its role with new legislation and the modernisation of the social insurance process.

4.3.2. EDUCATION AND SKILLS

Although Cyprus invests significantly in education and training, educational results are below average. Cyprus features a relatively high, though decreasing, level of general government expenditure on education. It was 6.5 % of GDP in 2013 and 5.8 % in 2014. However, education spending has been considerably reduced as a proportion of total general government expenditure, from 15.7 % in 2013 to 11.8 % in 2014, moving towards the EU-28 average of 10.2 %. Expenditure per pupil for 2013 remained relatively higher than for other countries with a similar level of socioeconomic development, especially at primary and secondary level. The education system's slow adaptation to the country's changing economic structure (e.g. smart specialisation areas ⁽²¹⁾) is still a major concern. The low level of digital skills is particularly worrying as in 2015 only 43% of Cypriots had at least basic levels of digital skills, below the EU average of 56% (European Commission, 2017b).

The continuous deterioration of the performance of Cypriot students in basic skills is worrying. The proportion of low achievers in Cyprus is the largest in the EU for mathematics (43 %) and science (42 %), and it is the third largest for reading (36 %) according to results from the OECD's Programme for International Student Assessment (PISA 2015). The results for Cyprus have further deteriorated in comparison to 2012 in all tested areas, placing the country well below both the OECD and the EU averages. At the same time the proportion of top performers has also decreased across the board, therefore showing a significant downward trend in general achievement levels (OECD, 2016).

Early school leaving is generally decreasing but remains very high for foreign-born male students. The early school leaving rate decreased

⁽²¹⁾ Smart specialisation is a new innovation policy concept designed to promote the efficient and effective use of public investment in research. Its goal is to boost regional innovation in order to achieve economic growth and prosperity, by enabling regions to focus on their strengths.

from 6.8 % in 2014 to 5.3 % in 2015, well below the EU average of 11.0 % in 2015. While native-born students have an early school leaving rate of only 3.1 %, the rate for foreign-born is 16.7% of which females account for 10.7 %, and males for 23.3 %. This gender gap of 12.6 pps. for foreign-born individuals is much wider than the EU average (2.3 pps.).

Participation in vocational education and training (VET) in Cyprus is relatively low, pointing to potential scope for raising the relevance and attractiveness of VET systems.

The strategic goals set out in the MoEC strategic plan for 2016-2018, the strategic plan for the system of technical and vocational education and training for 2015-2020 and the upgrade of the apprenticeships scheme aim to improve skills provision and reform the VET system. Some measures include (i) enhancement of the cooperation between secondary technical and vocational education (STVE) and businesses through social partner dialogue, (ii) promotion of practical training (industrial placement) of STVE pupils in industry, and (iii) increasing the percentage of time STVE pupils spend in industry for their practical training, introduced as of the 2016-2017 school year. The new apprenticeship scheme provides preparatory and core measures and develops about 40 specialisations based on the apprentices' demand, labour market needs and the readiness of organised employers to cooperate with the MoEC.

As of 2016, the fields of study and specialisations and the existing curricula started being reviewed. New curricula will be developed, oriented towards learning results and based on learning modules and the European Credit System for Vocational Education and Training units. A set of 80 new standards will be developed within the system of vocational qualifications in 2016-2017. In the period 2014-2020, the existing and new standards will be revised and around 10 000 certificates will be awarded ⁽²²⁾.

Cyprus has a very high tertiary education attainment rate, but a relatively low proportion

of graduates in the fields most strongly linked to innovation.

The tertiary attainment rate reached 52.5 % in 2014 and 54.6 % in 2015, well above the EU average. However, a widening gender gap persists, with women outperforming men by 12.2 pps. in 2014 and 14.9 pps. in 2015. In 2014, as many as 44 % of students were in the fields of social science, business and law, one of the largest proportion in the EU. On the other hand, there is a low proportion of science, technology, engineering and maths graduates, 9.2 per 1000 individuals (age 20-29), below EU average of 19 per 1000 individuals (age 20-29), which may hamper the development of the digital economy. However, this seems to be a legacy of the previous growth model of the country (based on financial and legal services). It does not necessarily correspond to future developments based on smart specialisation.

Improving the quality of higher education institutions is a challenge and study programme accreditation operations are still not fully in place.

After a long period of consultation the Cypriot House of Representatives adopted a law setting up an Agency of Quality Assurance and Accreditation in Higher Education. This Agency aims to help ensure the quality of the higher education offered by Cypriot institutions and establish Cyprus as a regional higher education centre of excellence. However, it is not fully operational and cannot yet proceed with accreditation activities.

The overall rate of adult participation in lifelong learning is low and below the EU average.

The participation rate was 7.5 % for the 25-64 age group in 2015. More participation in lifelong learning by adults with lower educational attainment (ISCED levels 0-2) is needed to keep skills up-to-date and help prevent early retirement.

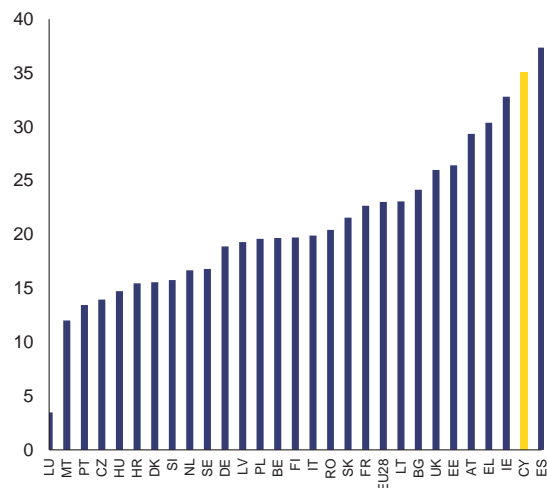
Changes were recently introduced to provide financial support for companies that invest in lifelong learning for their employees.

There are also relevant EU-funded schemes and programmes at Cyprus' two evening technical schools. These programmes are meant to offer good-quality mainstream VET education to adults. They help adults re-enter the formal school system, obtain a qualification at upper secondary level, move on to tertiary education if they wish and/or re-enter the labour market as skilled workers.

⁽²²⁾ The courses for the certification in fluorocarbon refrigerant use and handling, and also for certification in the requirements for electrical installations have already started.

The skills mismatch is a challenge for Cyprus and employment rates vary strongly in line with the level of education. For lower qualifications (ISCED 0-2 level) the employment rate was 55.5 % in 2015, only slightly above the EU average. For medium qualifications (ISCED 3-4) the rate was 69.4 % in 2015, this time slightly below the EU average. For higher qualifications (ISCED 5-8) it stood at 80.2 % in 2015, but below the EU average ⁽²³⁾.

Graph 4.3.4: **Proportion of tertiary graduates working in ISCO categories 4-9**



The indicator measures the share of tertiary qualified workers who work in jobs classified in ISCO categories 4-9.

Source: Eurostat, European Commission

Cyprus is among the countries with the highest proportion of tertiary graduates working in occupations sometimes considered as not requiring a university education. Notably, 35 % of tertiary graduates were in jobs classified under International Standard Classification of Occupations (ISCO) categories ⁽²⁴⁾ 4-9 (EU average: 23 %), considered by the International Labour Organisation (2007) as not requiring a tertiary degree. In practice this means that a large

proportion of tertiary graduates are working as clerical support workers or as service and sales workers. Here the potential of university education to contribute to productivity, technological innovation and growth may be weaker than if the graduates were working as managers, (associate) professionals or technicians.

4.3.3. SOCIAL POLICY

The ‘at risk of poverty or social exclusion’ (AROPE) rate increased in 2015 by 1.5 pps. to 28.9 % and is now one of the highest in the EU. Notably the ‘at risk of poverty’ rate and the proportion of households with very low work intensity were on the rise in 2015 (see Graph 4.3.5). Recent developments make it more difficult for Cyprus to meet its 2020 poverty target.

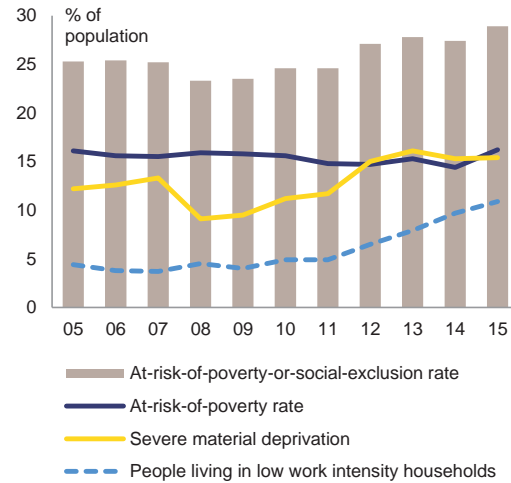
In-work poverty is also increasing. The number of working poor is on the rise (see Graph 4.3.5) while the positive effect from increased employment is still to materialise. However, given that 2015 poverty figures refer to 2014 income data, the rise of in-work poverty mostly reflects the worsening of working conditions during the crisis. This is especially the case as temporary and part-time employment have increased in recent years, and a significant wage adjustment has taken place. Additionally, in line with the still fragile labour market conditions, the number of people living in households with very low work intensity has also been increasing (10.9 % in 2015 from 9.7 % in 2014), close to the EU average (10.5 % in 2015).

The poverty or social exclusion rate among children has worsened. In 2015, the AROPE rate for children (aged 0-17) grew by 4.2 pps. to 28.8 % and is now above the EU average. On the other hand, the rate for people over 65 continues to improve (20.8 % in 2015 compared to 27.2 % in 2014) due to continued actions targeting this age group. Cyprus also has one of the highest risks of poverty or social exclusion for people with disabilities, at 38.1 % (2014). The average gap between people with disabilities and people without activity limitations is also one of the highest.

⁽²³⁾ Systematic employment forecasting and the identification of skills gaps is done by the Human Resource Development Authority, which provides 10-year employment forecasts on a regular basis (latest 2014-2024). For further analysis see European Commission (2016b).

⁽²⁴⁾ The ISCO one-digit classification is as follows: 1: Managers; 2: Professionals; 3: Technicians and associate professionals; 4: Clerical support workers; 5: Service and sales workers; 6: Skilled agricultural, forestry and fishery workers; 7: Craft and related trades workers; 8: Plant and machine operators and assemblers; 9: Elementary occupations; 10: Armed forces occupations.

