Ministry of Finance

Stability Programme 2018-2021

April 2018

CONTENTS

INTRODUCTION

In accordance with the provisions of the Stability and Growth Pact, the Republic of Cyprus submits its Stability Programme (SP) for the period 2018-2021 as approved by the Council of Ministers on 24th April 2018. The SP has been prepared in line with the updated Code of Conduct, which sets out the "Guidelines on the format and content of the Stability and Convergence Programmes". The SP has also been prepared in the context of the European Semester, which gives a clear ex ante dimension to economic policy coordination at EU level and it takes into account the key policy orientations provided in the Annual Growth Survey.

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

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

The analysis and forecasts contained in this document are based on data available up to 4th April 2018. The macroeconomic forecasts contained herein have been endorsed by the Fiscal Council.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Economic activity in Cyprus continues on a strong path, firmly establishing a period of sustained expansion based on solid economic indicators. According to the latest estimates published on 16th March 2018 by the Statistical Service, the economy expanded at an accelerated rate of 3.9% in real terms in 2017, compared to a real growth rate of 3.4% in 2016. Over the course of the programming period, economic activity is expected to be buoyant, with the main drivers stemming from the performance in key export sectors of the economy, along with a significant support from investments and structural reforms. The strong economic performance is expected to be a catalyst for a continued gradual normalization of the labour market and a reduction in non-performing loans, inter alia with other significant measures in the financial sector.

Imbalances in the economy are still persistent as a stock legacy from the crisis, but that said, significant progress has been achieved amid a very challenging environment, as a combination of efforts between the authorities and the private sector. Private debt as a per cent of GDP decreased by 9% in 2016 and by a further 16% in the first three quarters of 2017, along with a 13.6% decrease in non-performing exposures at the end of December 2017, which according to the ECB Annual Report on supervisory activities, is the highest year-on-year decrease for NPLs in the EU. The decrease in the unemployment rate to 10.1% of the labour force in 2017 was the steepest exhibited in the EU, while employment increased by 3.4%. External imbalances measured by the current account and the net international investment position, are greatly distorted by the inclusion of special purpose entities (SPEs) in the data. A dedicated box on this issue is included in this Stability Programme update, in order to demonstrate the magnitude of this impact.

The risks in the economic outlook are concentrated domestically, the most significant of which relating to developments in the financial sector where important changes are underway that could potentially derail recovery over the programming horizon. More specifically, the high levels of non-performing exposures in the banking sector and the related supervisory pressures pose a risk to the economy. To this end, as detailed in Section 2.1.3, the government is promoting a three prone strategy to swiftly and efficiently address this challenge. External risks remain contained at this point in time and mainly relate to the UK's exit from the European Union, expected in 2019, with repercussions for the Cyprus economy estimated to be limited, and also from potential developments on the downside in the Eurozone due to the policy stance of the US.

This Stability Programme outlines the fiscal policy strategy for the period 2018-2021 under the central macroeconomic scenario adopted by the government, with the over-arching policy priority to safeguard stability and growth, while exerting all efforts to improve the resilience of the economy to absorb adverse developments. In order to achieve the main objective, the Government will continue to: (a) manage sound public finances, safeguarding a balanced budget in structural terms, focused on sustainability and growth enhancement within the boundaries of available fiscal space, (b) focus on a gradual and sustained reduction of public-debt to GDP ratio, (c) implement the structural reform agenda, (d) support efforts for as rapid as possible decrease in the ratio of non-performing loans and (e) enhance the competitiveness of the economy, building on the favourable economic environment, in order to further support investment. An overall environment of sustained macroeconomic stability ultimately aims at upgrading the rating of the economy and achieving a favourable investment grade, safeguarding sustained market access at attractive rates.

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

Fiscal Policy Objectives

The strong economic performance, along with the continued efforts for fiscal sustainability, resulted in a nominal budget surplus of 1.8% of GDP in 2017, compared to a surplus of 0.3% the year before. Over the medium term, nominal balance is projected to continue to be in surplus and hover around 1.8% of GDP. On the expenditure side, it is important to emphasise the measures containing public expenditure that are in effect and include the collective agreement reached between the Government and public and broader public sector unions, which introduce a control mechanism limiting the overall growth in the wage bill in the public and broader public sector below the growth of nominal GDP, and the Law which provides for the indefinite suspension of recruitment of new personnel in the public sector and the introduction of a mechanism regulating and controlling exceptions. On the revenue side, the better than anticipated results are due to the economic performance and improved labour market conditions, taking into consideration that no tax policy novelties have been introduced, since the previous update of the Stability Programme.

The nominal budget surplus corresponds to sizeable primary surpluses over the programming period exceeding 4.6% of GDP on average, overachieving the targets set in the previous update of the Stability Programme. The structural budget position, estimated in accordance to the commonly agreed methodology of the European Union was in surplus reaching 1.2% of potential GDP in 2017 and is forecast to remain in surplus averaging 0.3% over the period 2018-2021, thus achieving the national Medium-Term Objective (MTO), the anchor of the preventive arm of the Stability and Growth Pact (SGP), set at a balanced structural position.

The general government debt-to-GDP ratio in 2017 has decreased significantly by about 9 p.p. to 97.5% compared to 106.6% in 2016. The accelerated decline was attributed to the overperformance in the public accounts that enabled the earlier repayment of liabilities. Developments in 2018 are being hampered by decisive action undertaken by the government to address challenges in the banking sector including through a state bond issuance of €2.35bn maturing between 15-20 years with a possibility of an additional fiscal burden arising, in line with state aid rules. This will result in an estimated spike of debt-to-GDP ratio to 105.6% at the end of 2018. Going forward, over the programming period 2019-2021, debt-to-GDP ratio is projected to follow a downward trend declining to about 100.0%, 94.6% and 88.0% by year end 2019, 2020 and 2021 respectively, in full respect of the debt rule in the preventive arm of the SGP.

As is the firm target of the Government of Cyprus, the obligations of the SGP are fully respected, based on the Ministry of Finance central macroeconomic scenario and, as always, the authorities will continue to monitor fiscal developments and in case of deviation stand ready to adopt the necessary corrective measures.

Structural Reform Agenda

The government continues to strive towards advancing its structural reform agenda which spans over a range of policies aimed at maintaining the strong performance in public finances and improving fiscal governance, improving efficiency in public and local administration, improving the efficiency of the Judiciary and enhancing the implementation of the Insolvency and Foreclosure Frameworks, reducing private indebtedness and the high level of non-performing loans, boosting investment further and improving access to finance particularly for SMEs and, finally, improving the labour market relevance of the educational system and the quality of Active Labour Market Policies, particularly for young people, and, finally, health care reform.

Progress in the structural reform agenda is detailed in the National Reform Programme of the Republic of Cyprus, but in the framework of the Stability Programme it is worth to note the following:

➢ *Public Financial Management*

In June 2016, a bill titled "The National Investment Fund and the Cyprus Investment Management Organization and Related Matters Law of 2016", as well as the Regulations titled "Inputs and Outputs of the National Investment Fund and the Cyprus Investment Management Organization and Related Matters Regulations of 2016" were tabled before the House of Representatives for deliberations and approval. The purpose of these interlinked pieces of legislation is to ensure the sound revenue management arising from the activities in the hydrocarbon sector, and ensuring long term macroeconomic stability in the country.

This framework provides the basis for sound public financial management, limiting procyclicality of fiscal policy. Policies and rules for the SWF's funding, withdrawal, and spending operations are clear and consistent with the objectives of the fund. These objectives are already well specified in the Fiscal Responsibility and Budget Systems Law (FRBSL) and concern:

1. The creation of an alternative steady flow of income for the state budget, which allows a safety margin for the public finances and the economy against big fluctuations in the prices of hydrocarbons, with the accumulation of assets during periods of high returns;
2. The reduction of the general government debt and thus the strengthening of compliance in accordance with the principle of sustainability; and
3. The investment of surpluses in international financial assets with sufficient dispersion to ensure future generations or other long-term goals.

The investment objectives of the SWF are consistent with the Government's broad macro-fiscal objectives and policy priorities.

Discussions have resumed at the level of the Parliamentary Finance Committee and the aim is to conclude the process and enact the two legal acts within the first semester of 2018.

➢ *Public Sector Collective Agreement and Wage Bill setting mechanism*

Overall wage bill developments in the public and broader public sector are now governed by collective agreements signed between the Minister of Finance and the Unions of the public and broader public sector. In these collective agreements, a wage setting mechanism has been introduced that establishes a formula that ensures the application of an effective framework that monitors and regulates wage bill growth below nominal GDP growth for 2017-2018. In the absence of any amendments to the current agreements, the mechanism will continue to be in effect.

Wage bill developments stem primarily from employment policy changes affecting employment levels, as well as changes in pension levels, partial wage indexation and automatic annual increments. Furthermore, the collective agreements stipulate that contractual salary increases are discussed and agreed upon within the framework of the institutionalized dialogue only if the nominal GDP growth rate outweighs the expected increase in the wage bill by any other parameter.

It is noted that wage indexation (or cost of living adjustment-COLA) has been permanently reformed since 2014 through the respective Budget Law, changed from full indexation to partial indexation capped at 50% of the increase in the CPI. Also, a mechanism for the automatic suspension of COLA application and derogation procedures during adverse economic conditions have been embedded, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation will be effected for the following year.

Due to the automatic suspension provision, COLA was suspended in 2014, 2015, 2016 and 2017 due to negative inflation and/or real growth.

In direct relevance to the measures related to the containment of the growth in public and broader public sector wage bill is the freeze of new recruitments in the public and broader public sector, a measure that was due to expire at the end of 2017 but was extended indefinitely through the enactment of a new Law, voted by Parliament in June 2017, which stipulates an indefinite freeze on recruitments and an exceptions mechanism which requires Parliamentary approval.

- *Judiciary reform*

Increasing the efficiency of the Justice System

The quality of the administration of justice is of high standards in Cyprus. However, the great increase in the workload of the courts in the recent years especially due to the economic crisis and the subsequent increase in the backlog of cases in civil jurisdiction, coupled with a low level of ICT use in courts weigh on the efficiency of the justice system. The Government acknowledging the importance of efficient resolution of civil and commercial cases has put as a high priority the reform of the Justice System. The close cooperation between the Ministry of Justice and Public Order and the Supreme Court has in recent years been reinforced by a standing policy of frequent contacts between the Minister of Justice and Public Order (MJPO) and the President and Judges of the Supreme Court. A wide range of issues related to the operation of the courts is discussed, agreed and followed up. Measures taken in 2017 to that effect are the following:

On 21 July 2017, the Courts of Justice (amendment) Law of 2017 (Law 109(I)/2017) was enacted, providing for the filtering of the right to file an appeal in civil cases as regards interlocutory decisions during the proceedings. This does not deprive a party the right to raise at the stage of the appeal against the final decision, issues relating to any interim decision.

A bill for the establishment of an Administrative Court of International Protection was prepared and submitted to the HoR on 18 January 2018. The provisions of the bill provide that the cases of international protection will be transferred to this court from the Administrative Court, allowing the latter more time to deal with all other administrative cases. The decisions of the Court will be subject to appeal before the Supreme Court for any reason concerning only a legal point.

A bill for the establishment of a Commercial Court was also prepared and, following consultation with all the competent stakeholders is now at the final stage of discussion with the Legal Service of the Republic. The provisions of the bill include which cases will fall under the jurisdiction of the Court, what will be the qualifications of the judges etc.

Finally, the Administrative Court, operational since January 2016, was strengthened with two additional judicial posts since September 2017.

E- Justice is one of the main pillars for the reform of the Justice system. A tender was launched in March 2017 to purchase an electronic Court administration system so as to digitize the operations of the Courts. Following the evaluation of the tenders, the pilot operation of the system is expected to be launched in August 2019 whilst the system is expected to be fully operational in February 2020.

A project is now running for major reforms aiming at the overall modernization of the judicial system and management of courts, through technical support. In February 2017, the Supreme Court appointed a former Judge of the Supreme Court, as the Director of Reform and Training, in order to coordinate the whole reform project. Also, a Courts' Reform Committee was established, comprising by the President of the Supreme Court (President) and 2 Judges of the Supreme Court, the President of the Judges' Association, the Director of Reform and Training, the Chief Registrar, a representative of the Ministry of Finance and of the Ministry of Justice and Public Order, and the President of the Cyprus Bar Association. The task of the experts was completed in March 2018 with the completion and delivery of the final report with their recommendations for addressing identified challenges regarding the operation in the Supreme Court and Courts of First Instance. The Government is currently analyzing the recommendations in order to proceed to the implementation phase.

In addition, Civil Procedure Rules are being reviewed and final recommendations are expected at the beginning of 2019.

The MJPO prepared a bill amending the Civil Procedure Law, so as to strengthen the legal framework for the enforcement of judgments. The provisions of the bill include measures which facilitate the execution of writs concerning the seizure of movable property. The bill is under legal vetting by the Law Office.

The MJPO assigned a study concerning mediation to experts. The study pertains, among other issues, to the accreditation of mediators, their qualifications, their training, their disciplinary supervision and the dissemination of information to the general public. The study also includes concrete suggestions for the amendment of the law as needed. The final report was completed and delivered to the MJPO at the end 2017. The Ministry requested further clarification on certain aspects of the report and these are expected to be delivered in April 2018. Following that, consultation will take place with the relevant stakeholders in order to promote the recommendations included in the study.

In addition, a study concerning the establishment of a training school for judges within the Supreme Court in Cyprus was completed in May 2017. The study was approved by the Supreme Court, and the implementation of its recommendations will now be promoted. The executive will financially support the establishment of the Training Department within the Supreme Court.

- *Financial sector*

The Authorities aim to further facilitate the reduction of NPFs, namely by strengthening the effectiveness of the legal framework related to the management of non-performing exposures and strategic defaulters, addressing the most challenging portfolio of NPFs (mortgage loans or SME loans with primary residence of the borrower as collateral) through burden sharing between stakeholders and state support targeting vulnerable households ("ESTIA" Project) and the sale of Cyprus Cooperative Bank (CCB) to strategic investor(s).

The first pillar focuses on the legal framework applicable for the management of NPFs. A comprehensive list of reforms has been compiled in order to enhance the effectiveness of the legal framework which was introduced in 2015. These amendments span in a wide range of laws as well as procedures.

The second pillar of the Government's strategy addresses NPFs related to mortgage non-performing loans and non-performing loans collateralized with the primary residence of the borrower. This segment of NPFs has proven the most challenging one and, in a nutshell, the incentive scheme aims, through burden sharing, at supporting vulnerable households and SMEs with these type of exposures to start repaying their loans. The details of the scheme are still to be finalized, but criteria will be embedded to address moral hazard and free rider issues.

The third pillar of the strategy focuses on the Cooperative Sector, where the Government, as the major shareholder of the Cyprus Cooperative Bank (CCB) has initiated the process of selling the whole or part of assets and liabilities of the CCB. In order to facilitate the transaction process, and in an effort to rebuild confidence and credibility in the CCB, the Government, has issued a series of Government Bonds in favour of CCB totaling €2.35 bn through a private placement process at market rates and deposited in parallel the proceeds in an account of the state held with CCB.

Section 2.1.3 provides a more detailed analysis on all three pillars.

Health reform

The legislation for the National Health Insurance System (NHIS) was adopted on 16th June 2017. The NHIS will provide universal health coverage, based on the principles of equality, solidarity and free choice. The system will be financed primarily from contributions from employers, employees, the self-employed pensioners and the State. Beneficiaries will also co-pay for the services and medicines they receive. The first phase of the NHIS implementation begins on the 1st of June 2019, followed by the second phase a year later.

In the meantime, the process of public hospitals administrative and financial autonomization has also been initiated, in accordance with the Law for the establishment of the State Health Services Organization adopted by Parliament on 26th June 2017.

The implementation of the NHIS is designed to be fiscally neutral upon the full introduction of the system and the expiration of the 5-year period where by law, hospital deficits could be financed by the state. Deficits after the expiration of the 5-year period will need to be managed by the Organization of Public Health Services.

2. ECONOMIC OUTLOOK

2.1 MACROECONOMIC DEVELOPMENTS 2017

2.1.1 GLOBAL ECONOMY

According to the European Commission's Winter Forecast 2018, world economic growth accelerated from 3.2% in 2016 to 3.8% in 2017, on the back of strong economic and trade activity.

The EU continued to grow in 2017 at a higher rate compared with 2016, with real growth accelerating to 2.4% (from 2.0% in 2016). Similarly, the euro area economy grew at a rate of 2.4%, compared with 1.8% growth of 2016. Although all Member States recorded positive economic growth 2017, economic performance is still uneven across EU Member States.

The economy of the UK, which is an important trade partner for Cyprus, expanded by 1.8% in 2017 compared with 1.9% the year before, despite fears for a deeper recession, given its decision to exit the EU.

The unemployment rate in the euro area stood at 8.7% of the labour force, its lowest level since 2009, with improved labour market conditions across all Member States. Although its path is on a decline, long-term unemployment remains above its pre-crisis level.

Inflation in the EU and euro area accelerated in 2017, amid improving labour demand conditions and stronger economic activity.

The euro strengthened significantly in 2017, on the back of higher than expected economic growth in the Eurozone, diminished political risk and weaknesses in rival currencies (the euro gained 14% against the U.S. dollar for the year, and was up by 4% against the British pound).

On the other hand, the US dollar had its weakest year (2017) since 2003, driven by relatively subdued economic growth in the U.S. and rising geopolitical pressures (e.g. North Korea).

The British pound was volatile throughout the year because of the continued Brexit-negotiations and the perceived uncertainty over U.K.'s future relationship with its biggest trading partner. The currency dropped around 20% against the euro since the date of referendum (June 2016).

2.1.2 DOMESTIC ECONOMY

According to latest estimates published on 16th March 2018, the economy expanded at an accelerated rate of 3.9% in real terms in 2017, following a positive growth rate of 3.4% in 2016. Growth in 2017 was mainly driven by domestic demand. Domestic demand grew by 8.3%, mainly driven by gross fixed capital formation and private consumption, which grew in real terms by 27.8% and 4.2%, respectively. Gross fixed capital formation was influenced by significant increases in investment in machinery, construction and transport equipment. Imports, in real terms, grew at a rate of 10.1% mirroring the trend of domestic demand, while exports, in real terms, also grew at a rate of 3.4%.

From a sectoral perspective, the economy's expansion was mainly due to the strong performance of Construction, Accommodation and Food Service Activities, Wholesale and Retail Trade and Manufacturing. Negative growth was recorded in the Financial and Insurance Activities.

The accelerated rate of growth of the economy in 2017 was reflected in a higher rate of growth of employment, reaching about 3.4%. Employment growth was stronger in the sectors of construction, wholesale and retail trade, accommodation and food service activities and professional scientific and technical activities. Unemployment declined further and averaged at 11% of the labour force in 2017, after peaking at 16.1% in 2014 and subsequently falling to 14.9% in 2015 and 12.9% in 2016.

Compensation per employee, compared to the preceding year, increased in 2017 by 0.7%, following a decrease of 0.7% in 2016 in contrast to a larger contraction of 1.2% in 2015 and a marked contraction of 3.6% and 5.4% in 2013-2014, respectively. As a consequence, nominal unit labour costs marginally increased in 2017 by 0.2%, following declines of 0.8% and 1.7% in 2016 and 2015, respectively.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), turned positive reaching 0.7% in 2017 from a negative inflation of 1.2% in 2016 to. Deflation is driven by developments in international oil prices, with a significant impact on domestic prices of energy products. The HICP, excluding seasonal food and energy, in 2017 remained essentially at the levels of 2016, compared to a decrease of 0.7% and 0.4% in 2016 and 2015 respectively.

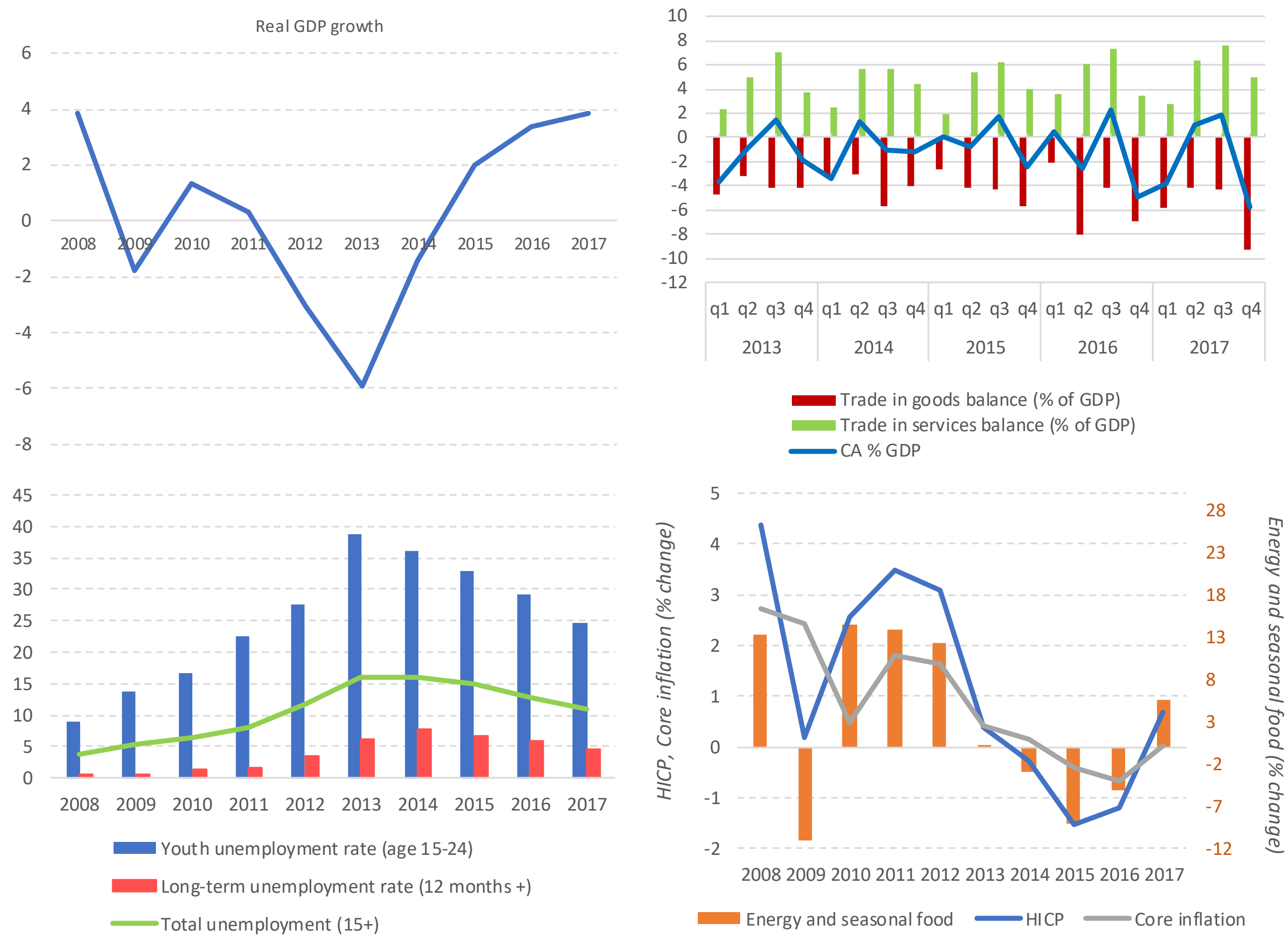
According to the latest Balance of Payments data for 2017, Cyprus' current account balance deteriorated recording a deficit of €1,291.0 million (-6.7% of GDP) compared with a deficit of €888.8 million (-4.9% of GDP) in 2016. This deterioration was mainly due to the trade balance of goods, with imports of goods, mostly ships and aircraft, being significantly higher in 2017 compared with 2016. The current account balance was, to a lesser extent, negatively affected by the deterioration recorded in primary income and, more specifically, portfolio income. In contrast, the services sector recorded an improvement, which occurred mainly in the travel and telecommunications, computer and information categories. Also, a small improvement was recorded in secondary income.

Table I: Selected economic indicators, 2015-2017, y-o-y %

	2015	2016*	2017*
GDP (constant prices)	2.0	3.4	3.9
Public consumption	-2.6	-0.3	2.7
Private consumption	2.6	3.3	4.2
Gross Fixed Capital Formation	13.6	35.0	27.8
Exports	5.8	4.0	3.4
Imports	7.4	6.8	10.1
Tourist arrivals (000's)	2,659.4	3,186.5	3,652.1
Tourist arrivals growth	8.9	19.8	14.6
HICP	-1.5	-1.2	0.7
Labour productivity growth (persons)	0.5	0.1	0.5
Employment growth	1.5	3.3	3.4
Compensation per employee	-1.2	-0.7	0.7
Unemployment rate (Labour Force Survey)	14.9	12.9	11.0

Source: Statistical Service
**Provisional Data*

Figure 1: Economic trends



Source: Statistical Service and Central Bank of Cyprus

The international investment position (IIP) of Cyprus in 2017 recorded a marginal improvement, showing a net liability position at €23,139 million, compared with €23,167 million in 2016. The decrease in Cyprus' net liabilities was mainly due to the improvement in portfolio investment and other investments. Direct investment, in contrast, deteriorated in 2017 and outweighed to a large extent the aforementioned improvements.

The difference between gross external debt and total liabilities in IIP is the absence of all equity and investment fund shares components and financial derivatives. Gross external debt reached €107,058 million in 2017, compared with €107,284 million in 2016. The small improvement was due to the decrease of debt in other sectors, which resulted from the decrease in loans and, to a lesser extent, the decrease in the debt of monetary financial institutions (excluding the CBC). Intercompany lending, on the other hand, recorded a deterioration which mitigated, to a large extent, the abovementioned decreases.

However, in the case of Cyprus, the methodological changes in the reporting of external trade statistics resulted in substantial changes in the CA and NIIP statistics. With the introduction of the ESA2010 and BMP6 statistical methods, total imports and exports of Cyprus include, among other, the economic transfer of mobile transport equipment and activities of ship owning SPEs. This methodological change skews statistics in the current account balance, disproportionately negatively due to the characteristics of the Cyprus economy, given the relative significance of the international business and shipping sectors. What is important for the economic reading of these statistics in the case of Cyprus, especially for exports and imports of goods, is that they do not concern transactions that affect nor are affected by domestic developments and, hence, do not reflect the economic fundamentals of the domestic economy.

The table below shows the evolution of the CA in Cyprus from 2009-2017 with the significant amelioration that took place between 2010-2015. In 2016 and 2017 CA deficit widens to -4.6% and -6.7% respectively. When excluding SPEs, however, the CA deficit actually improves. According to published data by the Central Bank of Cyprus, the CA deficit in 2015 excluding SPEs decreased by 1.9 p.p. of GDP and decreased by a further 0.8 p.p. of GDP in 2016. In 2017, the CA deficit excluding SPEs amounts to -1.5% of GDP.

Table II: Balance of Payments, 2009-2016

in per cent of GDP	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Exports of Goods	12.0	13.1	13.9	15.3	15.6	15.0	15.9	16.2	14.2	12.9
Imports of Goods	42.2	34.7	36.8	35.5	33.6	31.2	31.9	33.0	35.5	36.4
Goods Balance	-30.1	-21.6	-22.9	-20.2	-18.0	-16.2	-16.0	-16.7	-21.2	-23.5
Services Balance	17.4	16.3	15.6	17.2	16.5	18.0	18.0	17.5	20.4	21.6
Primary Income Balance	-2.5	-1.3	-3.0	0.0	-3.0	-4.7	-3.6	0.6	-1.6	-2.5
Secondary Income Balance	-0.3	-1.1	-1.0	-1.1	-1.4	-2.1	-2.7	-2.9	-2.5	-2.2
Goods & Services Balance	**-12.8**	**-5.3**	**-7.3**	**-2.9**	**-1.5**	**1.8**	**2.0**	**0.8**	**-0.8**	**-2.0**
Current Account Balance	**-15.5**	**-7.7**	**-11.3**	**-4.1**	**-6.0**	**-4.9**	**-4.3**	**-1.5**	**-4.9**	**-6.7**
CAB (without SPEs)							**-2.9**	**-1.0**	**-0.2**	**-1.5**

Source: Central Bank of Cyprus

Similarly, the NIIP is affected by the adoption of the methodological changes and the implementation of the new statistical standards, as well as the inclusion of the economic transfer of mobile transport equipment of ship owning companies. The latter have significant financial liabilities used for financing their operations including the acquisition of the companies' assets. While these loans impact directly on the IIP, the respective real assets (ships) do not, thus creating an imbalance in the figures reported. Most importantly, SPEs do not have a link domestic economy as these operations are financed from abroad. Excluding the transactions of SPEs, the net IIP in 2016 amounted to -€9.2 bn or -50.3% of GDP. In 2017, the net IIP in 2016 amounted to -€7.8 bn or -40.8% of GDP (close to the macroeconomic imbalances scoreboard threshold of -35%).

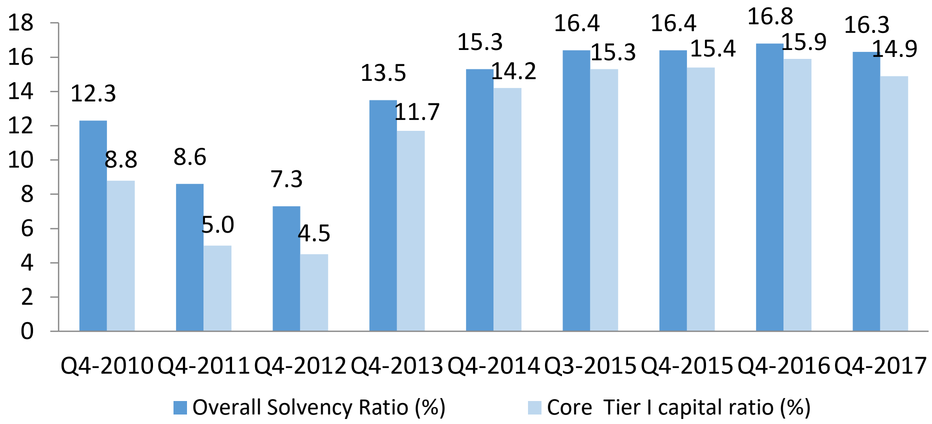
2.1.3 FINANCIAL SECTOR DEVELOPMENTS

Banking sector developments

The Cyprus banking sector is dominated by four systemic domestic banks (Bank of Cyprus-BOCY, Cyprus Co-Operative Bank-CCB, Hellenic Bank-HB and RCB) which collectively represent a share of 74.7% in total deposits, while the remaining market consists of the three Greek subsidiaries with a market share of 14.5% in total deposits and other smaller credit institutions.

The three large domestic banks (BOCY, CCB, and HB) have been recapitalised in the past years on the basis of (i) an independent due diligence exercise conducted by an international firm under the direction and review of the Commission, the ECB and IMF, (ii) the comprehensive assessment conducted in 2014 by the European Central Bank which included Asset Quality Reviews and Stress Tests as a precondition for the undertaking of the direct supervision of the systemically significant Eurozone banks and (iii) the SREP exercise performed by the SSM. As part of the restructuring process, the infusion of equity capital and retained profits boosted overall solvency ratio across the Cyprus banking system by 9 percentage points (Dec 12: 7.3% to Dec 17: 16.3%).