Graph 4.3.5: AROPE rate and its components

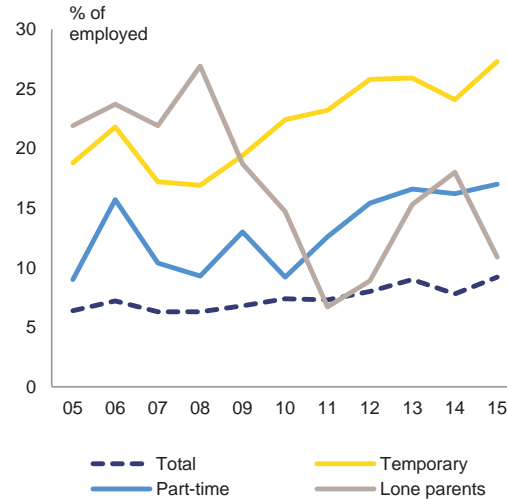


Source: Eurostat

Cyprus experiences a large gender gap in pensions. At 48.8 %, it is one of the highest in the EU. The adequacy of pensions to meet living standards for older women is low due to low employment rates and participation in unpaid work. This occurs in the informal sector of the economy or in family businesses, with no or low social insurance contributions.

Cyprus has had one of the highest increases in inequality in the EU in recent years, which remains a source of concern. As mentioned in Section 1, the ratio between the incomes of the 20 % of the population with the highest incomes and the incomes of the 20 % with the lowest incomes (S80/S20) increased to 5.4 in 2014 from 4.4 in 2009. It only showed a slight decrease to 5.2 in 2015. The precariousness of the labour market and the significant wage adjustment that took place in recent years contributed to increased income inequalities. Furthermore, the tax-benefit system in Cyprus plays a limited role in reducing inequality and poverty. The 'at risk of poverty' rate after social transfers has actually increased in recent years (16.2 % in 2015 compared to 14.4 % in 2014).

Graph 4.3.6: In-work poverty rate, groups



In-work-poverty rate (% of employed). Employed who have an equivalised disposable income below 60 % of the national equivalised median income.

Source: Eurostat

The social welfare system of Cyprus has undergone a major reform in recent years. In 2014 the Guaranteed Minimum Income and Social Benefits Act was adopted (European Commission, 2016b, pp. 63-64). The GMI system is now fully in place, and as of September 2016 only 6577 beneficiaries of the old public assistance system remain, requiring more thorough examination. In the last quarter of 2016, around 27 000 families were receiving GMI. Initial feedback shows that the GMI seems to perform well, but due to the system's complexity further monitoring of the scheme is essential (see Box 4.3.1).

4.3.4. HEALTHCARE

Cyprus has announced the implementation of a dual strategic healthcare reform programme. If adopted by the House of Representatives, the reform programme will include the establishing autonomous health organisations (by June 2017), the reform of primary healthcare services (by June 2019) and full implementation of a national health system (NHS) (by June 2020).

There is currently no universal healthcare coverage in Cyprus and healthcare is provided by two uncoordinated sub-systems leading to inefficiencies and increased spending. Around 85 % of the population is entitled to public

healthcare, but many opt for private healthcare and pay out of pocket. However, there are no links between public and private providers to ensure the continuity of care, while in many cases citizens are spending additionally for the same health service. In 2014 households' out-of-pocket payment for health reached 49.9 % of health expenditure, which is the highest in the EU (17.6 %). The current situation generates inefficiencies related to the fragmentation of care provision while a significant part of the population is not adequately protected from the financial consequences of illness.

The proposed design of the NHS would entitle access to care for the whole population and significantly reduce current high out-of-pocket payments. The draft bill also envisages implementing the NHS on the basis of a single-payer system, funded by payroll contributions from the state, employers and employees. Any budgetary shortfall is expected to be covered by the building-up of financial buffers. The timelines for NHS implementation will particularly depend on the duration of parliamentary discussions and the successful roll-out of the NHS IT solutions.

Currently, there is no formal referral system from primary to specialist and hospital care. The restructuring of primary healthcare is key for national authorities to establish a gatekeeper system⁽²⁵⁾. Authorities have announced plans to enhance primary healthcare services by clustering small healthcare facilities, extending opening hours, standardising procedures and improving synergies and coordination with community care centres.

Increasing waiting times result in accessibility problems. An increase of waiting times for specific treatments is evident since 2011. In fact, there are long waiting lists for certain surgical operations, and high-cost screening tests worsen inequalities in access to care. (Theodorou *et al.*, 2012). In response, the Ministry of Health established a voucher project for two schemes. As of September 2016, 942 patients have benefited from financial assistance for services not offered in

the public sector. Furthermore, 6 308 patients have been referred to the private sector to skip waiting lists in public hospitals. Cyprus is considering expanding the scheme further to cover unmet health needs. Improved cooperation with other EU Member States, under the Directive 2011/24/EU on patients' rights in cross-border healthcare, would also increase treatment options that are not currently available in Cyprus.

A comprehensive human resources strategy to improve efficiency is lacking. The total number of practising physicians per 100 000 inhabitants (338 in 2014) is lower than the EU average (350 in 2014). In addition, Cyprus has the lowest ratio of nurses to doctors in the EU (in 2014, 1.6 compared to 2.4 on average). Health professionals belong to high-shortage occupations for Cyprus (as per CEDEFOP skills needs analysis). There is no health workforce planning system aligning the provision of future health education graduates with public health needs. This prevents Cyprus from developing a balanced skill-mix in multidisciplinary teams that would strengthen the healthcare sector⁽²⁶⁾.

Spending on prevention and public health policies is low in Cyprus and is a major source of inefficiency. Chronic non-communicable diseases are the main cause of death and disability in Cyprus. Although the main risk factors associated with these diseases are preventable, Cyprus dedicates relatively little expenditure to preventive care (0.6 % of total current healthcare expenditure in 2014). Expenditure on health promotion and prevention, as a proportion both of GDP and of total current health expenditure, are below the EU average (0.1 % of GDP and 1.4 % of total current health expenditure in Cyprus respectively, as against 0.2 % and 2.5 % in the EU (European Commission, 2016d)).

Cyprus' healthcare sector is not making effective use of open and competitive public procurement. This is shown by the scarcity of EU-wide public tenders in this sector. Therefore the benefits from centralised purchasing of medical supplies and services through public procurement

⁽²⁵⁾ Mechanism of care referral where the general practitioner is the first point of contact in the patient's care path. The general practitioner refers the patient to a specialist or any other form of secondary care.

⁽²⁶⁾ The EU Joint Action on health workforce planning and forecasting provides methodologies and tools which Member States can draw on for national implementation of planning systems, see <http://healthworkforce.eu/>.

remain widely untapped. Competition is also insufficiently encouraged, as from 2012 to 2015 about a third of contracts were awarded through negotiated procedure without prior call for competition. In addition, only one single bid was attracted in close to half of EU-level tenders. In most procurement procedures, the lowest price is used as sole award criterion. This suggests that public procurement in the healthcare sector is not sufficiently professionalised (see Section 4.6.4).

Stronger governance and coordination of the pharmaceutical market can improve efficiency.

Without universal coverage, many citizens are not covered for pharmaceutical products and have to pay directly out of pocket. In 2014, Cyprus had the lowest public coverage of outpatient medicinal goods in the EU (20.2 % compared to 70.1 % in the EU). In addition, prescribing habits of private doctors are not monitored, therefore presenting difficulties for the authorities following-up on current recommendations for the cost-effective use of medicines. Cyprus has high levels of antibiotic consumption and non-prescription use of antibiotics. In addition to implementing the current national strategy for antimicrobial resistance, introducing e-prescription tools would increase efficiency. Furthermore, the authorities have announced plans to develop by the end of 2017 an autonomous medicines organisation seeking to obtain an overview of the situation.

4.3.5. LONG-TERM CARE (LTC)

Despite recent reforms, Cyprus' long-term care system remains fragmented and characterised by a relatively low coverage and limited financing.

Public expenditure on long-term care is one of the EU's lowest (0.3 % of GDP in comparison to an EU average of 1.6 %). This is only partly explained by favourable demography ⁽²⁷⁾. Without a comprehensive public system for long-term care, these services are mostly provided by the private sector or informally by family members. Therefore, some people with care responsibilities, mainly women, might be pushed into flexible working arrangements or even out of the labour market. However, recently an increase in the number of live-in carers (mostly from non-EU countries) has had a positive effect on female employment. The implementing of the scheme for training the unemployed to assist in providing long-term care services in 2017 is also positive. Overall, long-term care lags behind in many areas such as the governance framework, availability of long-term care services and support for informal carers. A peer review of this issue is expected to take place in 2017.

⁽²⁷⁾ In 2016 the population aged 65 and over amounted to 14.6 % of the total, against an EU average of 18.9 %.

*Box 4.3.1:***Selected highlights: the Guaranteed Minimum Income**

During the economic adjustment programme, Cyprus overhauled its welfare system to cushion the social impact of the economic crisis. In 2012, Cyprus' welfare system proved ineffective to cope with the rapid deterioration of the economic and social environment and the need to support an increasing number of people at risk of poverty and social exclusion. It suffered from fragmentation, poor targeting, weak coordination, frequent abuses, and lacked incentives for reintegration in the labour market. In July 2013, as part of the economic adjustment programme, Cyprus adopted a welfare reform plan aiming at rationalising and better targeting social benefits to those most in need. The plan also intended to reduce benefits-dependence and promote social inclusion, while providing support to certain groups that were not eligible under the previous scheme.

The reform of the welfare system addressed inefficiencies in order to better support vulnerable households, while keeping the social budget envelope unchanged. At the core of the new social welfare system is the reformed public assistance programme, the Guaranteed Minimum Income (GMI), which was adopted in 2014. The GMI covers the basic needs of different household types defined on the basis of a new minimum consumption basket and additional allowances for housing cost and taxes (European Commission, 2016a, p.63). The scheme is designed to incentivise work, as beneficiaries that are able to work must be registered with the public employment services and be willing to participate in active labour market programmes. The implementation of the GMI and the streamlining of all benefits with specific criteria and control processes enabled a more effective allocation of benefits to those in need, avoiding the waste of valuable resources. More importantly, this allowed Cyprus to service the growing number of persons in need at a time when Cyprus was experiencing its economic crisis. The system is now fairer, as the eligibility criteria are clearer and the extent of abuses is limited by extended investigative powers given to the administration. The key success factors for this reform are that it combined increased effectiveness with a more efficient use of public resources.