Figure 2: Overall Solvency Ratio (%) and Core Tier I Capital Ratio (%), aggregate banking sector



Source: Central Bank of Cyprus

The main indicators of the financial sector have shown substantial improvements. The sector is now based on sound fundamentals in terms of capitalization and liquidity. Banks' strategies are based on deleveraging through the disposal of non-core operations, focusing on domestic operations (core businesses) and at the same time strengthening their capital and liquidity positions. The profitability of credit institutions though, continues to be adversely affected by the prolonged environment of low interest rates, as well as the burden of increasing provisions for bad debts. The implementation of the accounting standard on interest earned from non-performing facilities (IFRS9) is expected to further increase the stock of credit impairment provisions and affect profits. Its estimated impact however will be phased in over a period of years for capital regulatory purposes and is expected to be manageable and within the credit institutions' capital plans.

The deposit base continues to record positive growth rates. The comfortable increase in the deposit base enabled the full repayment of the remaining Emergency Liquidity Assistance in January 2017, with €3.8 bn of ELA being repaid during 2016 and early 2017. The outstanding amount of deposits reached €49.4 bn in December 2017 compared to €49 bn by end December 2016.

There has been a steady upward trend in new loans supported by historically low domestic interest rates, favourable macroeconomic conditions and rising demand. It is noted, however, that the increase in new lending has occurred concurrently with the ongoing deleveraging of existing loans. During 2017, total new loans (including renegotiated loans) to euro area households reached €1.3bn (decomposed into €1.087mln pure new loans and €195mln renegotiated loans) and remained fairly stable compared to 2016 (€868mln pure new loans and €423mln renegotiated loans). These loans consist of €187mln consumer credit loans, €858mln for house purchase and €237mln for other lending purposes (€149mln, €869mln and €272mln for 2016 respectively). Total new loans to euro area non-financial corporations reached €2.5bln (decomposed into €547mln pure new loans and €1.977mln renegotiated loans) compared to €2.3bln in 2016.

Box 1: Macroeconomic imbalances in Cyprus and the real economy

In the in-depth review (IDR) of 2018, the European Commission (EC) identifies that Cyprus faces important imbalances in the form of a weak financial sector, combined with large stocks of private, public, and external debt. The high ratio of non-performing loans in the domestic banking system constrains deleveraging and banks' profitability, reducing the amount of credit that can be channeled to the economy.

Macroeconomic imbalances accumulated prior to the crisis in Cyprus as part of the overheating of the economy in the years prior to the accession to the EU and the euroarea and the overexpansion of the banking sector. At the onset of the crisis, imbalances exacerbated as unemployment increased radically, along with public debt and financial sector developments. A gradual correction has been taking place over the years, especially attributed to the swift correction of the fundamentals of the Cyprus economy, supporting increased confidence and the continuity of a strong growth over the forecast horizon. Given their magnitude and nature, these imbalances are expected to persist as a stock legacy over the medium term before an effective correction can be portrayed in the data. Although the size of the stock of the imbalances is considerably large to require continued effort to be effectively rectified, the interpretation of their impact on the real economy should be carefully read, bearing in mind that their magnitude is significantly heightened by the small and open nature of the Cyprus economy with an international business center and a sizeable, by international standards, shipping sector with a small footprint on the real economy.

External Balance

In the 2018 IDR, the still high negative Net International Investment Position (NIIP) is highlighted as one of the imbalances of the Cyprus economy, combined with a Current Account (CA) deficit that is not small enough to reduce the NIIP position. In particular, the EC notes that Cyprus would need a current-account balance close to zero to reduce its NIIP, excluding SPEs, to the MIP threshold of -35% of GDP by 2026. At the same time, it is acknowledged that the (NIIP) of Cyprus is adversely affected by two factors.

First, it is affected by the fact that domestic funding sources in Cyprus during the crisis were scarce and as Cyprus requested and obtained official financial support by the ESM and the IMF have resulted in refinancing domestic debt through foreign financing sources including official financing. Official financing has very long-term maturity structure at favourable rates and therefore is not exposed to short term refinancing risks.

Second, the significance of the large and negative NIIP is reduced when excluding Special Purpose Entities (SPEs) operating primarily in the shipping sector, which for Cyprus have a distorting effect due to the sizeable international business and shipping sector. These companies have significant financial liabilities abroad and in particular loans which are used for the acquisition of their assets. While these loans are significant both in absolute terms, as well as in percentage to GDP, significantly impact negatively IIP, the respective real assets (ships) do not, thus explaining the bulk of the imbalance recorded. These SPEs are not considered to pose an immediate risk to domestic economy, since they have a small footprint on the real economy of Cyprus. According to the Central Bank of Cyprus, the NIIP stood at minus €23.2 bn (-127.2% of GDP) in 2016. As of end-2016, the net external debt of non-financial SPEs reached EUR 14.0 billion, or -76.8% of GDP (and 60.4% of NIIP). Therefore, the NIIP corrected from the impact of non-financial SPEs' own movable equipment was -71% of GDP in 2015 and -50.3% of GDP in 2016. Furthermore, a large part of the external debt is composed of general government debt to the ESM and the IMF, which has a very long term maturity structure and therefore is not exposed to short term refinancing risk. Taking these factors into account, the "underlying" NIIP could be considered closer to the MIP threshold of -35% of GDP. Excluding the transactions of SPEs in 2017, the net IIP in 2016 amounted to -€7.8 bn or -40.8% of GDP.

Similarly, the Current Account balance is also significantly affected by the activity of SPEs due to the size of the economy and the value of their assets, through the registration and deregistration of ships, which are recorded as imports and exports respectively. The current account deficit in 2016 rose to 4.9% of GDP, albeit adjusting for the impact from SPEs, the current-account deficit in 2016 was only marginal at about 0.2% of GDP. In 2017, the CA deficit excluding SPEs is limited to -1.5% of GDP, as opposed to -6.7% of GDP when including SPEs.

Private Debt

Private debt as a percentage of GDP stands high in Cyprus. At the end of the third quarter of 2017 it stood at about 328% of GDP. The private debt ratio declined at one of the highest rates in the EU, of the magnitude of 9 percentage points of GDP in 2016 (from 353.5% of GDP in 2015 down to 344.6% in 2016) and by another 16 percentage points of GDP in the first three quarters of 2017. The reduction is attributed to both the economic performance and via increased debt write-offs and debt-to-asset swaps. Taking into account fundamental benchmarks, Household Debt in 2016 was 16 percentage points of GDP above what fundamentals suggest. At the same time, as far as households are concerned, it is worth to note that private debt is backed to a considerable degree by assets in the form of deposits that households accumulate as precautionary savings for retirement and also in the face of limited social safety nets.

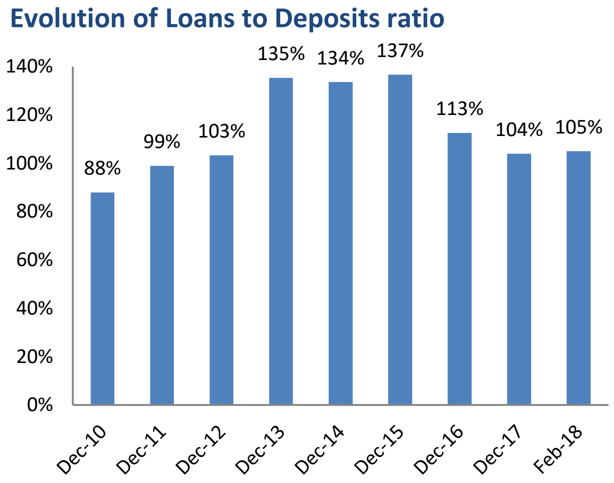
Non-financial SPEs liabilities also influence private sector debt and account for a substantial portion of the accumulated private debt estimated at 78.8 percentage points of GDP at the end of the third quarter of 2017. Excluding the liabilities of SPEs', private sector debt stood at about 250% of GDP at the end of the third quarter of 2017.

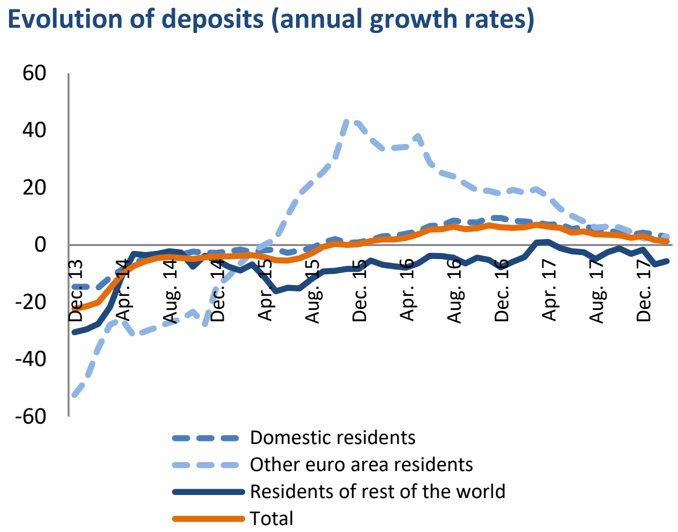
Deleveraging in the private sector is essentially linked to the efforts of reducing non-performing loans, a process that will require time to correct and will be supported by specific action by the authorities, acknowledging this significant challenge facing the banking sector and the economy at large, aimed at increasing the pace at which progress is achieved (as analysed in detail in Section 2.1.3)

Public Debt

Public finances have exhibited a sustained correction that has been supported by the structural reforms introduced in the Public Financial Management framework in the recent years, thus creating the necessary space and allowing the government to perform liability management exercises improving debt sustainability. General government debt came down significantly in 2017, to around 97.5% of GDP. This positive development is attributed to strong economic growth and fiscal overperformance that enabled the early repayment of part of domestic and external debt, resulting in a decline of about 9 percentage points of GDP in a single year. Given the positive fiscal performance, the low gross financing needs and relatively low short-term general government debt, the Cyprus economy does not face short term financing risks.

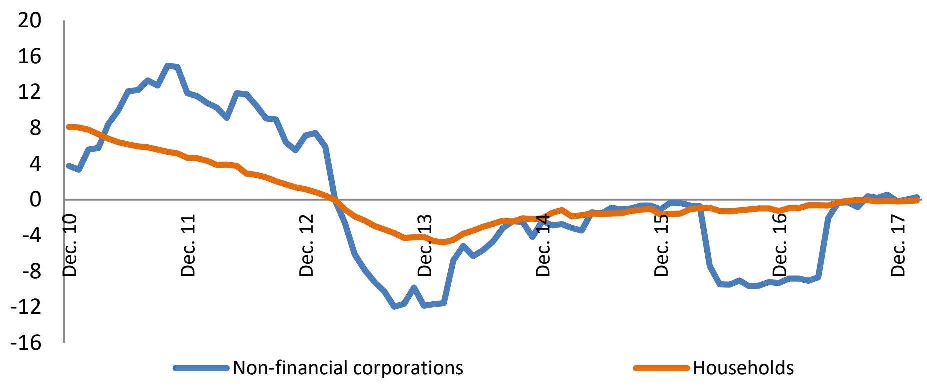
Figure 3: Deposits





Source: Central Bank of Cyprus

Figure 4: Loans to non-financial corporations and households (annual growth rates %)



Source: Central Bank of Cyprus

Non-performing facilities (NPFs)

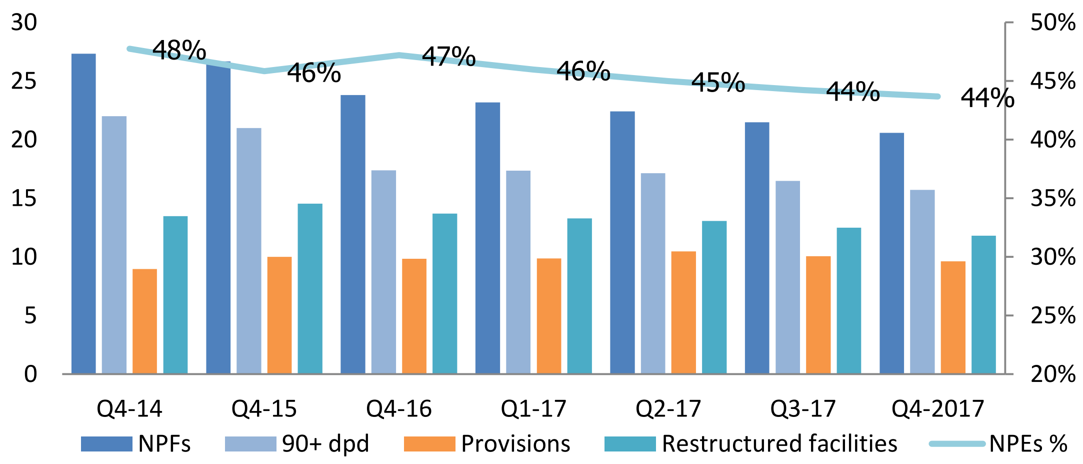
Addressing the high level of NPFs in the banking system, is a key priority on the reform agenda and policy action has been taken and continues to be taken to deal with this priority. The amount of non-performing facilities (NPFs), excluding the overseas operations of Cyprus credit institutions, despite the observed progress remains high at 43.7% of total loans at end-December 2017 compared to 47.2% at end-December 2016. In particular, total NPFs for all credit institutions (excluding their overseas operations) decreased by 13.4% to €20.6 bn at end-December 2017, with provisions of €9.6 bn, compared with €23.8 bn at end-December 2016 with provisions of €9.8bn.

The downward trend in NPFs can be attributed to increased restructurings successfully completed by the end of the observance period and reclassified as performing facilities, repayments and settlement of debt through swaps with immovable property that is expected to be sold with the aim of a faster cash collection, as well as write-offs. The reduction in NPFs was predominantly brought by reductions in non-performing facilities of non-financial corporations, with a drop of €2.1 bn in NPFs at end-December 2017 compared to end-December 2016 accounting for 63.7% of the total drop in NPFs.

Banks have established internal arrangements and have strengthened their arrears management units. New lending criteria are more vigorous, putting the ability of the borrower to pay as the primary criterion for new lending. Credit institutions continue their efforts towards restructuring their NPFs in cases were viable settlements are possible, though debt restructuring is becoming more challenging and a slowdown of loan restructurings has been observed, as the less challenging cases often with large exposures have been restructured first and the more challenging ones are yet to be addressed.

To this end, all three core domestic banks have partnered with foreign debt specialists and established independent debt servicing companies: Pepper Cyprus (fully owned subsidiary of Pepper Europe (UK) associated with Bank of Cyprus), Altamira Asset Management (Cyprus) (joint venture of Spanish Altamira Asset Management with the Cyprus Cooperative Bank) and APS Debt Servicing Cyprus (joint venture of Czech APS Holding with Hellenic Bank).

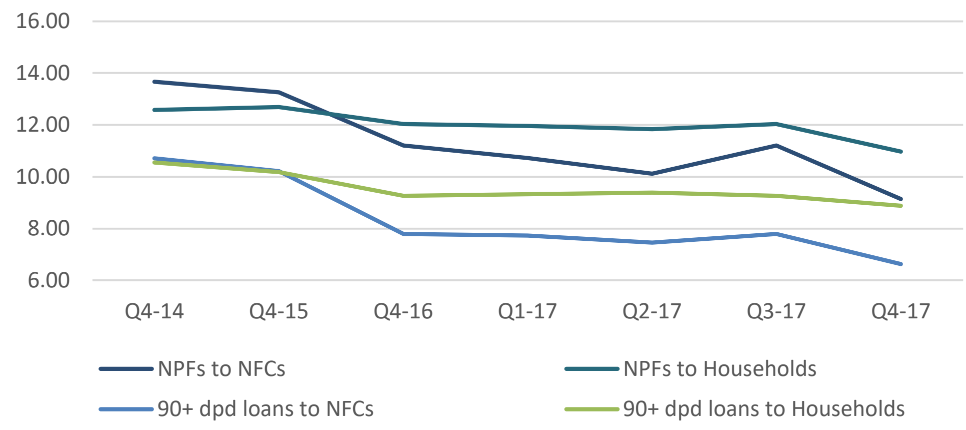
Figure 5: NPFs (excluding overseas operations of CCIs), € bn



Source: Central Bank of Cyprus

It should be noted that credit institutions apply the definition of NPFs adopted by the European Banking Authority. Based on this definition, when an NPF is restructured it remains under observation within the NPF category for a further period of at least 12 months, even if the customer follows the new repayment schedule without arrears.

Figure 6: NPFs and +90 dpd for all credit institutions (excl. overseas operations) by institutional sector €bn



Source: Central Bank of Cyprus

Policy strategy for the reduction for NPFs

The Government has set as a priority to effectively and swiftly tackle the most challenging issue facing the financial sector and the broader economy. To this end a comprehensive strategy has been designed in order to successfully resolve, during the course of 2018, the final hurdle to full normalization of the economy that of NPFs burdening the banking sector. The policy strategy for the reduction of NPFs is enshrined in the following three pillars:

- Strengthening the effectiveness of the legal framework related to the management of non-performing exposures and strategic defaulters.
- Addressing the most challenging portfolio of NPLs (mortgage loans or SME loans with primary residence of the borrower as collateral) through burden sharing between stakeholders and state support targeting vulnerable households ("ESTIA" Project).
- Sale of Cyprus Cooperative Bank (CCB) to strategic investor(s).

The first pillar focuses on the legal framework applicable for the management of NPFs. The legal framework was recently introduced in 2015 following the advice received by international experts in the area. Despite the limited period available for evaluation the legal framework, it is acknowledged that there are certain shortcomings in the process that hamper the effectiveness of the system and prohibit the normalization of the sector. To this end, consultations have taken place among stakeholders as well as the IMF and the Commission in order to identify the specific provisions as well as processes of the framework that undermine its effectiveness. As a result, a comprehensive list of reforms has been compiled outlining the amendments that need to be implemented over the short term and over the medium term. These amendments span in a wide range of laws as well as procedures.

In this regard, the Government is in the process of enhancing the corresponding legal framework, which among others, would facilitate the development of a functioning secondary market for NPFs in Cyprus, further strengthening the law on foreclosures, through enhancing the sale of loans law and introducing a bill on loan securitization with a view to tackle the problem of strategic defaulters. Tangible progress in all these areas is key for the banking sector to address effectively and swiftly legacy issues and adequately support the real economy.

The objectives of the proposed changes that are being promoted are:

- Encourage restructuring of viable loans through the Arrears Management Directive of the CBC.
- Encourage restructuring of non-viable loans that will become viable after a successful completion of the repayment plan, through the insolvency framework.
- Create an efficient secondary loan market to the benefit of banks and debtors. The former will directly strengthen their liquidity, while the latter will be able to settle their debts at more favourable terms.
- Improve the effectiveness, efficiency, and transparency of the foreclosure framework to act as a credible thread especially to strategic defaulters.
- Improve the efficiency and effectiveness of the operation of the Insolvency Service of Cyprus.
- Introduction of a provision which allows electronic auctions of properties
- Create a framework that enables a swift transfer of title deeds, minimizing costs and delays by identifying and resolving problems at early stage.
- Reform of the judicial process in order to greatly increase the efficiency of handling of NPFs cases by the judicial system.

The second pillar of the Government's strategy addresses the most challenging segment among NPFs in the entire system, that of mortgage non-performing loans and non-performing loans collateralized with the primary residence of the borrower. In order to enable eligible households with these types of exposures to start repaying their loans, the Government is considering the introduction of a social scheme incentivizing these households or SMEs to do so.

Through burden sharing, the incentive scheme aims at supporting vulnerable households, enabling them to meet their obligations to the extent possible, thus contributing to the stabilization of the banking sector and the creation of conditions for sustainable growth. Even though the detailed provisions of this scheme have not been finalized yet, it is envisaged that for the participation in the scheme, eligible portfolio will be NPFs that have been classified as such in 2017 while borrowers should meet specific pre-defined income and asset criteria in order to exclude free riders or strategic defaulters exploiting the government's support, thus ensuring fairness and limiting moral hazard.

The third pillar of the strategy focuses on the Cooperative Sector, where in order to meet supervising requirements, a process has been initiated which includes selling the whole or part of assets and liabilities of the CCB. The request for proposals has been issued on the 19th of March. The process is ongoing.

In order to facilitate the transaction process, and in an effort to rebuild confidence and credibility in the CCB, the Government, has issued a series of Government Bonds in favour of CCB totaling €2.35 bn through a private placement process at market rates and deposited, in parallel, the proceeds in an account of the state held with CCB.

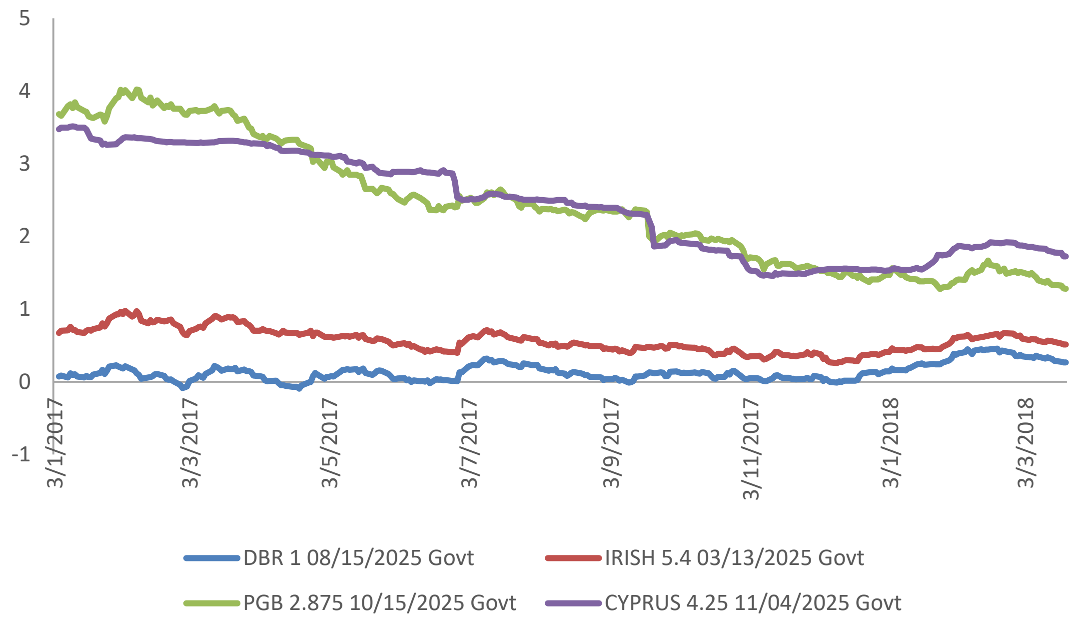
The above strategy aims at successfully and swiftly addressing the last remaining challenge of the banking sector in the course of 2018 with the objective of reducing the NPFs of the sector significantly, as much as 40%. The annual fiscal impact of the three-prone strategy is estimated at 0.3-0.4 percentage points of GDP while debt-to-GDP is estimated to exhibit a one-off increase of about 11.7 percentage points of GDP which have been included in the baseline forecast presented in this Stability Programme with a possibility of an additional fiscal burden arising, in line with state aid rules.

Spreads – secondary market yields

As presented in Figure 7 below, the 2025 Cyprus sovereign market bond yield has shown relevant stability despite the fact that the Republic of Cyprus is currently excluded from the ECB's QE programme. The 2025 Cyprus bond performed well and had tightened further during the year decreasing towards the end of 2017 by 194 basis points compared to the beginning of the year underpinned by the robust economic performance of the Cyprus economy resulting in a number of upgrades of Cyprus' sovereign rating in 2017.

With regards to spread developments, the Government bond yield spreads for Cyprus vs. Germany have fluctuated during the year and towards the end of 2017 had decreased by 201 basis points compared to the beginning of the year. During the first two months of 2018, market bond yields exhibited minor increases. As the economy continues on a strong growth path, we expect spreads to continue to narrow albeit at a slower pace.

Figure 7: Secondary market yields levels of Cyprus and selected Eurozone States (10-year government bonds)



Source: Bloomberg

2.2 MACROECONOMIC OUTLOOK 2018-2021

2.2.1 GROWTH PROSPECTS 2018-2021

Medium-term Scenario 2018-2021

In the medium-term, the outlook of the economy is positive and growth is expected to continue to be robust albeit at somewhat lower levels. Due to an environment of improved confidence and credit conditions, resulting from progress in the restructuring of the banking sector and the anticipated gradual reduction in non-performing loans, as well as the gradual normalization of the labour market, growth is expected to remain strong in the forecast horizon of this Programme. The favourable macroeconomic environment is expected to improve the attractiveness of the Cyprus economy and investment and domestic demand are expected to continue contributing positively to growth. In addition, composition of public expenditure is also expected to contribute positively to growth through higher investment expenditures.

Domestic demand is expected to continue growing and be the main driver of growth, while employment is expected to increase further with unemployment continuing on its downward path. Imports are expected to grow in line with consumption and investments. All of the above, combined with the improved expectations regarding investment opportunities in the energy and tourism sector, create a positive outlook for the Cyprus economy.

Table III: Medium Term Framework, 2018-2021

change in percent	2017	2018	2019	2020	2021
Real GDP	**3.9**	**3.8**	**3.6**	**3.2**	**3.0**
Government Consumption	2.7	0.6	1.2	0.2	0.1
Private Consumption	4.2	3.5	3.0	2.5	2.0
GFCF	27.8	16.3	10.2	7.4	7.2
Exports	3.4	4.4	4.2	4.0	4.0
Imports	10.1	7.4	5.4	4.2	4.0
Deflator	1.5	1.0	1.0	1.5	2.0
Nominal GDP	5.5	4.8	4.6	4.7	5.1
HICP	0.7	0.5	1.0	1.5	2.0
CPI	0.5	0.5	1.0	1.5	2.0
Employment (persons)	3.4	3.0	2.5	2.2	2.0
Unemployment (LFS)	11.0	9.5	8.0	6.5	5.0
Compensation of employees	4.1	4.5	4.5	4.7	5.0
Compensation per employee	0.7	1.5	2.0	2.5	3.0

Source: Statistical Service and Ministry of Finance

For 2018, the economy is estimated to expand further, in real terms, at around 3.8%. This is primarily supported by a continued positive contribution of gross fixed capital formation and private consumption to growth, driven by the implementation of a significant number of projects and improving disposable incomes due to increased employment levels. In particular, for employment, the positive trend is expected to continue in line with growth expectations.

Growth forecast is projected to decelerate to about 3.6% in 2019 and then exhibit a growth of about 3.2% in 2020 and 3% and 2021. Inflation, measured by the CPI, is estimated to be marginally positive in 2018 exhibiting an increase of 0.5% and then projected to accelerate and increase by 1.0% in 2019 and rising further to 1.5% and 2.0% in 2020 and 2021, respectively.

Growth is estimated to remain relatively strong over the projected horizon, mostly due to internal drivers and to a lesser extend external drivers. Consumption will continue to provide a positive contribution to growth, but with a slowdown compared to 2017, mainly due to employment developments rather than wages. Investment growth is estimated to be the main driver and contribute positively to growth with an accelerating rate of growth compared to 2017, due to a significant number of new projects that are being implemented in the areas of tourism, energy, transport and education and include inter alia the construction of marinas, a casino resort and an infrastructure development of the University of Cyprus.

Additional investments are expected over the projected horizon, but are not factored in the baseline scenario constituting an upside risk to forecasts if materialized. These investments are linked to the energy sector, i.e. the development of the hydrocarbon industry and the construction of major renewable energy projects.

From a sectoral perspective, growth is expected to emanate mainly from the tourism, retail trade, shipping, construction, manufacturing and other business services sectors. Tourist arrivals in 2018 are anticipated to grow at a rate 5% over the record performance of 2017 and 2016, fueled particularly by the UK, Germany and other European markets.

The current account deficit improved significantly in recent years, mostly due to a cyclical correction of the goods balance. In general, however, on average an annual deficit of around 4.7% of GDP was recorded for the period 2012-2017 attributed to primary and secondary income account balances reflecting net outflows by MNEs with foreign shareholding in the form of dividends, as well as net outflows by non-resident employees.

On average the goods balance is forecast to be in deficit while the services balance in surplus. Due to the implementation of significant projects as well as the projected strong growth in consumption, the imports of goods are expected to grow significantly over the forecast horizon. The current account deficit (including SPEs) is thus anticipated to deteriorate over the medium-term. This projection relies on the assumptions that the primary and secondary income account balances will hover around the 2016-2017 levels, in absolute terms, during the period covered in this Stability Programme, while ship registration/deregistration will also remain at 2017 levels.

2.2.2 LABOUR MARKET

Labour Market

The expectations in the labour market are encouraging. In 2017, employment has expanded at a rate of 3.4% and is expected to continue growing in 2018 at a rate of about 3%. In 2019, employment is projected to grow at a rate of 2.5%, while in 2020 and 2021 is forecast to record a more moderate rate of growth of about 2.2% and 2%, respectively. At the same time, the unemployment rate is envisaged to maintain its downward path which commenced in 2015, declining from 11% of the labour force in 2017 to 9.5% in 2018 and gradually falling to 8% in 2019 and, subsequently, to 6.5% and 5% in 2020 and 2021, respectively. The reduction in the unemployment rate is triggered by the continued positive economic growth fostered by significant capital investment and strong private consumption leading to a sustained job creation.

Table IV: Labour market developments

	2014	2015	2016	2017	2018	2019	2020	2021
Employment (persons) growth	-1.8	1.5	3.3	3.4	3.0	2.5	2.2	2.0
Unemployment rate	16.1	14.9	12.9	11.0	9.5	8.0	6.5	5.0
Compensation per employee, growth	-3.6	-1.2	-0.7	0.7	1.5	2.0	2.5	3.0
Nominal unit labour cost, growth	-4.0	-1.7	-0.8	0.2	0.7	0.9	1.5	2.0
Real unit labour cost, growth	-2.6	0.4	0.6	-0.3	0.2	-0.1	0.0	0.0
Productivity (persons)	0.4	0.5	0.1	0.5	0.8	1.0	1.0	1.0

Source: Statistical Service and Ministry of Finance

The composition of unemployment shows that youth and long-term unemployment remain the major challenges in the labour market, but with encouraging signs of de-escalation. Youth unemployment peaked in Q2-2013 reaching a rate of about 40% of the labour force and since then followed a downward path declining to about 24.7% by Q4-2017. Similarly, long-term unemployment decreased to 4.5% in 2017, down from a peak of 7.8% in Q3 2014.

Wages

Wage growth, as reflected in compensation per employee, in 2017 is estimated to have exhibited an increase of about 0.7% and it is forecast to gradually accelerate and grow at a rate of 1.5% in 2018 and 2% in 2019. It is then projected to accelerate further to 2.5% in 2020 and 3% in 2021. Wage developments follow the steady recovery of the economy denoting an improving labour market and a labour demand rising faster than supply.

Productivity and ULC

Based on the indicative forecasts in the labour market, productivity is estimated to have been positive in 2017 reaching 0.5%. Productivity in 2018 is projected to rise to 0.8% and then accelerate to 1% in 2019-2021.