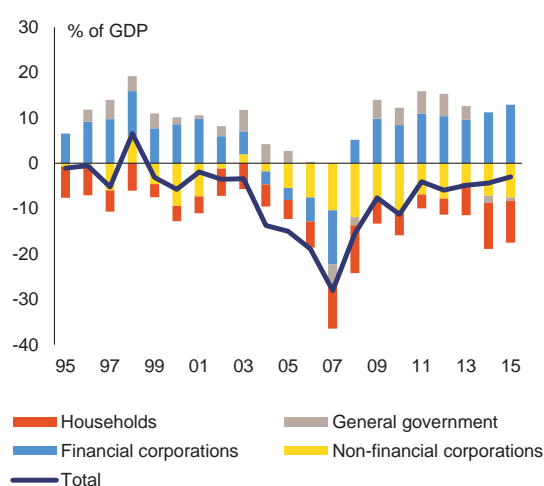
The Guaranteed Minimum Income is expected to help reduce the intensity of poverty in Cyprus. The number of GMI applications has risen steadily since its introduction, although a limited number of cases are still treated under the old system (see Section 4.3.3). According to first preliminary simulations during the design phase, the GMI contributes to reducing absolute poverty and the intensity of relative poverty. However, its full impact on reducing poverty has not yet been assessed.

4.4. EXTERNAL COMPETITIVENESS AND PRODUCTIVITY

4.4.1. EXTERNAL COMPETITIVENESS *

The current account improved on the back of higher savings. The current account improved to -3.0 % of GDP in 2015. This was due to higher savings, which more than offset a rise in investment. Savings by households and non-financial corporations grew in 2015, but remained negative. As a result the savings-investment balances of households and non-financial corporations also remained negative (-9.2 % of GDP and -7.5 % of GDP, respectively). The savings-investment balance of financial corporations increased to 12.9 % of GDP in 2015. This was mainly due to the need for banks to raise risk-provisioning levels and generate internal capital, and therefore to save more.

Graph 4.4.1: Savings-investment balance

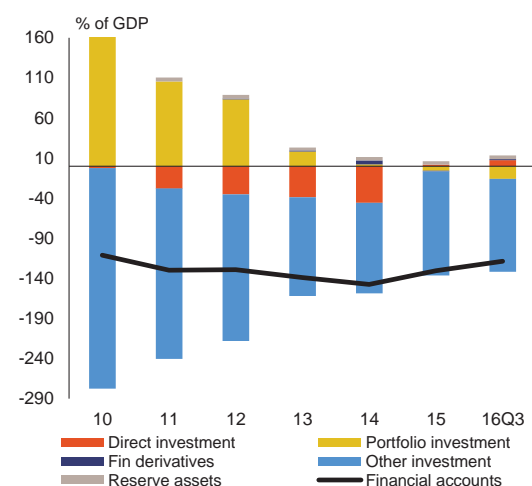


Source: Eurostat

The net international investment position (NIIP) continued to improve in 2016. The NIIP improved from -147 % of GDP in 2014 to -118 % of GDP in the third quarter of 2016. While SPEs accounted for more than half of the negative NIIP (Central Bank of Cyprus, 2016), the public sector had a NIIP of around -80 % of GDP (EUR 14.5 billion). Public external debt is mainly long-term and includes EUR 7.3 billion in loans from the European Stability Mechanism and the International Monetary Fund, and a EUR 2.5 billion loan from the Russian government. Although the NIIP for the private sector was positive, external debt remained high for the financial sector. This is due to the still sizeable

amount of foreign (predominately short term) deposits, which amounted to 110 % of GDP in the third quarter of 2016.

Graph 4.4.2: Net international investment position



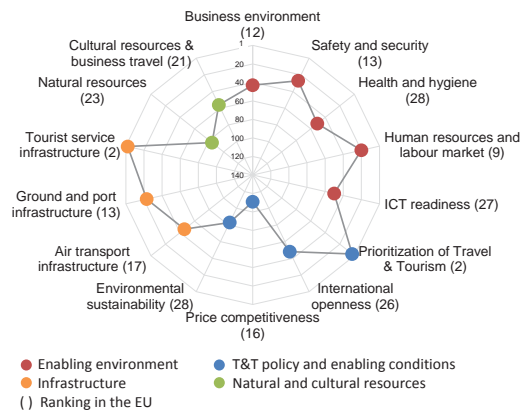
Source: Central Bank of Cyprus

Higher tourism receipts explain the bulk of the improvement in the service account. Tourist arrivals increased by around 20 % in 2016, reaching levels not observed for more than a decade. The strong growth in the tourism sector came notably from gains in price competitiveness, as shown by the real effective exchange rate depreciation in 2015. This was mainly due to a nominal effective exchange rate depreciation vis-à-vis the US dollar and the British pound, and was partly offset by a large appreciation vis-à-vis the Russian rouble. Furthermore, lower inflation in Cyprus compared to its large trading partners contributed to the large real effective exchange rate depreciation.

The non-price competitiveness of the tourism sector ranks among the lowest in the EU and lack of investments limits future tourism sector growth. Growth in the tourism sector in 2016 was supported by measures taken to extend the season and improve air connectivity. As regards the travel and tourism competitiveness indicator (see Graph 4.4.3), although the infrastructure and prioritisation indexes rank high, several structural features push down the overall performance (e.g. natural resources and environmental sustainability). Increased accommodation capacity in existing facilities has helped house the rising number of tourist arrivals. However, low

investment in tourism facilities is likely to hold back growth and productivity. Exploiting new forms of tourism could boost further tourism sector growth.

Graph 4.4.3: Travel and tourism competitiveness

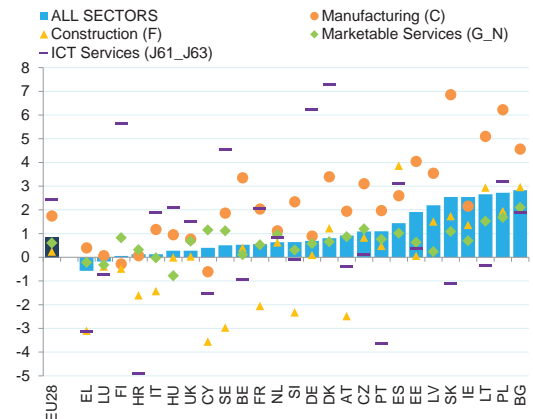


Source: World Economic Forum.

4.4.2. PRODUCTIVITY AND INVESTMENT *

Labour productivity growth has fallen noticeably in the post-crisis period and is below EU average. Generally, productivity growth tends to slow down in the initial phase of a recession, due to the lagged employment reactions, and then to pick up when employment starts to adjust. However, productivity growth in Cyprus has remained low since 2008, due also to underlying structural weaknesses. In almost all manufacturing sectors Cyprus ranks among the EU Member States with the lowest productivity growth rates, notably in construction and information and communication technology (ICT) services (see Graph 4.4.4). Poor productivity performance points to several competition issues in product and service markets and also to some regulatory and financing barriers that inhibit the growth of healthy businesses.

Graph 4.4.4: Labour productivity, 2006-2015

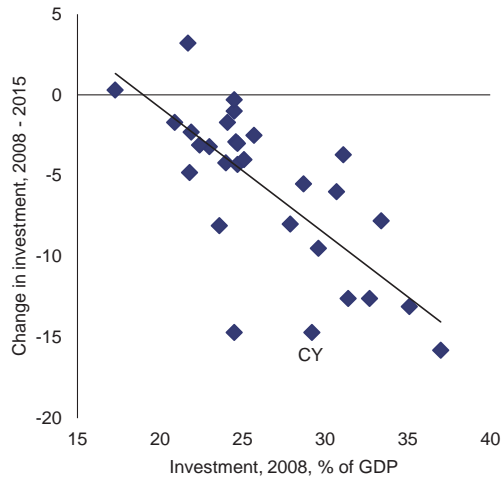


Note: 2006-2014 average for all industries in CZ and IE, 'C', 'G_N' and 'J61_J63' in EU28, 'J61_J63' in CY, DE, ES, FR, IT, LV, PL, PT, RO, SE; 2008-2014 average in HR; 2009-2010 change excluded in HU due to methodological change; no available data for MT

Source: Eurostat and OECD.

The deterioration in productivity growth was accompanied by weak productivity-enhancing investments. Overall, low private and public investment levels, particularly in research and development, and a subpar quality of infrastructure help explain low productivity growth in Cyprus. From 2008 to 2015, investment in Cyprus contracted by almost 15 pps. of GDP, which was among the largest declines in the EU. This was partially due to the current tight credit conditions. Alternative financing, through venture and seed capital, is only marginally benefiting young and innovative firms (European Central Bank, 2015). Business sector involvement in research and innovation activities and investment in intangible assets is among the lowest in the EU (see Section 4.5). This limits productivity and economic growth, which stems in good part from investments in knowledge creation.

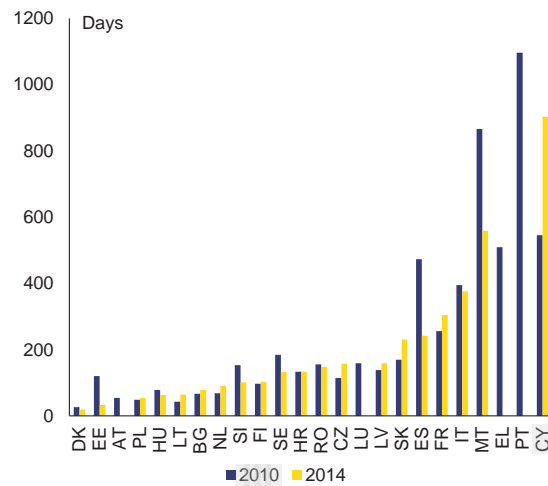
Graph 4.4.5: Investment, EU Member States



Source: Eurostat.

The non-price competitiveness of the business environment is declining. Since 2012, Cyprus has dropped 25 places in the Global Competitiveness Index (World Economic Forum, 2016). The most problematic areas are access to finance, corruption and government bureaucracy (see Section 4.6). Cyprus also lost four places in 2017 (45th instead of 41st in 2016) in the Ease of Doing Business indicator and has a low EU ranking in this area (World Bank, 2016). Sizeable barriers exist in the area of building permits, where Cyprus ranks 125th out of 189 countries. It takes almost four times longer (617 days) than the OECD average to obtain a building permit. The procedure for updating land titles, which is required in order to sell property, is particularly burdensome. This procedure can take six to eight months and sometimes as long as eight years. Contract enforcement is also weak in Cyprus, which has a low EU ranking (see Graph 4.4.6). Inefficiencies in the justice system (see Section 4.6.2), in particular lengthy judicial procedures, hamper the swift resolution of civil and commercial cases and therefore impact negatively on the general business environment. Weak contract enforcement also deters debtors from swiftly repaying their debt making a reduction in the stock of NPLs more difficult (see Section 4.2).

Graph 4.4.6: Average disposition time in first instance courts (excluding criminal cases)

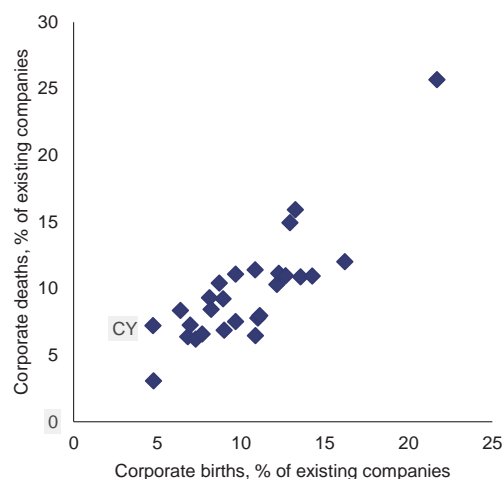


Source: European Commission, European Commission for the Efficiency of Justice

Low business dynamism continues to hinder a more efficient allocation of labour and capital.

Cyprus shows one of the lowest corporate birth and death rates and the lowest percentage of high-growth enterprises (see Graph 4.4.7). Most sectors of the economy are heavily indebted. The high ratio of non-performing loans and low corporate death rates suggest the presence of unviable firms throughout the Cypriot economy. This locks labour and capital into unprofitable firms, while they could be used more effectively. The new insolvency framework intends to provide second chances for insolvent entrepreneurs but its use has been limited, due to obstacles to their effective application (see Section 4.2.4).

Graph 4.4.7: Corporate deaths and births, average of 2008-2014



Source: Eurostat

The action plan for growth is gradually being implemented, but tangible results are still limited. The action plan includes several initiatives supporting higher business dynamism and innovative growth. The June 2016 progress report shows progress in some areas, including the development of a tourism growth strategy and a strategic framework for promoting entrepreneurship and enhancing SME development. Some measures were also taken to reduce administrative burden and improve the law-making process (see Section 4.6). However, other reforms are lagging behind, notably the setting-up of fast-track procedures for strategic investment. The legislative proposal to attract and facilitate investments is still in the draft stage. More generally, improvements in productivity and competitiveness will depend on continuing the reform process and implementing successfully the action plan for growth.

Access to finance remains the most pressing issue for businesses (Schwab, 2016; European Central Bank, 2015). Cyprus ranks below the EU average regarding access to finance. This is because of the restructuring and consolidation of the financial sector, which has led financial institutions to set more stringent lending standards. Although credit conditions appear to be slowly easing, the financing environment remains difficult for SMEs which have limited or no collateral

available, while many companies remain over-indebted.

Financial SME support measures introduced in recent years are limited and not sufficiently well-targeted. A number of non-repayable schemes are available to SMEs under the operational programmes and the rural development programme co-funded by the 2014-2020 European Structural and Investment Funds. However, support to SMEs is not integrated and is insufficiently targeted towards sectors with high added-value products and services, as defined by Cyprus' Smart Specialisation Strategy. This limits support for the modernisation of those sectors, which is a key condition for attracting new businesses and creating new jobs. The SME initiative could be also an effective tool to address the liquidity problem faced by SMEs in Cyprus. The Cyprus Entrepreneurship Fund supports both working capital and investment loans for SMEs. Results in 2016 for this risk-sharing facility are more promising as more financing intermediaries are participating in it.

The European Investment Bank directed more funds to the Cypriot economy in 2016, especially to SMEs, through its Multi-Beneficiary Intermediated Lending facility. This programme has helped cut the cost of funding for businesses. The need to develop alternative forms of financing has been recognised in the National Policy Statement on the Enhancement of the Entrepreneurial Ecosystem in Cyprus. Despite several initiatives from the public and private sector, alternative financing (equity financing, venture capital, crowdfunding, business angels) is still marginal. Cyprus has so far made little use of the European Fund for Strategic Investments (EFSI) ⁽²⁸⁾, which provides financial guarantees and aims to stimulate private investment in large and/or risky projects such as infrastructure, low carbon economy and small businesses.

⁽²⁸⁾ On EFSI use Cyprus is at the bottom of the EU ranking (European Commission, 2016e)

Box 4.4.1: Investment challenges and reforms in Cyprus

Macroeconomic perspective

Since 2008, investment in Cyprus has significantly decreased and currently stands among the lowest in the EU, at around 13% of GDP. The decline in investment concerned mainly private residential investment, although public sector and non-construction investment were also reduced. The decline was mainly driven by high public and private debt levels as well as tight credit conditions, resulting from high stock of non-performing loans in the banking sector. As demand is expected to strengthen in 2017 and 2018, investment is forecast to gradually expand and support total factor productivity and capital deepening, which in turn should support growth potential.

Assessment of barriers to investment and ongoing reforms

Public administration/ Business environment	Regulatory/ administrative burden		Financial Sector / Taxation	Taxation	
	Public administration	CSR		Access to finance	CSR
	Public procurement /PPPs			Cooperation btw academia, research and business	
	Judicial system	CSR	R&D&I	Financing of R&D&I	
	Insolvency framework	CSR		Business services / Regulated professions	
	Competition and regulatory framework	CSR	Sector specific regulation	Retail	
Labour market/ Education	EPL & framework for labour contracts	CSR		Construction	
	Wages & wage setting			Digital Economy / Telecom	
	Education			Energy	
				Transport	

Legend:

	No barrier to investment identified		Some progress
CSR	Investment barriers that are also subject to a CSR		Substantial progress
	No progress		Fully addressed
	Limited progress		

In addition to macroeconomic constraints, the overall business environment in Cyprus does not appear to facilitate investment (European Commission, 2016a). An action plan for growth has been developed and is slowly being implemented. The plan mainly aims to improve the business environment, lighten the administrative burden for companies as well as support growth and investment. Furthermore, a wide range of reforms have been adopted or are envisaged, in particular in the areas of the judicial system and labour legislation. Nevertheless, some barriers remain to be addressed in areas such as contract enforcement and judicial procedures.

1. Firms' access to finance remains wholly dependent on bank lending, which has been significantly reduced over recent years. Banking sector vulnerabilities still persist and capital markets remain underdeveloped, while Cypriot banks are not equipped to assess early-stage business risks and innovative projects. This is a significant constraint, particularly for small and medium-sized businesses. Access to alternative financing sources such as venture capital remains limited. More intensive use of the new insolvency and foreclosure frameworks, material progress with reforming the system of issuing and transferring title deeds, and modernising the legal procedures are necessary to support the much-needed clean-up of banks' balance sheets.

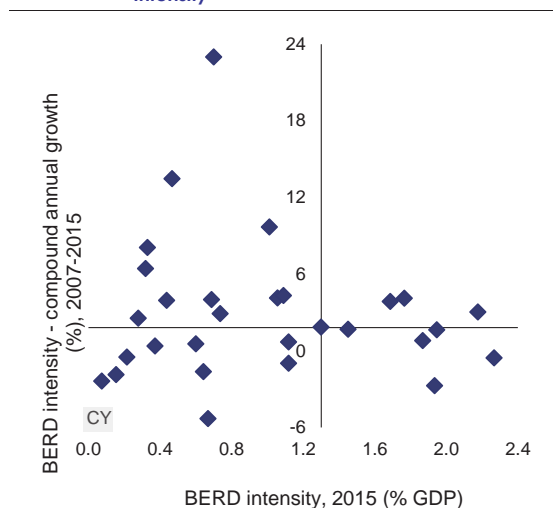
2. The regulatory and administrative burden remains high and hampers business activities and investment decisions. There are significant inefficiencies in the public administration, low quality and availability of digital public services, and the perception of corruption is particularly high. Additionally, the low quality of Cypriot regulations and inadequate enforcement due to lengthy administrative and court proceedings weaken the effectiveness of Cyprus' legislation and overall legal certainty.

4.5. RESEARCH AND DEVELOPMENT, ENVIRONMENT AND CLIMATE

4.5.1. RESEARCH AND DEVELOPMENT (R&D)

R&D investment remains modest in Cyprus. In 2015, total R&D intensity stood at 0.46 % of GDP, with public R&D intensity accounting for 0.31 % of GDP. Investment in R&D carried out by the private sector was 0.08 % of GDP, which is the lowest across all Member States (see Graph 4.5.1). These very low values illustrate the nascent and significantly underdeveloped nature of the R&D system in Cyprus. This can notably be explained by structural limitations such as Cyprus' remote location, small market size, and service-oriented economy. The low levels of R&D hinder Cyprus' ability to diversify its economic structure and boost productivity.

Graph 4.5.1: Business enterprise expenditure on R&D (BERD) Intensity



Source: European Commission

Although some measures have been adopted to redirect scarce public funding towards priority areas, there are still some shortcomings in R&D governance and evaluation of funding. Cyprus has adopted a series of policy instruments to promote R&D. For example, a scheme to support private R&D investment has been introduced and the government plans to set up a national knowledge transfer office. However, there is still limited monitoring and evaluation of how public research is structured and strategically steered. Sustained monitoring is necessary to boost science-business linkages and ensure the relevance of public research. Overall, reforms undertaken by

Cyprus go in the direction of building a more robust R&D policy system.

4.5.2. ENVIRONMENT AND CLIMATE

Total environmental investments in Cyprus in GDP terms are close to the EU average, but there is potential to improve their efficiency and targeting. Investment by specialised environmental protection service providers in Cyprus is among the highest in the EU as a proportion of GDP, and benefit from strong support by EU funds. However, there is potential to further raise the standard of environment protection in the country, as shown by a still weak eco-innovation performance. Cyprus also faces critical environmental needs in the water, waste treatment and energy sectors.