Nominal Unit labour costs (NULC) are forecast to follow a similar path to compensation per employee. In 2017, NULC estimated to have increased by 0.2% following a decline of 0.8% in 2016. The trend is forecast to turn positive as from 2018 onwards reflecting the anticipated positive economic developments. NULC are forecast to exhibit an increase of 0.7% in 2018, 0.9% in 2019, and then accelerate to 1.5% and 2% in 2020 and 2021, respectively. The projections in NULC underpin that cost competitiveness shall be sustained at relatively satisfactory levels maintaining a good overall competitiveness of the Cyprus economy.

Real unit labour costs (RULC) in 2017 was marginally negative falling by 0.3% following an increase of 0.6% in 2016, due to a marginally positive inflation, while in 2018 RUC increased by 0.2%. Over the period 2019-2021 RULC are forecast to remain overall stable, reflecting cost competiveness gains.

2.2.3 PRICE DEVELOPMENTS

Harmonised Consumer Price Index (HICP)

Inflation, as measured by the HICP, turned positive in December-2016 after its prolonged continuous negative trend since late-2014. During 2017, harmonized inflation averaged at 0.7%. Harmonized energy inflation was positive at 8.4% and total harmonized inflation excluding energy prices was marginally positive at 0.1%. During the first two months of 2018 inflation was negative of about 0.9% mainly due to the decrease of seasonal food prices of about 15%, contributing negatively to the y-o-y HICP rate by about 0.6 percentage points. Taking into account the projected trends in international oil prices, HICP is estimated to average to around 0.5% in 2018, compared to 0.7% the year before.

Consumer Price Index (CPI) - Price developments in 2018

In 2017 the Consumer Price Index (CPI) recorded an increase of the order of 0.5% compared to the year before. Analysis of CPI by economic activity indicates that this increase was mainly attributed to electricity and water prices as well as petroleum products, which recorded an annual rate of growth of 12.1% and 7.1% respectively (total contribution to 2017 inflation of about 0.8 percentage points).

During the first two months of 2018, inflation was negative of the order of 0.5% attributed mainly to local agricultural goods prices due to good weather conditions, as well as imported industrial goods prices, which recorded an annual negative rate of growth of 12.6% and 1.4%, respectively (total contribution to January-

February 2018 inflation of about -1.2 percentage points). Transport services recorded the highest price increase during the first two months of 2018, contributing 0.3 percentage points to the CPI annual growth rate. Core inflation (CPI excluding seasonal food and energy prices) averaged at about 0.2%.

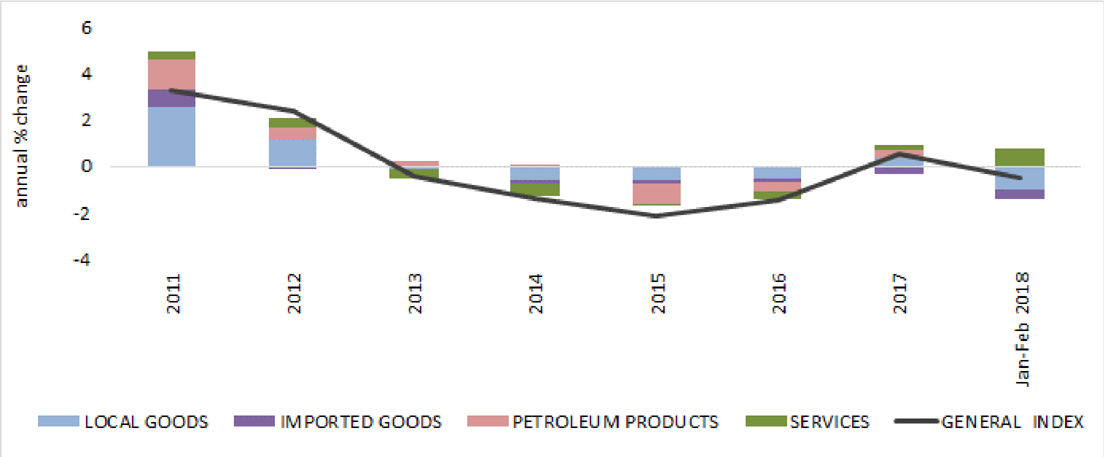
Inflation trend is expected to reverse and follow a positive growth for the remainder of the year, in line with the expected increase of international oil prices, and average at around 0.5% for the full year 2018.

Table V: CPI by Economic Activity

	2011	2012	2013	2014	2015	2016	2017	Jan-Feb 2018
GENERAL INDEX	**3.3**	**2.4**	**-0.4**	**-1.4**	**-2.1**	**-1.4**	**0.5**	**-0.5**
LOCAL GOODS	11.0	6.7	-1.6	-3.4	-3.9	-2.7	1.4	-4.2
Local Agricultural	-1.6	-1.3	-1.0	-3.7	1.0	0.4	-0.7	-12.6
Local Industrial	11.8	2.0	0.9	-0.2	-0.5	-0.6	-0.7	-0.7
Electricity and Water	13.5	26.8	-6.5	-9.2	-16.3	-13.8	12.1	-1.2
IMPORTED GOODS	2.8	-0.6	-0.2	-0.6	-0.6	-0.4	-1.0	-1.5
Imported Agricultural	13.8	2.6	-0.9	-2.0	0.7	-0.6	2.4	-4.4
Imported Industrial (Excl. petr.)	2.7	-0.7	-0.1	-0.5	-0.6	-0.4	-1.1	-1.4
PETROLEUM PRODUCTS	19.2	7.9	3.3	0.3	-13.3	-7.6	7.1	0.6
SERVICES	1.6	1.0	-0.5	-0.9	0.0	-0.8	0.5	1.6
Rents	0.7	0.2	-6.7	-5.9	-1.2	-0.5	0.8	1.5
Repairs & maint. of dwellings	0.1	-0.6	-0.5	-1.5	-2.0	1.1	1.8	4.3
Transport	-0.5	0.5	1.9	3.4	2.1	-14.1	0.5	10.7
Communication	0.0	1.4	1.3	2.0	1.0	-0.3	-1.0	-0.2
Insurance	-1.4	-0.1	3.0	-0.8	0.1	0.2	-2.5	0.4
Government services	4.8	1.8	2.7	9.1	0.7	-2.4	0.6	2.4
Education	3.2	2.4	-0.7	-3.5	-1.1	0.4	0.7	2.3
Medical care	1.3	0.6	-2.9	-1.7	1.0	1.6	1.1	1.2
Restaurants & Coffee shops	1.2	1.0	0.4	-1.4	0.2	0.3	0.7	0.8
Personal & Household services	1.1	1.2	-0.3	-1.1	-0.6	-0.1	0.8	0.8

Source: Statistical Service

Figure 8: CPI by economic category, contributions to total CPI annual % change



Source: Statistical Service and Ministry of Finance

2.2.4 RISKS TO MACROECONOMIC OUTLOOK

The risks on the economic outlook are tilted on the downside, with the most important risk factors concentrated domestically, in relation to the financial sector. The high levels of non-performing loans (NPLs) are a suppressing factor to the potential growth of the economy and pose risks to the stability of the banking system and, in turn, the outlook of the economy. However, the measures taken by the authorities to effectively tackle the NPL reduction challenge, address the likelihood of the impact that would be described as medium for the forecast horizon of this Stability Programme.

The strengthening of the legal framework related to NPLs, although essential for NPL reduction, poses a downside risk to the central macroeconomic scenario to the extent that it will impact private consumption growth due to increased repayments.

External risks remain contained at this point in time and mainly relate to the UK's exit from the European Union, expected in 2019, with repercussions for the Cyprus economy estimated to be limited via the exchange rate channel. International developments, especially connected to the policy stance of the US, can also have potential impact stemming from developments on the downside in the Eurozone. The effect of the recent build- up of the geopolitical tension in the eastern Mediterranean is too early to assess in an articulate way. However, potential risks on the downside do exist to the extent that it persists long enough to create uncertainty in the area and renewed tension between the EU and Russia that could impact the exports sector of the economy directly (tourism), in a similar manner that existing sanctions imposed on Russia pose a risk to the degree that they negatively affect growth prospects of the Russian economy.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1 POLICY STRATEGY

In 2017, fiscal performance amid the good economic performance was better than anticipated in the previous update of the Stability Programme and windfall revenues in that respect were used for the early repayment of part of public debt. Supporting growth and cementing confidence in the economy is a primary goal of the government and fiscal policy represented in the Budget 2018 and the Medium Term Budgetary Framework reflects this by maintaining important expenditure containing measures, while continuing to contribute to increasing potential growth through selected investments in key sectors of the economy. High primary surpluses are envisaged throughout the forecasting period of this Stability Programme which will support the resumption of a downward trend of the debt-to-GDP at a satisfactory pace, following the one-off spike realized in 2018 as a result of the decisive action undertaken by the government to address challenges in the banking sector. At the same time, these actions are pivotal in the strategy towards addressing the NPLs challenge releasing the full potential of the economy.

3.2 GENERAL GOVERNMENT BALANCE FOR 2017

The government's budget policy in 2017 was reflecting the neutral fiscal stance adopted, allowing thus automatic stabilizers to operate freely. The budget balance turned positive reaching a surplus of 1.8% of GDP in 2017, compared to a surplus of the order of 0.3% of GDP the year before, reflecting the improvement in the economic environment and labour market conditions. Primary balance position strengthened further reaching a surplus of 4.4% of GDP compared to a surplus of 3.0% the year before, recording an improvement of about 1.4 percentage points of GDP.

Revenue

In 2017, total revenue as a percentage of GDP amounted to 39.7% compared to 38.6% in 2016, exhibiting an increase of about 1.1 percentage points of GDP. In value terms, total revenue increased by 8.6% compared to the year before. Tax revenue increased by 8.8% mostly due to an increase in taxes on production and imports. In more detail, taxes on production and imports increased by 11.3% due to the increase in VAT receipts by 15.9% compared to 2016, reflecting the improvement in economic conditions and the increase in private consumption fueled by the exceptional performance in the tourist sector. Revenue from taxes on income and wealth increased by 4.9%, despite the abolition of the immovable property tax, as well as from the termination of the temporary tax on private sector emoluments as from January 1st 2017, resulting in revenue losses amounting to about 0.2 percentage points of GDP, respectively. These losses were fully compensated from the strong performance of corporate tax receipts and capital gains taxes exhibiting a robust growth compared to the year before of 10.3% and 63%, respectively.

Concerning the rest of the key revenue components, revenue from social security contributions increased by 10.5%, reflecting the improved conditions in the labour market namely employment and wage developments. On the other hand, revenue from property income decreased by 23.9%, primarily due to the lower dividend from the Central Bank of Cyprus (CBC) by about €33.4 million compared to the dividend received the year before, as well as from lower dividends from the Cyprus Telecommunications Authority (CYTA) and the Ports Authority by €30.9 mn in total. Finally, revenue from other sources, which consists of non-tax revenue, exhibited an increase of about 11.6%, reflecting the pick-up in the rate of absorption from the EU's Structural and Cohesion Funds.

Expenditure

Total expenditure in 2017, as a percent of GDP, exhibited a decline falling to 37.9% of GDP from 38.3% of GDP in 2016. In value terms, total expenditure increased by about 4.6%. Compensation of employees exhibited an increase of about 4.2%, attributed mainly to the termination of the temporary contribution on public sector emoluments, as of 1st January 2017, amounting to about 0.2 percentage points of GDP, as well as from the restructuring of security forces resulting in the employment of permanent army personnel with a fiscal cost estimated to about 0.1 percentage points of GDP. Despite these developments, as a percentage to GDP, compensation of employees decreased to 12.2% in 2017 compared to 12.4% the year before.

Intermediate consumption increased at a rate of 11.3% mostly due to increased expenditures associated with higher prices of electricity consumption and petroleum products as a result of rising oil prices in the commodity markets, as well as increased expenditures for pharmaceuticals and desalinated water due to the protracted drought. As a percentage to GDP, intermediate consumption increased by 0.2 percentage points from 3.5% of GDP in 2016 to 3.7% of GDP in 2017.

Despite the significant decrease in unemployment benefits and redundancy payments in 2017 compared to the year before, of the order of 6.3% and 46.1% respectively, social payments increased at a rate of 2.1%, brought by increased outlays related to old age pension exhibiting a rise of the order of 4.2%. As a percentage of GDP, social payments decreased to 13.6% from 14.1% of GDP the year before.

Interest expenditure recorded an increase of 2.9% in 2017 compared to 2016 despite the absolute reduction in the debt level. As a percentage to GDP, interest expenditure remains broadly constant at 2.6% in 2017, compared to 2.7% of GDP the year before. Gross fixed capital formation recorded an increase of the order of 17.2%, rising as a percentage to GDP to 2.5% in 2017 from 2.3% the year before, associated with increased outlays for security and defense purposes.

3.3 BUDGET FOR 2018

As in the previous year, the Budget for 2018 reflects the policy of the government for a growth friendly, prudent fiscal stance, safeguarding the maintenance of robust primary surpluses supporting a sustained reduction of public debt-to-GDP at a satisfactory pace. In this context, the Budget also reflects a continuation in the employment policies adopted by the government over the past few years and continues to place emphasis on the reallocation of government expenditure towards growth-enhancing activities and other policy priorities.

The budget surplus in 2018 is estimated to amount to 1.7% of GDP, with the primary balance position strengthening marginally reaching a surplus of about 4.5% of GDP.

A more detailed analysis on the revenue and expenditure components of the 2018 Budget is presented below.

Revenue

In accordance with our central macroeconomic scenario, total revenue in 2018 is anticipated to record a positive rate of growth of the order of 3.0% compared to 2017 and is estimated to decline as a percentage to GDP to about 39.1% of GDP from 39.7% the year before.

Tax revenue in 2018 is expected to exhibit a rate of growth of about 3.7% compared to 2017, resulting in a marginal fall, as a percentage of GDP to 25.2% in 2018 from 25.4% the year before. The growth is brought by increases in revenues from taxes on production and imports which are forecast to grow at a rate of 4.2%, in line with domestic demand developments reflected in increases in consumption and gross fixed capital formation, as well as due to the introduction of VAT rate on property land estimated at 0.1% of GDP. As a percentage to GDP, taxes on production and imports are estimated to remain at last year's levels at about 15.7%. Taxes on income and wealth are estimated to increase by about 3.0% compared to the year before, in line with real growth and improvements in the labour market. As a percentage to GDP, taxes on income and wealth are estimated to decline to about 9% compared to 10% the year before.

Social Security contributions are forecast to exhibit an increase in 2018 by about 4.5% compared to the year before, reflecting the continuous improving conditions in the labour market reflected in job creation and increasing nominal earnings, stabilizing at 8.9% of GDP, as was the year before.

Revenue from property income in 2018 is forecast to exhibit a decline of the order of 10.8% compared to 2017, contracting also as a percentage to GDP by about 0.2 p.p. to 0.6%, solely attributed to the lower dividend received from the Central Bank of Cyprus by about €35.7 mn. It should be mentioned that one third of the revenue of the signature bonus related to the production sharing contracts for the exploration and exploitation of hydrocarbon reserves, received in April 2017, is also reflected in the 2018 data since methodologically these revenues have been equally distributed, in accordance with the contract provisions, over a three-year period 2017-2019.

Finally, "other revenue", is estimated to record a modest increase of 1.2% in 2018 compared to the year before, resulting in a contraction, as a percentage of GDP, by about 0.3 percentage points to 4.4% from 4.7% in 2017, as financing from the EU's Structural and Cohesion Funds is expected to normalize and decline to the levels of the preceding programming period.

Expenditure

Total expenditure is estimated to exhibit an increase of 3.3%, falling, as a percentage of GDP, to 37.4% compared to 37.9% the year before.