Cyprus' waste management performance is one of the main environmental concerns. This is reflected in an increase of the GDP-intensity of waste generation well above the EU average, a low waste recovery rate and a strong dependence on landfilling, including in illegal facilities. Cyprus' transition towards a more circular economy hinges upon the country's ability to move away from landfilling and sub-optimal treatment options. Several measures have been taken to protect the environment by promoting separate collection to increase recycling rates, updating the national waste management plan (for municipal waste only) and approving a waste prevention programme. However, managing waste efficiently and fulfilling the obligations from the EU waste legislation remain a challenge. An increased policy focus, more investments and economic incentives towards reducing waste generation and increasing recycling rates, by implementing the separate collection obligation, would be beneficial. In view of its relatively low waste recovery rate and the very low amount of toxic waste as a proportion of total waste volume, the economic potential for waste treatment seems high.

Cyprus faces major challenges concerning water management, in the context of severe water scarcity and over-abstraction of groundwater. The level of the water exploitation index is among the highest in the EU. This indicates a severe and increasing water scarcity.

Furthermore, the water use intensity in Cyprus has been increasing faster than for the rest of the Member States since 2008, despite remaining below the EU average. Thus, the water management framework remains inadequate for the challenges, despite the government's investment in desalination and water recycling. The water pricing policy is not in line with the Water Framework Directive, as it has not yet been fully implemented with new tariffs only adopted in January 2017.

Cyprus appears on track to meet its greenhouse gas emissions target in 2020, according to the latest national projections submitted to the Commission in 2016 which take existing measures into account. Cyprus adopted a "low carbon development strategy" and aims to fulfil its commitments on greenhouse gas emissions by reducing its dependence on fossil fuels. This involves the promotion of renewable energy sources, energy efficiency and climate-friendly technologies. While Cyprus is on its planned trajectory for increasing the share of renewables in final energy consumption, an acceleration of renewable energy supply is likely to be needed to meet the target for 2020. Preliminary data indicate that, also as a consequence of the recovery in economic activity, sales of petroleum products increased substantially in 2016, which might translate into rising energy consumption and, consequently, greenhouse gas emissions.

The reform of Cyprus' energy sector has not progressed. Cyprus' energy market is characterised by the dominance of the former public electricity monopoly and by an over-reliance on imported fossil fuels (European Commission, 2016b, pp. 73-74). The timeline for the ownership unbundling of the Electricity Authority of Cyprus (EAC) has been significantly pushed back. Moreover, the approval process of the new electricity trade and settlement rules is proving very slow. The transmission system operator's limited capacity and dependence on EAC might also result in a slow implementation of the new market rules. Finally, no progress has been made in designing a solution that would allow the introduction of natural gas in the domestic market by 2020.

There is no specific climate-related transport policy in Cyprus. Transport policy merits

attention as Cyprus is among the Member States with the highest ratio of greenhouse gas emissions from transport to GDP (in 2014, the ratio was 220.4 tonnes of CO₂-equivalent per million EUR of GDP in Cyprus versus 93.7 in the EU as a whole). This shows a high reliance on private road transport, as Cyprus has one of the highest car ownership ratios in the world (more than 600 cars per 1 000 inhabitants), although passenger traffic intensity in the country is lower than the EU average. It also reflects the lack of fuel efficiency policies which would provide incentives for a more fuel efficient fleet of private vehicles. The use of private road transport is also encouraged by the currently insufficient availability of public transport.

Measures have not yet been taken to ensure continued compliance with the Industrial Emissions Directive once current derogations have expired. Cyprus' electricity is generated mostly by plants using heavy fuel oil (HFO) which must comply with the Industrial Emissions Directive. These facilities currently enjoy derogations under the Directive until the end of 2019, while one of the plants will benefit from derogations until 2023. To date, no action to deal with the expiry of the derogation, for example by using natural gas instead of HFO, has been reported to the Commission.

4.6. PUBLIC ADMINISTRATION

4.6.1. PUBLIC ADMINISTRATION *

Public administration continues to suffer from a number of inefficiencies. Although Cyprus' public sector wage bill is among the highest in the EU (as a share of GDP), perceptions of the government's effectiveness are barely above the EU average. This is particularly due to (i) the large influence of institutional rules, rather than performance, on wage-setting and promotion, (ii) weak performance assessment tools and (iii) limited mobility of human resources. Several international rankings confirm these challenges. According to the World Bank, Cyprus ranks only in the bottom half of the EU for the efficiency of its public administration (World Bank, 2015). Also, Cyprus is among the worse rated EU member states on executive capacity and executive accountability (Bertelsmann Institute, 2016).

The reform of the public administration remains a critical issue in Cyprus. A series of reforms were rejected by the House of Representatives in December 2016. These reforms were designed during the economic adjustment programme and negotiated and agreed with social partners. They provided for a mechanism contributing to better control of the public sector wage bill.

These reforms also aimed to modernise the appraisal system through written exams and interviews, and make the promotion system more open and more closely linked to merit. They addressed the insufficient flexibility and resilience of the public administration by incentivising staff mobility and enhancing redeployment rules.

The reform of the public administration could have a cross cutting impact on the functioning of government services. The negative parliamentary vote on the current reform plans is therefore likely to delay progress in other reforms, notably the reform of local governments and increased autonomy of public hospitals.

The reform of local governments has stalled. The draft bill on local governments is still pending adoption by the House of Representatives and the implementation deadlines remain vague. The local government reform affects the delivery of vital local public services and plays an important role in the process of issuing title deeds. The reform

particularly aims at making the issuing of building permits and certificates more efficient. It also improves public financial management by addressing the current gaps in local government financial reporting with the establishing of a common accounting and reporting framework.

The supply of digital public services is currently weak. Cyprus' performance in the provision of digital public services is below the EU average, with a low degree of sophistication of certain electronic services (e-services). Cyprus features in the bottom half of EU countries in the Digital Economy and Society Index, dropping two places compared to the previous year (European Commission, 2017b). Better online public services are likely to improve the percentage of e-government users in Cyprus (29 % of Internet users have submitted forms with public authorities online in 2016, below the EU average of 33 %). The design of effective online services and tools can increase the transparency and efficiency of the public administration. Well-functioning digital public services are also effective tools to improve citizens' trust and participation.

Cyprus' e-government strategy intends to remedy the lack of digital public services. The strategy applies to the broad public administration, focusing on technical, operational and organisational aspects of e-services. It envisages the provision of (i) advanced electronic identification and signatures, (ii) an integrated information system covering the judicial system and automating all court procedures, and (iii) the creation of an integrated health information system (see Section 4.3). An Electronic Governance Council was established in 2015 to approve and implement all e-government projects and monitor policy developments in this area. In 2016, the government decided to create a single portal for all digital public services.

4.6.2. JUSTICE SYSTEM *

The Cyprus justice system faces serious challenges as regards its efficiency. According to data collected through the 2017 EU Justice Scoreboard (forthcoming), the time needed to reach a first-instance judicial decision in civil, commercial and administrative cases is particularly long. The backlog of pending cases is also

significant (European Commission, 2016b p. 22). These problems stem mainly from complex procedural rules prone to abuse and the low level of ICT use in courts, in particular for case management. Furthermore, there are discussions concerning (i) the relatively low level of budgetary resources dedicated to the judiciary, (ii) the underuse of alternative dispute resolution mechanisms (in particular the voluntary use of mediation), and (iii) the lack of organised lifelong training of judges. Most of these issues were recognised in a report adopted by the Supreme Court in June 2016. The inefficiency of the justice system is an obstacle to the swift resolution of civil and commercial cases. This particularly concerns credit enforcement and the proper implementation of the insolvency and foreclosure frameworks. More generally, it may deter investments and dampen economic activity.

Some reform initiatives have been launched.

Draft bills have been proposed to improve civil procedures, by reforming interlocutory appeals⁽²⁹⁾ during proceedings and by amending the Civil Procedure Law to strengthen the enforcement of judgments. To increase the use of ICT, the government intends to set up a court administration/management information system for the Cypriot courts. The use of alternative dispute resolution mechanisms remains low, as few mediation took place in 2016 despite an increasing number of registered mediators (over 300). For this reason, the Ministry of Justice and Public Order (MJPO) has commissioned a study on how better to promote voluntary use of mediation. To increase courts' specialisation, the MJPO and the Supreme Court have announced a feasibility study on establishing a commercial court. To improve judicial training, the Supreme Court is examining the creation of a special section in charge of the lifelong training of judges, which may become operational in 2018. Following a technical assistance request from the Supreme Court to the European Commission, a review of the operations of the court system is expected to be conducted in 2017 to further support the reform momentum. The effectiveness of the reform of the judicial system will depend on the full support not only of the Supreme Court but also of all the

relevant stakeholders including the Ministry of Finance and the MJPO.

4.6.3. BETTER REGULATION

Regulatory quality has weakened considerably in Cyprus in the last five years.

According to the World Bank (World Bank, 2015) Cyprus ranked in the bottom half of EU member states in 2015 with regard to regulatory quality, dropping seven places compared to 2011. Key challenges include the limited use of both *ex-ante* evaluations and *ex-post* assessment of impacts on small businesses. Although public consultations reach stakeholders, results are often not made publicly available. Efforts are being made to improve the quality of legislation. A new impact assessment mechanism was approved in August 2016, with the aim to ensure more focused and thorough impact assessments. It will enter into force in January 2017 and introduce an SME test, which will aim to assess all possible impacts of new legislation on SMEs.

The operation of the Law Office of the Republic and the Attorney General is under strain.

Litigation cases linked to the restructuring of the banking sector have increased the workload of the Attorney General's office. There has been a considerable increase in regulatory and legislative activity due to reforms initiated under the economic adjustment programme. Therefore the drafting and legal vetting of legislation, which require coordination with ministries and the House of Representatives, is not taking place in an efficient or timely manner. Ministries lack developed skills for the preparation of legislation, while the Law Office's vetting unit lacks capacity to cope efficiently with the increased workload. Significant delays have appeared in the clearance of legislation for adoption by the government and consideration by the House of Representatives.

Efforts are being made to improve legal drafting and vetting processes.

The Government provides specialised training for relevant personnel in the Ministries. An action plan has been developed, including (i) workshops on legal drafting for relevant officers, (ii) an increased focus on impact assessment and (iii) guidelines for preparing legislation. With technical assistance from the European Commission, a comprehensive

⁽²⁹⁾ Interlocutory appeals are appeals of a ruling by a trial court that are made before all claims are resolved as to all parties.

review of the Law Office's operations has started in 2017 to address its various shortcomings. Particular emphasis is to be given to the drafting and vetting of legislation.

4.6.4. CORRUPTION

Trust in the public institutions is undermined by a high perceived level of corruption.⁽³⁰⁾ Recurrent surveys highlight the perception that patronage, bribery or abuse of power are significant problems in the Cypriot public administration (World Bank, 2015; Transparency International, 2017). 87 % of companies agree that corruption hampers business competition in Cyprus. According to the World Economic Forum, corruption is seen as the third most problematic factor for doing business in Cyprus. The 2016-2017 Global Competitiveness Report ranked Cyprus 103rd out of 138 countries regarding favouritism in decisions of government officials (Schwab, 2016). This might affect competition in public tenders and efficiency of public procurement. For example, in 2015, 40 % of public procurement procedures involved only a single bidder, while 24 % of procedures did not feature a call for tender, the highest percentage in the EU (European Commission, 2016f). From 2009 to 2015, only 9 % of public tenders were assessed according to the principle of the most economically advantageous tender, resulting in one of the lowest scores in the EU.

Some reforms have been undertaken to tackle corruption. Recent developments include reforms to professionalise public procurement at local level, and a political party funding law enacted in December 2015. A constitutional amendment enabling asset disclosure for public officials has been adopted in 2016. However, the Coordinating Body against Corruption remains without full-time staff, while the national anti-corruption strategy has been under preparation since September 2015, with no tangible outcome to date. Moreover, many weaknesses in the disciplinary regime for public servants highlighted in the *2014 EU Anti-Corruption Report* remain unaddressed. (European Commission, 2014b) Finally, the government's

draft law on whistleblower protection has not yet been submitted to House of Representatives, despite evidence that whistleblowers face significant obstacles in Cyprus (Transparency International, 2015).

4.6.5. STATE-OWNED ENTERPRISES

The framework for managing state-owned enterprises (SOEs) still poses certain risks. During the economic adjustment programme the authorities had identified several weaknesses in the management framework of SOEs. There are no established common reporting standards, financial data are not centralised and benchmarked, while direct supervision is scattered among line ministries. There are no common standards regarding corporate governance. The lack of visibility and long-term strategy regarding SOEs may pose risks concerning contingent liabilities, as the State is their ultimate guarantor.

The reform of SOE's management has not been adopted yet. The draft law on SOEs aims to improve their corporate governance and ensure a more effective monitoring of their functioning, while minimising fiscal risks related to contingent liabilities and losses. The law was submitted for discussion in the House of Representatives in April 2015, but has so far not been adopted. The delays in adopting this law undermine the public sector's efficiency, by holding up the improvement of SOEs' governance and preventing the mitigation of SOE-related fiscal risks.

The privatisation process of Cyprus' main SOEs has been halted. The privatisation plan adopted by Cyprus in 2013 aimed at privatising, at least partially, the main SOEs such as the Cyprus Telecom Authority (CyTA) and the Electricity Authority of Cyprus (EAC). The plan's main objective is to attract strategic investors in key utilities, in order to (i) improve governance, (ii) bring in foreign technical expertise and capital, and (iii) increase productivity. The privatisation proceeds are also intended to accelerate the reduction of Cyprus' public debt. However, strong political opposition to privatisation has resulted in the withdrawal of budgetary appropriations for the privatisation unit, while the government repealed several privatisation decrees.

⁽³⁰⁾ Cyprus is one of the countries where the perception of corruption has increased most over the last two years (European Commission, 2015).

ANNEX A

Overview table

Commitments

Summary assessment⁽³¹⁾

2016 Country-specific recommendations (CSRs)	
<p>CSR 1: Following the correction of the excessive deficit, respect the medium-term budgetary objective in 2016 and in 2017. By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public employees. By the end of 2016, adopt the horizontal reform of the public administration and the law on the governance of state-owned entities, and implement the reform of local governments. By the end of 2016, adopt the secondary legislation to complete the new budgetary framework.(MIP-relevant)</p> <ul style="list-style-type: none"> Following the correction of the excessive deficit, respect the medium-term budgetary objective in 2016 and in 2017. By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public employees. By the end of 2016, adopt the horizontal reform of the public administration... (...) and the law on the governance of state- 	<p>Cyprus has made limited progress in addressing CSR 1 despite the completion of the budgetary framework. Indeed, limited progress has been made to adopt the draft bills regarding the wage bill while no progress was made concerning the public administration reform. No progress was made regarding the reform of state owned enterprises and local government, which related bills are still pending adoption by the House of Representatives.</p> <ul style="list-style-type: none"> The assessment of compliance with the Stability and Growth Pact will be included in spring 2017, when final data for 2016 will be available There has been limited progress with regard to the binding mechanism containing the growth rate of the compensation of public employees. The mechanism has been introduced until 2018 in collective agreements with public sector unions. However, the legislative proposal to make this mechanism permanent has been rejected by the House of Representatives. There has been no progress with regard to the horizontal reform of the public administration. The draft laws have been rejected by the House

⁽³¹⁾ The following categories are used to assess progress in implementing the 2016 country-specific recommendations:

No progress: The Member State has not credibly announced nor adopted any measures to address the CSR. Below a number of non-exhaustive typical situations that could be covered under this, to be interpreted on a case by case basis taking into account country-specific conditions:

no legal, administrative, or budgetary measures have been announced in the National Reform Programme or in other official communication to the national House of Representatives / relevant parliamentary committees, the European Commission, or announced in public (e.g. in a press statement, information on government's website);

no non-legislative acts have been presented by the governing or legislator body;

the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures that would need to be taken (unless the CSR explicitly asks for orientations or exploratory actions), while clearly-specified measure(s) to address the CSR has not been proposed.

Limited progress: The Member State has:

announced certain measures but these only address the CSR to a limited extent;

and/or

presented legislative acts in the governing or legislator body but these have not been adopted yet and substantial non-legislative further work is needed before the CSR will be implemented;

presented non-legislative acts, yet with no further follow-up in terms of implementation which is needed to address the CSR.

Some progress: The Member State has adopted measures that partly address the CSR

and/or

the Member State has adopted measures that address the CSR, but a fair amount of work is still needed to fully address the CSR as only a few of the adopted measures have been implemented. For instance: adopted by national parliament; by ministerial decision; but no implementing decisions are in place.

Substantial progress: The Member State has adopted measures that go a long way in addressing the CSR and most of which have been implemented.

Full implementation: The Member State has implemented all measures needed to address the CSR appropriately.

<p>owned entities</p> <ul style="list-style-type: none"> • and implement the reform of local governments. • By the end of 2016, adopt the secondary legislation to complete the new budgetary framework. 	<p>of Representatives.</p> <ul style="list-style-type: none"> • There has been no progress with regard to the law on the governance of state-owned entities, and the reform of local governments. These reforms have not yet been adopted by the House of Representatives. • There has been substantial progress as the legislation to complete the new budgetary framework has been adopted by the House of Representatives but implementation steps are still missing for it to be effective.
<p>CSR 2: By June 2017, eliminate impediments to the full implementation of the insolvency and foreclosure frameworks and ensure adequate resources for the Insolvency Service. Ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. Increase the efficiency and capacity of the court system. Reform the civil procedure law. (MIP-relevant)</p> <ul style="list-style-type: none"> • By June 2017, eliminate impediments to the full implementation of the insolvency and foreclosure frameworks and ensure adequate resources for the Insolvency Service. • Ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. • Increase the efficiency and capacity of the court system. Reform the civil procedure law. 	<p>Cyprus has made limited progress with regard to CSR 2 on implementation of the insolvency and foreclosure frameworks and improving the title deeds issuance and transfer system. Some measures have been announced but remain to be adopted, while no full review of the insolvency and foreclosure frameworks, nor title deeds reform legislation have been tabled.</p> <ul style="list-style-type: none"> • There has been some progress in eliminating barriers to fully implementing the insolvency and foreclosure frameworks and in ensuring adequate resources for the Insolvency Service. Necessary amendments to the legislation on insolvency have been identified but not yet drafted, and no timetable has been released for their submission to the House of Representatives. Rules of Court have been adopted for personal insolvency procedures and are being prepared for corporate insolvency procedures. The capacity of the Insolvency Service has been increased. The foreclosure infrastructure has been developed. • There has been limited progress on ensuring reliable and swift systems for issuing title deeds and transferring immovable property rights. Administrative and legislative measures have been taken to facilitate the issuance of title deeds, but no draft legislation for transfer of title deeds has been prepared due to the lack of understanding and agreement among stakeholders. • There has been limited progress on increasing the efficiency and capacity of the court system and reforming the civil procedure law, as several reform initiatives have been announced

	but remain at a preliminary stage.
<p>CSR 3: By the end of 2016, take measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. Increase the range of information available for creditors to make the credit registry fully operational. (MIP-relevant)</p> <ul style="list-style-type: none"> • By the end of 2016, take measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. • Increase the range of information available for creditors to make the credit registry fully operational. 	<p>There has been some progress overall on CSR 3, regarding measures to ensure a decline in non-performing loans and increase the range of information available for creditors through the credit registry, which is now fully operational for loan origination purposes.</p> <ul style="list-style-type: none"> • There has been some progress on taking measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. In particular, due to increased loan restructuring efforts incentivised by Government and Central Bank of Cyprus measures, the stock of NPLs has started to decline, but remains at a very high level. Some steps were also taken to create a secondary market for loans although no transaction has taken place. • There has been some progress in increasing the range of information available for creditors through the credit registry, which is currently operational for loan origination purposes.
<p>CSR 4: Remove impediments to investment, notably by implementing the action plan for growth, pursuing the privatisation plan and strengthening the national regulatory authorities. Take measures to increase access to finance for small and medium-sized enterprises. (MIP-relevant)</p> <ul style="list-style-type: none"> • Remove impediments to investment, notably by implementing the action plan for growth. • Remove impediments to investment, notably by pursuing the privatisation plan. 	<p>Cyprus has made some progress towards removing impediments to investment as it started implementing the action plan for growth and made some minor progress with regard to privatisation, while limited progress was achieved concerning the facilitation of SME's access to finance.</p> <ul style="list-style-type: none"> • There has been some progress in implementing the action plan for growth. However, many workstreams have yet to enter their implementation phase. • There has been limited progress in pursuing the privatisation plan. Draft bills aimed at launching the privatisation process of the Cyprus Telecommunications Authority (CyTA) were abandoned at the eve of the May 2016 general election, due to strong political opposition. Alternative proposals have not yet been formulated. Although minor privatisation projects still follow their course, budgetary funding for the privatisation unit has been cancelled. • There has been some progress in strengthening the national regulatory authorities, notably