In more detail, compensation of employees is forecast to exhibit an increase of 3.0% in 2018 compared with the year before, brought by the unfreezing of promotions, the provision of Cost of Living Allowance (COLA), annual increments as well as the extension of employment of seasonal personnel from 8 months to 11 months per year. In percent of GDP, compensation of employees is forecast to exhibit a decline by about 0.2 p.p. falling at 12.0%.

Intermediate consumption is forecast to record an increase by about 2.2% mainly due to increases anticipated in the energy prices for 2018 which, in turn, increase government expenditure on electricity and fuels. In percent of GDP, intermediate consumption is estimated to remain broadly at 2017 levels at 3.6%.

Regarding social transfers other than in kind, these are estimated to increase by about 2.4%, fueled by a growth in pension outlays of the order of 4.1% curtailed by a combined drop in unemployment and redundancy payments, in view of the envisaged continued improving conditions in the labour market. As a percentage to GDP, social transfers other than in kind are estimated to record a decline by 0.3 percentage points, declining to 13.3% of GDP in 2018.

Interest expenditure is forecast to record an increase of 14.4% in 2018, rising, as a percentage to GDP, to 2.8% in 2018 from 2.6% the year before. This development is attributed to the bonds issued in favour of Cyprus Cooperative Bank amounting to €2.35 bn or to about 12% as a percentage to GDP.

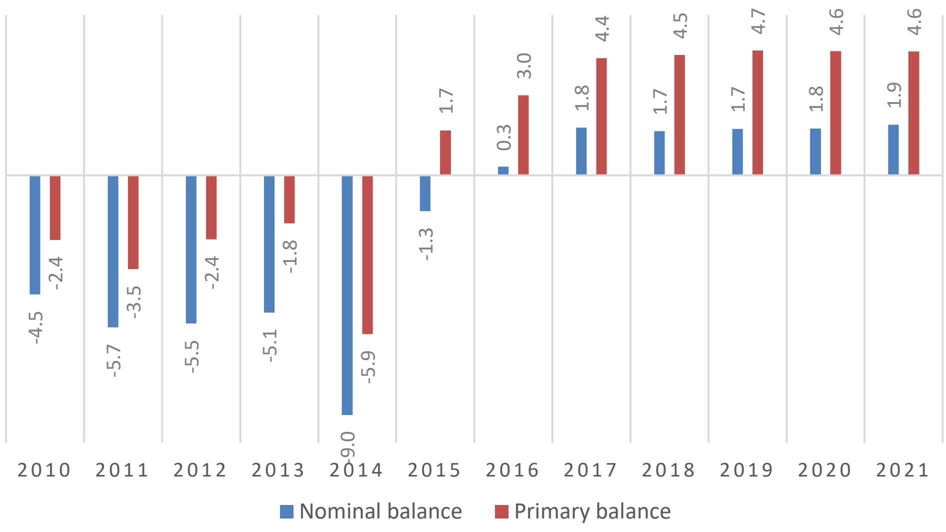
Gross fixed capital formation is forecast to exhibit an increase at a rate of 4.0%, remaining in 2018 as a percentage to GDP, at the levels of the year before at 2.5%.

Other expenditure is estimated to exhibit a decrease of 1.5% and to contract as a percentage to GDP to 2.7%, exhibiting a decrease by about 0.2 p.p. of GDP compared with the year before.

3.4 MEDIUM TERM BUDGET BALANCE 2019-2021

Over the medium term, the government aims at maintaining its prudent fiscal policy stance, using windfall revenues to reduce debt or improve the cash position of the state thus locking in the benefits of overperformance and maintaining an overall neutral fiscal stance. The robust economic growth results in high revenue growth which, in conjunction with the contained growth of expenditures established in the Medium Term Budgetary Framework through expenditure ceilings per line ministry, which results in high primary surpluses for the period 2019-2021, allowing debt-to-GDP to resume its downward path over 2019-21 at a satisfactory pace, following the spike of about 8 p.p. due to the government bonds issued in favour of the Cyprus Cooperative Bank.

Figure 9: Nominal Balance and Primary Balance (% GDP)



Source: Statistical Service and Ministry of Finance

Total expenditure, as a percentage of GDP, is forecast to grow below nominal GDP growth and exhibit a gradual decline to 37.0%, 36.6% and 35.7% in 2019, 2020 and 2021, respectively. The projected increase in compensation of employees remains stable over the medium-term horizon at about 2.8% per year, taking into account the government's employment policy. Social payments are also forecast to remain in control as they are projected to exhibit an increase of about 2.8% on average over the period 2019-2021, exhibiting a steady marginal decline as a percentage of GDP. Gross fixed capital formation is forecast to exhibit an annual growth over the programming period of about 4%, remaining at 2.5% of GDP over the whole period.

Total revenue, as a percentage of GDP, is forecast to grow by 3.7% on average over the period 2019-2021, averaging at 38.3% of GDP. Tax revenues are forecast to exhibit an annual increase of 3.9% on average over the programming period of 2019-2021 and as a percentage of GDP remain stable at around 25% of GDP on average. Taxes on production and imports are forecast to grow by 4.1% per year, while taxes on income and wealth by 3.6%. Taxes on production and imports still continue to amount on average to 15.6% of GDP over the period 2019-2021, while taxes on income and wealth amount to 9.2% of GDP, on average, over the same period. Corporate taxes continue to account on average for about 17.9% of total tax revenues, in line with previous years. Social Security Contributions are forecast to grow by 11.2% in 2019, due to the upcoming increase in that year in social security contributions, according to the relevant Law, estimated to amount to 0.2% of GDP.

Allocation of expenditure

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

Table VI: Functional classification of expenditure

% of GDP	2011	2012	2013	2014	2015	2016	2017	2021 f.
General public services	19.5	22.1	20.0	17.0	20.9	19.6	19.6	18.8
Defence	4.3	4.2	3.8	3.0	3.5	3.9	3.9	3.9
Public order and safety	4.9	4.8	5.2	3.6	4.3	4.4	4.4	4.4
Economic affairs	8.6	7.3	7.1	23.3	8.7	6.7	6.7	6.3
Environmental protection	0.7	0.7	1.1	0.5	0.9	0.7	0.7	1.3
Housing and community amenities	5.8	5.0	4.6	4.6	4.5	3.9	3.9	3.9
Health	7.3	7.2	7.4	5.5	6.4	6.8	6.8	7.8
Recreation, culture and religion	2.8	2.4	2.2	1.8	2.3	2.3	2.3	2.3
Education	16.0	15.2	16.3	12.4	14.9	15.6	15.6	15.2
Social protection	30.0	31.1	32.3	28.3	33.7	35.9	35.9	35.9
Total expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Ministry of Finance

3.5 MEDIUM TERM OBJECTIVE

The medium-term fiscal strategy of the government is consistent with the fiscal rules embedded in our Public Financial Management Framework through inter alia the enactment of the Fiscal Responsibility and Budget Systems Law. According to the law, the overall budgetary position rule establishes that the general government structural fiscal balance is balanced or in surplus in the medium term. During the programming period covered in the current update of the Stability Programme, the medium-term objective remains unchanged, i.e. a balanced position (0.0% of GDP) in structural terms.

Potential output estimates used for the calculation of the cyclical position of the fiscal policy are obtained from the commonly agreed methodology of the European Commission. Potential GDP is estimated to follow an expansionary path as from 2016 onwards, following a previous four-year long period of negative potential growth. From a potential growth estimated at 0.5% in 2016 rising to 1.9% already in 2017, it gradually reaches 3.2% by the end of the programming period. The gradual rise in potential growth is brought by increased positive contributions of both the labour and capital components, the former rising from 1.0% in 2018 to 1.1% by 2021 due to the projected reduction of structural unemployment rate (NAWRU) over the programming period, and the latter from 1.5% in 2018 to 1.8% in 2021 due to the dynamism foreseen in the macroeconomic projections for GFCF. The contribution of total factor productivity turns positive in 2019 and rises up to 0.3% by the end of the programming period.

Table VII: Potential GDP and Output Gap estimations

	2016	2017	2018	2019	2020	2021
Real GDP growth	3.4	3.9	3.8	3.6	3.2	3.0
Potential GDP growth	0.5	1.9	2.5	3.1	3.2	3.2
Output Gap (% GDP)	-0.9	1.1	2.4	2.9	2.9	2.8

Source: Ministry of Finance

As a result of real and potential GDP evolution, the output gap from a negative of 0.9% in 2016, turns positive as from 2017 and over the whole period up to 2021, increasing from 1.1% in 2017 to 2.4% in 2018, 2.9% in 2019 and remains broadly constant at 2.8% between 2019-21.

The cyclically-adjusted budget balance is estimated to have registered a surplus of 1.2% of GDP in 2017 and, as the positive output gap widens, it is projected surplus amounts to 0.4% of GDP in 2018, 0.2% in 2019 and 2020 and 0.5% in 2021. In absence of any one-off and other temporary measures during the programming period, the structural balance path coincides with the cyclically-adjusted balance path.

Table VIII: Cyclical developments

in percentage of GDP	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP growth (%)	3.4	3.9	3.8	3.6	3.2	3.0
Net lending of general government	0.3	1.8	1.7	1.7	1.8	1.9
Interest expenditure	2.7	2.6	2.8	2.9	2.9	2.7
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0
Potential GDP growth (%)	0.5	1.9	2.5	3.1	3.2	3.2
Output gap	-0.9	1.1	2.4	2.9	2.9	2.8
Cyclical budgetary component	-0.5	0.6	1.2	1.5	1.5	1.5
Cyclically-adjusted balance	0.8	1.2	0.4	0.2	0.2	0.5
Cyclically-adjusted primary balance	3.5	3.8	3.3	3.2	3.1	3.2
Structural balance	0.8	1.2	0.4	0.2	0.2	0.5

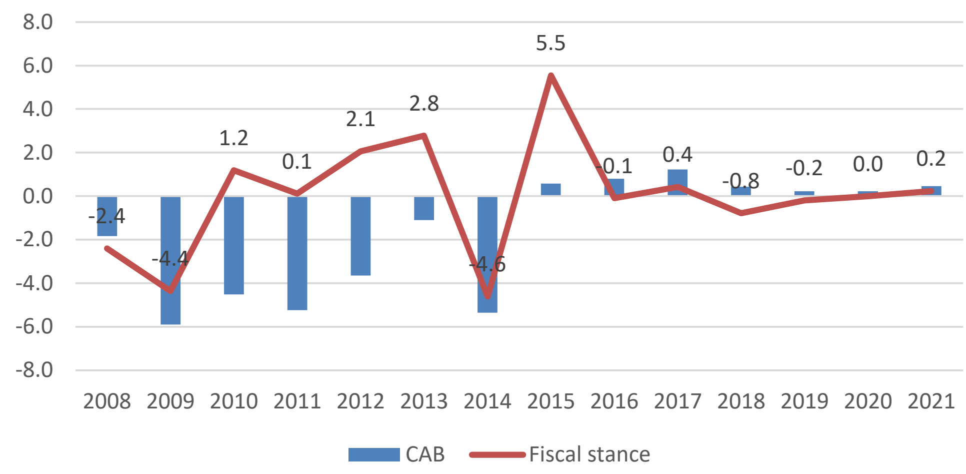
Source: Statistical Service and Ministry of Finance

Therefore, the structural balance during the period 2017-2021 overachieves the medium-term budgetary objective by the same magnitude in percentage points of GDP. This ensures the respect of the rules of the

Stability and Growth Pact and more precisely the respect of the medium-term objective for Cyprus in 2017 and 2018, as well as up to 2021. Fiscal stance turns negative only in 2018 and remains broadly neutral over the rest of the medium term.

Despite the above, the authorities will continue to monitor fiscal developments and in case of deviation stand ready to adopt the absolutely necessary corrective measures.

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



Source: Ministry of Finance

3.6 DEBT MANAGEMENT

The medium term public debt management strategy (MTDS) extends to a 3-5 year horizon and is endorsed by the Council of Ministers. The presently active Strategy covers the period 2016-2020. It is intended to lead public debt management in the post EU-IMF programme period which commenced in April 2016.

The guidelines of the MTDS 2016-2020 are the following:

1. smoothening of maturity profile of public debt and extension of the maturity of marketable debt;
2. risk mitigation through increased cash reserves and management of foreign exchange and interest rate risks;
3. development of the government securities markets;
4. minimisation of marketable debt borrowing costs through the improvement of investor relations and expansion of the investor base.

Both qualitative and quantitative targets for each of the above guidelines are included in the strategy. The MTDS 2016-2020 has been published in early 2016 and, after an approval of the Council of Ministers in September 2017, the main guidelines of the MTDS remain the same.

Financing actions in 2017

The main source of financing in 2017 was derived from the issuance of a 7-year Euro Medium Term Note (EMTN) of €850 million at a coupon of 2.75% and yield rate of 2.80%. The benchmark bond added a further point in the sovereign yield curve of Cyprus after four benchmark bond issuances during the years 2014-2016 and attracted a larger and diversified pool of investors. Furthermore, one 7-year bond was issued through private placement to meet demand by domestic investors of €300 million at a coupon of 3.25%. Finally, loans of €121 million were provided by the European Investment Bank and the Council of Europe Development Bank throughout the year for infrastructure projects.

The regular 13-week Treasury Bill auctions of €100 million per month continued during 2017. The weighted average yield in 2017 was -0.05% compared to 0.59% the year before, recording the significant decline during the year.

Despite the political uncertainty related to major events internationally such as elections in several EU member States, the sovereign bond yields of Cyprus demonstrated overall resilience with some short periods of yield steepening. By year end all bonds had tightened in a range between -119 to -220 basis points compared to the beginning of the year. The new bond issued in July maturing in 2024 performed strongly in the secondary market with the year closing 150 basis points tighter than its launch.

Parts of the proceeds from the debt issuances where used to conduct liability management operations. In conjunction with the new EMTN issuance, investors were invited to sell their bond holdings for three EMTNs due in 2019-20 to the issuer at market rates. With prices trading above par the investor interest was strong and total debt buybacks amounted to €546 million in nominal terms. The weighted average coupon of repurchased bonds was 4.97%. Furthermore, an amount of €271 mn was used for an early repayment of a portion of the IMF loan, carrying an interest rate of about 3.60%.

The debt management operations of 2017 contributed positively to the Cyprus' debt portfolio risk targets in line with the Medium-Term Debt Management Strategy.

The weighted average maturity of total debt improved considerably in the years 2013-2017 reaching 7.0 years at end 2017 compared to 4.5 years at the end of 2012. This improvement is attributed to the long-term official funding by the ESM-IMF loans, liability management transactions, as well as to the bond issuances with longer maturities. Indeed, the weighted average maturity of marketable debt was 4.9 years at end 2017 in relation to 2.7 years at the end of 2012. The share of debt that falls due within 1 year and within 5 years improved substantially reducing thereby the debt refinancing risk. By end 2017, the share of debt due within 1 year and 5 years reduced to 6% and 35% respectively, compared to 22% and 76% at end 2012. This outcome is attributed to the long-term official funding by the ESM-IMF loans and asset liability management transactions undertaken during the last couple of years which strategically intended to improve the debt maturity profile.

The weighted average cost of outstanding debt is estimated at 2.2% at end 2017 compared to 4.2% at end 2012. The cost has benefited significantly from the low interest rates of ESM/IMF loans and the current market rates which impact new issuances and older floating-rate debt indexed on Euribor.

What has changed significantly since 2013 was the interest rate distribution of debt. The floating-rate debt increased from 12% at end 2012 to 36% at end 2013 due to the financing provided by the ESM and IMF at floating interest rates. By the end of 2017, the said debt increased to 46%. The fixed-rate debt reduced to 54% at end 2017 compared to 88% at end 2012. Despite its sharp increase and taking into consideration that the floating-rate debt relates to loans by supranationals (ESM, IMF, EIB) and commercial long-term bank loans with low margins over the basis, the interest rate risk is estimated to be limited. The fiscal impact from a potential interest rate increase is thus contained. The composition of the general government debt at end 2017 was as follows:

1. Short-term public debt comprised 1% of total debt
2. The distribution among loans and securities was 65% and 35% respectively
3. The share of fixed interest rates in the public debt stock was 54%
4. Public debt denominated in euro was 96%.