<ul style="list-style-type: none"> Remove impediments to investment, notably by strengthening the national regulatory authorities. Take measures to increase access to finance for small and medium-sized enterprises. 	<p>through the capacity increase of the energy regulator CERA.</p> <ul style="list-style-type: none"> There has been limited progress in increasing access to finance for SMEs, as most new initiatives from the authorities remain at a preliminary stage.
<p>CSR 5: Enhance the capacity of the public employment services and their provision to the long-term unemployed; improve outreach to the non-registered unemployed. Adopt legislation for a hospital reform and advance with the planned implementation of universal health care coverage. (MIP-relevant)</p> <ul style="list-style-type: none"> Enhance the capacity of the public employment services and their provision to the long-term unemployed; improve outreach to the non-registered unemployed. Adopt legislation for a hospital reform and advance with the planned implementation of universal health care coverage. 	<p>There has been limited progress overall in addressing CSR 5.</p> <ul style="list-style-type: none"> Limited progress has been made concerning the enhancement of the capacity of the public employment services. This is because the recruitment of additional counsellors has been continuously delayed and the plans for improving the service remain vague. Some progress has been made to reach out to the non-registered unemployed, especially young people, but the outcome of these initiatives in terms of outcomes is not yet known. There has been limited progress in adopting legislation for a hospital reform and advancing with the planned implementation of universal healthcare coverage. Two bills for the creation of the National Health System and the autonomy of public hospitals were submitted to the House of Representatives, and are currently under discussion.
Europe 2020 (national targets and progress)	
Target	Summary assessment
Employment rate: 75 % - 77 % of the population aged 20-64 should be employed by 2020.	In 2015 the employment rate in the age class 20-64 stood at 67.9 %, 7.1 pps. below the lower bound set in the national target. The employment rate is increasing, but remains largely below the values reached in the pre-crisis period, when Cyprus was already fulfilling its national target.
Research and development target: Increase research and development expenditure to 0.5 % of GDP by 2020.	Overall, Cyprus has taken a step back with regard to its R&D target, with R&D intensity falling by 2 pps. at 0.46 % of GDP in 2015. Cyprus plans to increase the annual expenditure on research, development and innovation until 2020, and to

	<p>focus on the quality of spending.</p> <p>According to the Innovation Union Scoreboard 2016 index, Cyprus is a "moderate innovator" with a declining performance from 2012 onwards.</p> <p>The National Committee for Research, Innovation and Technological Development identified complex and lengthy procedures in the system of incentives and a lack of policies promoting cooperation between academia (universities and research centres) and businesses.</p> <p>The current governance of the R&D system may not be robust enough to allow a focused approach of the limited financial resources at hand.</p>
Renewable energy target: 13 % of gross final energy consumption from renewable sources.	<p>With a renewable energy share of 9.1 % in 2015 ⁽³²⁾, Cyprus is on track to reach the target for 2020. It has met the second interim target of 5.6 %. However, since the trajectory is not linear, the final target will need to be achieved by means of a stronger annual growth of the renewable energy share, in line with Cyprus's high potential in this area.</p> <p>With 2.7 % share in 2014, Cyprus is lagging behind in the use of renewable energy sources in transport and could have difficulty reaching the binding 10 % target by 2020.</p>
Emissions in the sectors not covered by the EU ETS must decrease by 5 % in 2020 compared to 2005.	According to the latest national projections submitted to the Commission and taking into account existing measures, the target might be achieved by 2020.
Energy efficiency target: absolute level of primary consumption of 2.2 Mtoe	Although gross inland primary energy consumption was reduced significantly in the last years, predominantly due to the economic recession, in 2015 Cyprus increased its primary energy consumption by 2 % (from 2.21 Mtoe in 2014 to 2.25 Mtoe). Furthermore, over 90 % of Cyprus's energy consumption is still covered by imported oil and oil products. More efforts are needed to further decrease Cyprus' primary energy consumption in order to achieve its 2020 target.
Early school leaving target: Reduce the rate of	Cyprus has already reached the Europe 2020 national target as regards early school leaving,

⁽³²⁾ Renewable energy shares for 2015 are approximations and not official data, reflecting the available data (04.10.2016). See the Öko-Institut Report: Study on Technical Assistance in Realisation of the 2016 Report on Renewable Energy, <http://ec.europa.eu/energy/en/studies>.

early school leavers to 10 % by 2020.	while still continuing to make significant progress in tackling this issue. In 2014, the early school leaving rate was 5.3 % (compared to an EU average of 11 %), down from 11.4 % in 2012. However this improvement masks a significant number of disparities. In Cyprus young men are more likely to leave school prematurely (7.7 %) than young women (3.1 %), although the gender gap is narrowing.
Tertiary education target: Increase participation in higher education to 46 %.	Higher education is generalised, but the employability of recent graduates is still a major issue. Cyprus has one of the highest tertiary education attainment rates in the EU with 54.6 %, compared to the European average of 38.7 % in 2015 and largely outperforms its Europe 2020 national target of 46 %.
Target for reducing the population at risk of poverty or social exclusion in number of persons: Reduce the number of people at risk of poverty or social inclusion by 27 000 persons or decrease to 19.3 % of the population.	The number of people at risk of poverty or social exclusion had been increasing since 2008, reaching 27.8 % of the total population in 2013. In 2015 it increased to 28.9 % (corresponding to 63 000 more people at-risk-of-poverty or social exclusion than in 2008). Based on these figures, the national target for 2020 appears far from reach.

ANNEX B

MIP Scoreboard

Table B.1: The MIP scoreboard for Cyprus

		Thresholds	2010	2011	2012	2013	2014	2015
External imbalances and competitiveness	Current account balance, 3 year average (% of GDP)	-4%/6%	-11.5	-7.7	-7.1	-5.0	-5.1	-4.1
	Net international investment position (% of GDP)	-35%	-111.2	-129.9	-129.2	-138.9	-147.3	-130.3
	Real effective exchange rate - 42 trading partners, HICP deflator 3 years % change	±5% & ±11%	0.0	-3.0	-5.9	-0.8	-1.7	-6.2
	Export market share - % of world exports 5 years % change	-6%	-15.7e	-11.2e	-21.5e	-14.6	-23.7	-16.8
	Nominal unit labour cost index (2010=100) 3 years % change	9% & 12%	10.6	9.4	3.1	-2.3	-7.8p	-10.5p
	Deflated house prices (% y-o-y change)	6%	-7.6p	-4.5p	-5.4p	-4.1p	-1.3p	2.9bp
Internal imbalances	Private sector credit flow as % of GDP, consolidated	14%	13.2	13.0	15.5	-11.7	0.2	4.4
	Private sector debt as % of GDP, consolidated	133%	315.6	321.6	327.4	340.9	354.3	353.7
	General government sector debt as % of GDP	60%	55.8	65.2	79.3	102.2	107.1	107.5
	Unemployment rate 3 year average	10%	5.1	6.5	8.7	11.9	14.6	15.7
	Total financial sector liabilities (% y-o-y change)	16.5%	8.4	-6.1	6.3	-15.0	-3.5	2.8
New employment indicators	Activity rate - % of total population aged 15-64 (3 years change in p.p)	-0.2%	-0.3	-0.1	0.5	0.0	0.8	0.4
	Long-term unemployment rate - % of active population aged 15-74 (3 years change in p.p)	0.5%	0.6	1.1	3.0	4.8	6.1	3.2
	Youth unemployment rate - % of active population aged 15-24 (3 years change in p.p)	2%	6.4	13.4	13.9	22.3	13.6	5.1

Flags: b: break in time series. e: estimated. p: provisional

Source: European Commission, Eurostat and Directorate General for Economic and Financial Affairs (for Real Effective Exchange Rate), and International Monetary Fund

ANNEX C

Standard tables

Table C.1: **Financial market indicators**

	2011	2012	2013	2014	2015	2016
Total assets of the banking sector (% of GDP)	667.1	658.2	498.3	518.9	516.1	476.7
Share of assets of the five largest banks (% of total assets)	60.7	62.6	64.1	63.4	67.6	-
Foreign ownership of banking system (% of total assets)	36.1	35.5	31.0	31.6	15.6	-
Financial soundness indicators: ¹⁾						
- non-performing loans (% of total loans)	11.9	18.7	36.2	35.6	34.7	35.8
- capital adequacy ratio (%)	8.6	7.3	13.5	15.3	16.6	16.7
- return on equity (%) ²⁾	-75.6	-100.8	-37.9	-7.1	-7.6	3.2
Bank loans to the private sector (year-on-year % change)	6.9	4.2	-9.4	-4.2	3.6	-10.7
Lending for house purchase (year-on-year % change)	4.8	0.3	-6.8	-2.8	-3.0	-0.7
Loan to deposit ratio	112.6	119.3	152.3	152.1	152.0	118.1
Central Bank liquidity as % of liabilities	5.1	9.0	15.7	12.4	6.9	2.0
Private debt (% of GDP)	321.6	327.4	340.9	354.3	353.7	-
Gross external debt (% of GDP) ¹⁾ - public	-	-	-	-	-	-
- private	-	-	-	-	-	-
Long-term interest rate spread versus Bund (basis points)*	317.9	550.5	493.0	483.7	404.1	371.7
Credit default swap spreads for sovereign securities (5-year)*	638.0	1196.2	943.9	423.1	330.6	262.5

1) Latest data Q2 2016.

2) Quarterly values are not annualised

* Measured in basis points.

Source: European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: Labour market and social indicators

	2011	2012	2013	2014	2015	2016 ⁴
Employment rate (% of population aged 20-64)	73.4	70.2	67.2	67.6	67.9	68.6
Employment growth (% change from previous year)	0.0	-3.2	-5.9	-1.9	0.8	2.6
Employment rate of women (% of female population aged 20-64)	67.7	64.8	62.2	63.9	64.0	64.0
Employment rate of men (% of male population aged 20-64)	79.6	76.1	72.6	71.6	72.3	73.5
Employment rate of older workers (% of population aged 55-64)	54.8	50.7	49.6	46.9	48.5	51.7
Part-time employment (% of total employment, aged 15-64)	9.0	9.7	11.9	13.5	13.0	13.4
Fixed-term employment (% of employees with a fixed term contract, aged 15-64)	14.2	15.1	17.5	19.0	18.4	17.1
Transitions from temporary to permanent employment	22.7	24.3	19.1	17.9	27.9	:
Unemployment rate ¹ (% active population, age group 15-74)	7.9	11.9	15.9	16.1	15.0	13.1
Long-term unemployment rate ² (% of labour force)	1.6	3.6	6.1	7.7	6.8	5.8
Youth unemployment rate (% active population aged 15-24)	22.4	27.7	38.9	36.0	32.8	29.1
Youth NEET ³ rate (% of population aged 15-24)	14.6	16.0	18.7	17.0	15.3	:
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	11.3	11.4	9.1	6.8	5.2	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	46.2	49.9	47.8	52.5	54.5	:
Formal childcare (30 hours or over; % of population aged less than 3 years)	17.0	19.0	22.0	20.0	:	:

1 The unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within 2 weeks.

2 Long-term unemployed are those who have been unemployed for at least 12 months.

3 Not in education employment or training.

4 Average of first three quarters of 2016. Data for total unemployment and youth unemployment rates are seasonally adjusted.

Source: European Commission (EU Labour Force Survey).

Table C.3: **Labour market and social indicators**
(continued)

Expenditure on social protection benefits (% of GDP)	2010	2011	2012	2013	2014	2015
Sickness/healthcare	4,5	4,6	4,5	4,5	4,5	:
Disability	0,7	0,7	0,7	0,7	0,7	:
Old age and survivors	9,2	10,0	11,1	12,0	12,3	:
Family/children	1,9	1,8	1,5	1,4	1,4	:
Unemployment	1,0	1,2	1,7	2,0	1,9	:
Housing	1,0	0,9	0,6	0,4	0,3	:
Social exclusion n.e.c.	1,4	1,4	1,2	1,1	1,1	:
Total	19,6	20,6	21,2	22,1	22,2	:
of which: means-tested benefits	2,7	2,6	2,9	2,7	2,6	:
Social inclusion indicators	2010	2011	2012	2013	2014	2015
People at risk of poverty or social exclusion ¹ (% of total population)	24,6	24,6	27,1	27,8	27,4	28,9
Children at risk of poverty or social exclusion (% of people aged 0-17)	21,8	23,4	27,5	27,7	24,7	28,9
At-risk-of-poverty rate ² (% of total population)	15,6	14,8	14,7	15,3	14,4	16,2
Severe material deprivation rate ³ (% of total population)	11,2	11,7	15,0	16,1	15,3	15,4
Proportion of people living in low work intensity households ⁴ (% of people aged 0-59)	4,9	4,9	6,5	7,9	9,7	10,9
In-work at-risk-of-poverty rate (% of persons employed)	7,3	7,3	7,9	8,9	7,8	9,1
Impact of social transfers (excluding pensions) on reducing poverty	33,6	37,0	37,4	37,0	41,5	36,2
Poverty thresholds, expressed in national currency at constant prices ⁵	9088	9304	8958	8148	7363	7072
Gross disposable income (households; growth %)	3,1	2,2	-1,6	-5,4	-6,2	-2,5
Inequality of income distribution (S80/S20 income quintile share ratio)	4,5	4,3	4,7	4,9	5,4	5,2
GINI coefficient before taxes and transfers	41,7	41,5	42,9	43,8	44,8	:
GINI coefficient after taxes and transfers	30,1	29,2	31,0	32,4	34,8	:

1 People at risk of poverty or social exclusion: individuals who are at risk of poverty and/or suffering from severe material deprivation and/or living in households with zero or very low work intensity.

2 At-risk-of-poverty rate: proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.

3 Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.

4 People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 month

5 For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices = 100 in 2006 (2007 survey refers to 2006 incomes).

Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table C.4: Product market performance and policy indicators

Performance indicators	2010	2011	2012	2013	2014	2015
Labour productivity (real, per person employed, year-on-year % change)						
Labour productivity in industry	4.24	-10.75	-5.09	2.79	4.40	2.22
Labour productivity in construction	-2.97	-1.47	-6.43	6.58	-0.54	-0.16
Labour productivity in market services	2.93	2.12	0.98	-0.45	-1.97	0.13
Unit labour costs (ULC) (whole economy, year-on-year % change)						
ULC in industry	3.42	12.59	11.61	-19.22	-1.20	-2.10
ULC in construction	4.65	2.89	3.10	-3.91	-3.25	-0.77
ULC in market services	1.53	1.47	0.80	-2.85	-0.83	-0.57
Business environment	2010	2011	2012	2013	2014	2015
Time needed to enforce contracts ¹ (days)	735.0	735.0	735.0	735.0	1100.0	1100.0
Time needed to start a business ¹ (days)	8.0	8.0	8.0	8.0	8.0	8.0
Outcome of applications by SMEs for bank loans ²	na	0.70	na	1.41	1.34	1.76
Research and innovation	2010	2011	2012	2013	2014	2015
R&D intensity	0.45	0.45	0.43	0.46	0.48	0.46
Total public expenditure on education as % of GDP, for all levels of education combined	7.92	7.87	6.67	7.07	na	na
Number of science & technology people employed as % of total employment	42	45	47	48	50	50
Population having completed tertiary education ³	32	34	35	35	36	36
Young people with upper secondary education ⁴	86	88	88	90	92	94
Trade balance of high technology products as % of GDP	-3.03	-1.40	-1.00	-0.23	-1.25	-0.25
Product and service markets and competition				2003	2008	2013
OECD product market regulation (PMR) ⁵ , overall				na	na	1.65
OECD PMR ⁵ , retail				na	na	1.67
OECD PMR ⁵ , professional services				na	na	3.11
OECD PMR ⁵ , network industries ⁶				na	na	2.64

1 The methodologies, including the assumptions, for this indicator are shown in detail at:

<http://www.doingbusiness.org/methodology>.

2 Average of the answer to question Q7B_a. '[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?'. Answers were scored as follows: zero if received everything, one if received most of it, two if only received a limited part of it, three if refused or rejected and treated as missing values if the application is still pending or if the outcome is not known.

3 Percentage population aged 15-64 having completed tertiary education.

4 Percentage population aged 20-24 having attained at least upper secondary education.

5 Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail at : <http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm>

6 Aggregate OECD indicators of regulation in energy, transport and communications.

Source: "European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans)."

Table C.4: **Green growth**

Green growth performance		2010	2011	2012	2013	2014	2015
Macroeconomic							
Energy intensity	kgoe / €	0,14	0,14	0,13	0,12	0,13	0,13
Carbon intensity	kg / €	0,56	0,54	0,53	0,51	0,55	-
Resource intensity (reciprocal of resource productivity)	kg / €	1,36	1,33	1,00	0,77	0,64	0,61
Waste intensity	kg / €	0,14	-	0,13	-	0,13	-
Energy balance of trade	% GDP	-6,0	-6,8	-7,6	-6,3	-5,9	-
Weighting of energy in HICP	%	10,57	8,73	9,41	9,53	9,33	8,35
Difference between energy price change and inflation	%	18,9	14,0	17,9	-7,0	-8,8	-17,5
Real unit of energy cost	% of value added	10,7	10,7	12,6	11,8	11,6	-
Ratio of environmental taxes to labour taxes	ratio	0,24	0,24	0,23	0,26	0,26	-
Environmental taxes	% GDP	2,8	2,8	2,6	2,7	3,1	-
Sectoral							
Industry energy intensity	kgoe / €	0,18	0,18	0,17	0,19	0,23	0,21
Real unit energy cost for manufacturing industry excl. refining	% of value added	27,3	26,7	28,8	26,7	26,4	-
Share of energy-intensive industries in the economy	% GDP	5,08	4,38	3,93	3,81	3,73	-
Electricity prices for medium-sized industrial users	€ / kWh	0,16	0,19	0,23	0,20	0,18	0,14
Gas prices for medium-sized industrial users	€ / kWh	-	-	-	-	-	-
Public R&D for energy	% GDP	0,00	0,00	0,00	0,00	0,00	0,00
Public R&D for environmental protection	% GDP	0,00	0,00	0,00	0,00	0,00	0,00
Municipal waste recycling rate	%	10,7	12,6	13,6	14,6	17,0	17,9
Share of GHG emissions covered by ETS*	%	53,2	49,8	50,3	50,6	53,2	50,1
Transport energy intensity	kgoe / €	0,97	0,91	0,87	0,76	0,82	0,86
Transport carbon intensity	kg / €	2,14	1,94	1,86	1,64	1,76	-
Security of energy supply							
Energy import dependency	%	100,8	92,4	97,0	96,3	93,2	97,7
Aggregated supplier concentration index	HHI	0,3	0,0	0,0	0,0	0,0	-
Diversification of energy mix	HHI	0,91	0,91	0,90	0,88	0,88	-

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2005 prices)

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)

Carbon intensity: greenhouse gas emissions (in kg CO₂ equivalents) divided by GDP (in EUR)

Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)

Real unit energy cost: real energy costs as a percentage of total value added for the economy

Environmental taxes over labour taxes and GDP: from European Commission's database, 'Taxation trends in the European Union'

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)

Real unit energy costs for manufacturing industry excluding refining: real costs as a percentage of value added for manufacturing sectors

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Electricity and gas prices for medium-sized industrial users: consumption band 500–20 000 MWh and 10 000–100 000 GJ; figures excl. VAT.

Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste

Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP

Proportion of GHG emissions covered by EU Emissions Trading System (ETS) (excluding aviation): based on greenhouse gas emissions (excl. land use, land use change and forestry) as reported by Member States to the European Environment Agency.

Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)

Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport sector

Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels

Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.

Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels

* European Commission and European Environment Agency

Source: European Commission (Eurostat) unless indicated otherwise

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