As presented in Table IX, the net annual financing by source in 2017 was negative reaching €609 million. The net financing shows the year's debt issuance minus the debt redemptions.

Table IX: Net annual financing by source in 2017

	€ million
Government Securities	**294**
Treasury Bills	(100)
Retail bonds	71
Domestic bonds	19
EMTNs	304
Loans	**(903)**
Total net annual financing	**(609)**

Source: PDMO

Financing in 2018

The total financing needs of 2018, excluding the banking sector needs, are estimated at €0.9 billion, of which 100% relates to debt redemptions. In case of the execution of liability management transaction for early repayment of loans, the financing needs increase to €1.2 billion.

The Republic of Cyprus is considering accessing the international market in 2018 with one benchmark new EMTN of the order of 0.75 to 1.0 bn subject to market conditions in order, primarily to refinance public debt due within the year and secondly, to enhance its re-established market presence.

Depending on the size, any over-financing in 2018 will be used to enhance the liquidity position of the state to a level sufficient to prefund a substantial share of the 2019 financing needs. The syndicated international bond issuance will aim additionally to further develop the international bond yield curve, an effort which has been initiated in 2014 and has so far created five benchmark yield points. The domestic Treasury Bill auctions are expected to provide on an annual basis €0.3 bn in order to roll over last year's stock. The annual financing will be completed through proceeds from the domestic retail bonds as well as disbursements by the European Investment Bank/Council of Europe Development Bank for ongoing infrastructure projects.

The grade of completion of the financing plan 2018 at the end of first quarter 2018 was 27% with cash buffers sufficient to cover the financing needs for the following 9-month period.

Table X: Financing plan for 2018

Financing needs	€ billion
Short term treasury bills	0.2
Long-term bonds & loans	0.9
Fiscal needs	(0.2)
Banking sector needs	2.35
Total	**3.25**
Financing sources	**€ billion**
Treasury Bills rollover	0.3
EMTN[1/]	0.75
Other sources (Retail bonds. EIB/CEDB loans)	0.2
Domestic bonds	2.35
Total	**3.55**

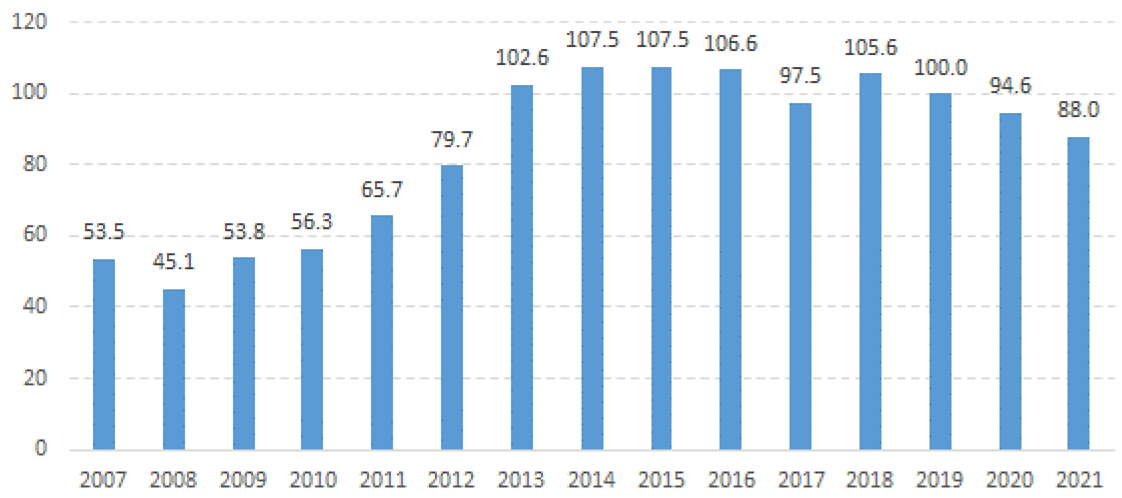
Source: PDMO

Note: Figures may not add due to rounding

1/ = The amount relates to the baseline scenario.

As presented in Figure 11 below, the general government debt-to-GDP ratio in 2017 has decreased significantly by about 9 p.p. to 97.5% compared to 106.6% the year before. The reduction was attributed to early repayment of liabilities financed by accumulated excess liquidity. In absolute terms, general government debt declined by €0.7 bn reaching €18.7 bn at the end of 2017 from €19.4 bn at the end of the previous year.

Figure 11: Debt ratio



Source: Ministry of Finance

Debt developments

General government debt is projected at €21.3 bn or as a percentage to GDP at 105.6% at the end of 2018, estimated to exhibit an increase by about 8.1 percentage points of GDP vis-à-vis the year before, attributed to the issuance of domestic bonds in favour of the Cyprus Cooperative bank. Over the programming period 2019-2021, debt-to-GDP ratio is projected to exhibit a downward trend declining to about 100%, 94.6% and 88% by year end 2019, 2020 and 2021, respectively. The reduction in the debt-to-GDP ratio satisfies the debt criterion of the Stability and Growth Pact (SGP) which, states that for Member States that breach the 60% reference rate for the debt-to-GDP, an annual reduction should be safeguarded of at least 5% of the part of the benchmark value being in excess of the 60% reference rate (averaged over three years).

The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called “snow ball” effect. The negative stock flow adjustment in 2017, equivalent to 1.8% of GDP, reflects financial transactions undertaken by government for repaying early liabilities of the state. In 2018, the stock flow adjustment is positive at about 14.3% of GDP owing to the accumulation of liquid assets in the form of deposits related to the issuance of domestic bonds in favour of Cyprus Cooperative bank.

The contribution of SFA is projected to remain positive during the years 2019 and 2020 at around 0.8% and 0.9% of GDP respectively, implying, partly, accumulation of liquid assets in the form of deposits, and turn negative in 2021 at around -0.1% of GDP.

Table XI: General government debt 2017-2021

in percentage of GDP	**2017**	**2018**	**2019**	**2020**	**2021**
Gross debt ratio	97.5	105.6	100.0	94.6	88.0
Change in debt ratio	-3.6	12.6	-1.0	-0.9	-2.0
Primary balance	4.4	4.5	4.7	4.6	4.6
Interest expenditure	2.6	2.8	2.9	2.9	2.7
Stock-flow adjustment	-1.8	14.3	0.8	0.9	-0.1

Source: Ministry of Finance

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

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

Macroeconomic risks

The central macroeconomic scenario of the government is contingent upon a number of external assumptions on oil prices and growth in the EU, the Eurozone and Cyprus's main trading partners. The associated external risks are on the downside and relate to: (a) Brexit, (b) the evolution of oil prices in the case these rebound faster than the central scenario assumption, (c) adverse growth developments in the EU and Eurozone, mainly due to effects from US policy stance and (d) adverse growth developments in Russia as well as developments regarding Russia's relations and possible repercussions that could impact the euro-ruble exchange rate. All in all, the probability of the external risks materializing in lower growth compared to the central scenario is rated as low to medium over the forecasting horizon of this Stability Programme.

The high level of NPLs and the risks this poses for the banking sector and the economy at large through the weighing down of private consumption and investments due to continued subdued lending to the economy, is indeed the most important risk factor for the central macroeconomic scenario. However, as already mentioned previously, the actions of the government towards stabilizing the banking sector and facilitating a faster reduction rate in NPLs are a mitigating factor to this risk.

Fiscal Risks

Fiscal outcomes are correlated to macroeconomic outcomes, in terms of how growth affects government revenues, but is also contingent to interest rates developments, contingent liabilities and other factors that may negatively weigh on public expenditure.

While interest rate risks are deemed low for Cyprus on existing stock of debt and projected debt issuance over the forecast horizon, risks from contingent liabilities are more substantial. Government guarantees at the end of 2017 amounted to around €2 billion, representing almost 10.6% of GDP. Out of these, an amount of €0.3 billion, or 1.5% of GDP, is already accounted for in the general government debt; the remaining amount of €1.8 bn represents contingent liabilities, €0.2 bn of which account for liabilities connected to the European Financial Stability Facility. Net of these, guarantees at the end of 2017 amount to about €1.5 bn, representing 7.9% of GDP. Further contingent liabilities concern:

- the outcome of the judicial process with respect to litigation against the Republic of Cyprus by public sector employees concerning the reduction in public sector wages;
- the outcome of the arbitration process that refers to claims against the Republic of Cyprus that refer to investors and depositors' losses brought by the recapitalization of the two systemic banks in 2013 through own resources;
- the outcome of the sale process of the Cyprus Cooperative Bank.

However, the effect to the fiscal outlook from the above risks, if realized, will be contained since risks on the upside are consistently embedded in the central forecasts of the government, especially concerning the prospects in tax revenues under the assumed central growth scenario. Furthermore, the effective management by a specialized private sector provider of the non-performing exposures pledged against the state's deposits with the Cyprus Cooperative Bank may result in counter balancing any negative developments with the sale process of Cyprus Cooperative Bank.

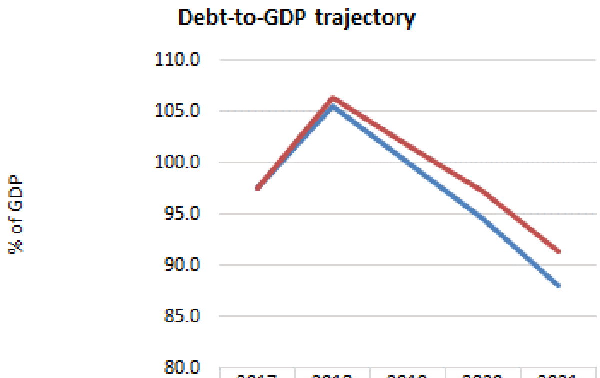
Sensitivity analysis

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

Scenario 1: Higher interest rate by 50 basis points annually

The first scenario assumes higher interest rates than the baseline scenario for each year over the programming period. In particular, the real interest rate increases by half of the 10-year historical standard deviation. Under this scenario, only the trajectory of general government public debt is affected which, however, continues to present a downward trend, declining to around 91.3% by 2021, compared to 88% under the baseline scenario.

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



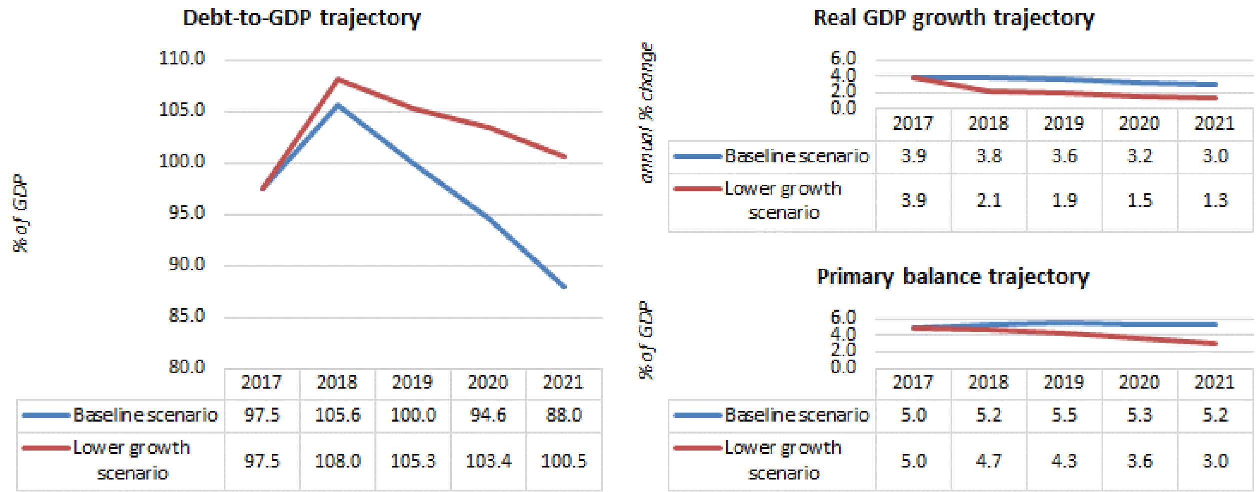
	2017	2018	2019	2020	2021
Baseline scenario	97.5	105.6	100.0	94.6	88.0
Higher interest rate scenario	97.5	106.4	101.7	97.2	91.3

Source: Ministry of Finance

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

Under this scenario, real growth in GDP is assumed to be lower by half of the 10-year standard deviation, for each year over the programming period, compared with the baseline scenario. Along with the real growth trajectory, Figure 13 below presents the trajectories for debt-to-GDP ratio and primary balance as percentage of GDP for the period 2017-2021. The debt ratio still projects a sustainable downward path over the medium term, declining to 100.5% by 2021.

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



Debt-to-GDP trajectory (% of GDP)

	2017	2018	2019	2020	2021
Baseline scenario	97.5	105.6	100.0	94.6	88.0
Lower growth scenario	97.5	108.0	105.3	103.4	100.5

Real GDP growth trajectory (annual % change)

	2017	2018	2019	2020	2021
Baseline scenario	3.9	3.8	3.6	3.2	3.0
Lower growth scenario	3.9	2.1	1.9	1.5	1.3

Primary balance trajectory (% of GDP)

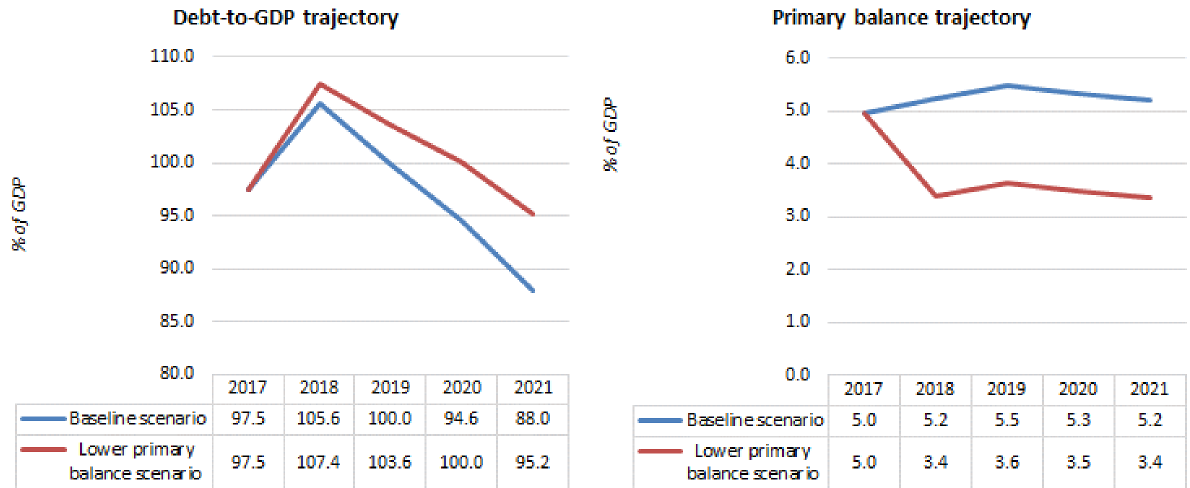
	2017	2018	2019	2020	2021
Baseline scenario	5.0	5.2	5.5	5.3	5.2
Lower growth scenario	5.0	4.7	4.3	3.6	3.0

Source: Ministry of Finance

Scenario 3: Lower primary balance by half of the 10-year historical standard deviation

In the third scenario, primary balance as a percentage of GDP is reduced by half of the 10-year historical standard deviation for each year over the programming period. Under this scenario, even though the debt to GDP in 2021 is expected to be higher than the baseline, there is still a downward trend, where debt ratio declines to 95.2% by 2021.

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



Debt-to-GDP trajectory

	2017	2018	2019	2020	2021
Baseline scenario	97.5	105.6	100.0	94.6	88.0
Lower primary balance scenario	97.5	107.4	103.6	100.0	95.2

Primary balance trajectory

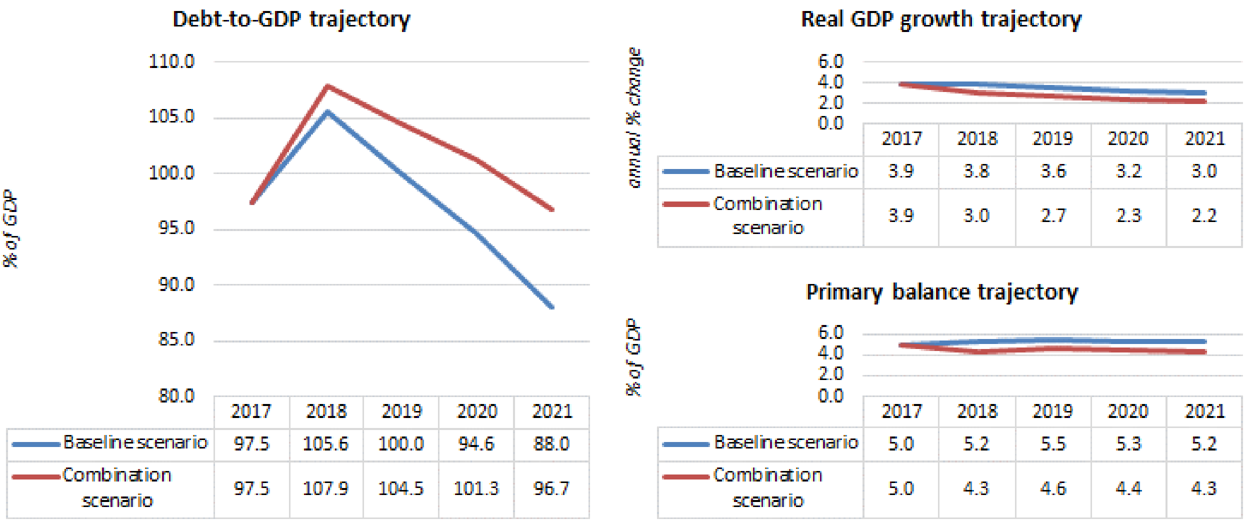
	2017	2018	2019	2020	2021
Baseline scenario	5.0	5.2	5.5	5.3	5.2
Lower primary balance scenario	5.0	3.4	3.6	3.5	3.4

Source: Ministry of Finance

Scenario 4: Combination scenario

The combination scenario assumed that shocks occur simultaneously on real interest rates, real growth and in primary balance, of the order of 1/4 of their 10-year historical standard deviation. Under this scenario, even though the debt to GDP in 2021 is expected to be higher than the baseline, there is still a downward trend, declining to 96.7% by 2021.

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



Debt-to-GDP trajectory	2017	2018	2019	2020	2021
Baseline scenario	97.5	105.6	100.0	94.6	88.0
Combination scenario	97.5	107.9	104.5	101.3	96.7

Real GDP growth trajectory	2017	2018	2019	2020	2021
Baseline scenario	3.9	3.8	3.6	3.2	3.0
Combination scenario	3.9	3.0	2.7	2.3	2.2

Primary balance trajectory	2017	2018	2019	2020	2021
Baseline scenario	5.0	5.2	5.5	5.3	5.2
Combination scenario	5.0	4.3	4.6	4.4	4.3

Source: Ministry of Finance

5. SUSTAINABILITY OF PUBLIC FINANCES

Chapter 5 illustrates the overall situation as regards to the sustainability of public finances. In this chapter a more detailed analysis is performed on the projected development of the General Social Insurance Scheme (GSIS) and other public age-related expenditures, as well as the future evolution of the general government expenditures and revenues. For the purposes of this analysis, it is assumed that the budgetary situation evolves in line with the Stability Programme targets of 2018-2021. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2021 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government balance.

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

The reforms were holistic and were introduced through the enactment of the Social Insurance Law N.193(I)/ 2012 and the enactment of the Pension Law N.216(I)/ 2012.

Furthermore, as it is stipulated in the Budget Law, future increases of the level of GEPS pensions may be granted the rate of increase of the COLA indexation over the previous year capped at 50% of the CPI increase. This adjustment of pensions is suspended during periods of recessions during the 2nd and 3rd quarter of the previous year.

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

Table 7 in the Appendix includes an analysis of the long-term fiscal sustainability taking into account the impact of age-related changes in expenditure over the period 2016-2060. The main elements of the analysis are the long-term projections on public pensions, health long-term care and education expenditures. The base year for the projections is 2016 and therefore, the figures for the subsequent years are projected. In addition, the projections undertaken for the purposes of the present Stability Programme exercise are primarily based on the latest available commonly agreed assumptions of the EPC-Ageing Working Group (AWG).

Table XII, presents the key demographic and labour market assumptions used for the purposes of this year's Stability Programme exercise. These assumptions are in line with those used in the 2018 Ageing Report, Underlying Assumptions and Projection Methodologies (published in November 2017) with certain adjustments made in order to captures recent developments.

Regarding the population projections, the population growth is projected at around 19% in the time period 2016-2060, which is among the highest population increase among the EU countries. Fertility rates, which have decreased between 2000 and 2014, are now projected to increase over the projection period from 1.31 in 2016 to 1.56 in 2060. Life expectancy also increases significantly. Gains in life expectancy over this period are for males 5.4 years and for females 5.0 years.

Table XII: Basic Demographic and Labour Market assumptions 2016-2060

	2016	2020	2030	2040	2050	2060
Total Fertility Rate	1.31	1.35	1.40	1.45	1.51	1.56
Life Expectancy at birth						
Males	80.6	81.4	82.7	83.8	84.9	86.0
Females	84.3	85.0	86.2	87.2	88.3	89.3
Participation Rates (15-64)	**72.9**	**75.2**	**77.0**	**77.1**	**77.9**	**78.6**
Males (15-64)	77.6	79.4	80.2	80.0	80.5	80.9
Females (15-64)	68.4	71.3	74.0	74.4	75.4	76.3
Net migration (thousand)	1.0	1.7	2.9	3.9	4.9	4.4

**Basic Demographic assumptions in accordance with the commonly agreed methodology and Eurostat's projections*

On the labour market, the total participation rate (15-64) is expected to increase by 5.8 p.p. between 2016-2060, mainly due to the increase in female participation rates (3.3 p.p. for males and 7.9 p.p. for females). Unemployment rate is expected to decline and stabilize at a low rate as from 2032. Table XIV presents the aggregate results of the projections for the public pension expenditure and the contributions over the period 2010-2060.

Table XIII: Projected public pension expenditure, contributions and reserves

in per cent of GDP	2010	2020	2030	2040	2050	2060
Total Expenditure[1]	6.9	9.2	8.8	8.5	8.1	8.1
Total Amount of Contributions[2]	7.0	7.3	7.5	7.6	7.5	7.1
Reserves of the GSIS	36.2	35.9	32.6	30.4	28.6	20.8

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

Results indicate a decrease in public pension spending of about 1 percentage point of GDP during 2020-2060. By 2040 contributions as a percent of GDP increase to 7.6 with the excess of expenditure over contributions contained at relatively low levels up to 2060.

In particular, total public pension expenditures are projected to increase from 6.9% of GDP in 2010 to 8.5% of GDP in 2040 and 8.1% of GDP by 2060. At the same time, contributions increase from 7.0% of GDP in 2010 to 7.6% of GDP over the period 2040 and reach 7.1% GDP by 2060. The low increase in public pension expenditures as a percentage of GDP over the period 2020-2060 is explained mainly by the 2012 pension reform, the demographics and the improved macroeconomic assumptions.

The accumulated reserves of the GSIS, peaked in 2015 reaching about 42% of GDP. From 2015 onwards, the GSIS reserves are expected to exhibit a gradual decline falling to about 20.8% of GDP by 2060.

In total, all age-related expenditure including spending on healthcare and education – which are based on the projection methodologies and assumptions of the EPC-AWG as adopted in 2017 for the purposes of the 2018 Ageing Report – are projected to decrease from 18.3% in 2010 to around 13.9% of GDP in 2060.

Health care expenditure is projected to marginally decrease by 0.7 p.p. between 2016-2060, decreasing from 2.8% of GDP in 2016 to about 2.1% in 2060. Long-term care expenditure is expected to remain stable at around 0.3%.

Additionally, education expenditure is projected to decrease from 6% in 2016 to about 3% of GDP by 2060. This decrease is also due to demographic factors and the change in the age structure of the population.

Other age-related expenditures are expected to remain stable at 0.7% of GDP across the projection period as it was during the last year with available information.

On the revenue side, property income is expected to remain stable at 0.8% of GDP across the projection period as it is projected to be in 2020. In contrast, pension contributions are expected to increase by 0.6% of GDP until 2040, and finally decrease by 0.5 p.p. of GDP in 2060.

As a result of the above, total general government expenditure will decrease from 42% of GDP in 2020 to 33.2% of GDP by 2060. General government revenue is projected to increase from 37.3% of GDP in 2010 to around 38.2% of GDP in 2060.

APPENDIX: STABILITY TABLES

Table 1a. Macroeconomic prospects

		2017	2017	2018	2019	2020	2021
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	16,582.5	3.9	3.8	3.6	3.2	3.0
2. Nominal GDP	B1*g	19,213.8	5.5	4.8	4.6	4.7	5.1
3. Private consumption expenditure	P.3	11,258.7	4.2	3.5	3.0	2.5	2.0
4. Government consumption expenditure	P.3	2,604.5	2.7	0.6	1.2	0.2	0.1
5. Gross fixed capital formation	P.51	3,748.5	27.8	16.3	10.2	7.4	7.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-215.0	0.0	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	10,900.0	3.4	4.4	4.2	4.0	4.0
8. Imports of goods and services	P.7	11,714.3	10.1	7.4	5.4	4.2	4.0
Contributions to real GDP growth							
9. Final domestic demand		17,611.7	8.4	6.1	4.8	3.7	3.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-215.0	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-814.3	-4.5	-2.3	-1.2	-0.5	-0.3

Table 1b. Price developments

	ESA Code	**2017** Level	**2017** rate of change	**2018** rate of change	**2019** rate of change	**2020** rate of change	**2021** rate of change
1. GDP deflator		115.9	1.5	1.0	1.0	1.5	2.0
2. Private consumption deflator		117.2	0.7	0.5	1.0	1.5	2.0
3. HICP[1] [2015=100]		99.5	0.7	0.5	1.0	1.5	2.0
4. Public consumption deflator		109.6	1.8	1.9	1.8	2.1	2.2
5. Investment deflator (GFCF)		108.2	0.0	0.4	0.4	1.2	1.5
6. Export price deflator (goods and services)		112.5	0.6	0.5	1.0	1.5	2.0
7. Import price deflator (goods and services)		111.2	-0.8	0.0	0.8	1.4	1.6

Table 1c. Labour market developments

	ESA Code	2017 Level	2017 rate of change	2018 rate of change	2019 rate of change	2020 rate of change	2021 rate of change
1. Employment. persons (thousands)[1]		393.3	3.4	3.0	2.5	2.2	2.0
2. Employment. hours worked[2] (thousands)		701,696	3.3	3.0	2.5	2.2	2.0
3. Unemployment rate (%)[3]		47,006	11.0	9.5	8.0	6.5	5.0
4. Labour productivity. persons[4]		…	0.5	0.8	1.0	1.0	1.0
5. Labour productivity. hours worked[5]		…	0.6	0.8	1.0	1.0	1.0
6. Compensation of employees (€ million)	D.1	8,404.3	4.1	4.5	4.5	4.7	5.0
7. Compensation per employee		24,300.6	0.7	1.5	2.0	2.5	3.0

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

Table 1d. Sectoral balances

% of GDP	ESA Code	2017	2018	2019	2020	2021
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-6.7	-7.1	-7.8	-7.9	-7.7
of which:						
- Balance on goods and services		-2.0	-3.6	-4.5	-4.7	-4.7
- Balance of primary incomes and transfers		-4.8	-3.5	-3.3	-3.2	-3.0
2. Net lending/borrowing of the private sector	B.9	-8.5	-8.8	-9.5	-9.7	-9.6
3. Net lending/borrowing of general government	EDP B.9	1.8	1.7	1.7	1.8	1.9
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Table 2a: General government budgetary prospects

% of GDP	ESA Code	2017*	2017	2018	2019	2020	2021
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	343.6	1.8	1.7	1.7	1.8	1.9
2. Central government	S.1311	142.9	0.7	0.9	1.0	1.0	1.2
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	29.9	0.2	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	170.8	0.9	0.7	0.7	0.7	0.6
General government (S13)							
6. Total revenue	TR	7,632.9	39.7	39.1	38.9	38.4	37.6
7. Total expenditure	TE[1]	7,289.3	37.9	37.4	37.2	36.6	35.7
8. Net lending/borrowing	EDP B.9	343.6	1.8	1.7	1.7	1.8	1.9
9. Interest expenditure	EDP D.41	500.6	2.6	2.8	2.9	2.9	2.7
10. Primary balance[2]		844.2	4.4	4.5	4.7	4.6	4.6
11. One-off and other temporary measures[3]		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		4,883,1	25.4	25.2	25.0	24.8	24.5
12a. Taxes on production and imports	D.2	3,041,4	15.8	15.7	15.7	15.6	15.4
12b. Current taxes on income. wealth. etc	D.5	1,841,7	9.6	9.4	9.3	9.2	9.1
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1,707,2	8.9	8.9	9.4	9.4	9.4
14. Property income	D.4	145.8	0.8	0.6	0.6	0.4	0.4
15. Other[4]		896.8	4.7	4.4	3.9	3.7	3.3
16=6. Total revenue	TR	7,632.9	39.7	39.1	38.9	38.4	37.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		6,590.3	34.3	34.0	34.4	34.2	33.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3,069.5	16.0	15.9	15.6	15.2	14.9
17a. Compensation of employees	D.1	2,350.4	12.2	12.2	12.0	11.8	11.5
17b. Intermediate consumption	P.2	719.1	3.7	3.6	3.5	3.4	3.3
18. Social payments (18=18a+18b)		2,618.3	13.6	13.3	13.1	12.9	12.6
of which Unemployment benefits[6]		79.9	0.4	0.4	0.4	0.4	0.3
18a. Social transfers in kind supplied via market producers	D.6311. D.63121. D.63131	5.9	0.0	0.0	0.0	0.0	0.0
18b. Social transfers other than in kind	D.62	2,612.4	13.6	13.3	13.1	12.9	12.6
19=9. Interest expenditure	EDP D.41	500.6	2.6	2.8	2.9	2.9	2.7
20. Subsidies	D.3	55.1	0.3	0.3	0.3	0.3	0.3
21. Gross fixed capital formation	P.51	487.9	2.5	2.5	2.5	2.5	2.5
22. Other[6]		557.9	2.9	2.5	2.8	2.8	2.8
23=7. Total expenditure	TE[1]	7,289.3	37.9	37.4	37.2	36.6	35.7
p.m.: Government consumption (nominal)	P.3	2,874.3	15.0	15.0	14.7	14.4	14.1

**in million of €*

[1]TR-TE=B.9.

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

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

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

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

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

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

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

	ESA	2017 Level	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP	2021 % of GDP
1. Total revenue at unchanged policies		7,632.9	39.7	39.1	38.9	38.4	37.6
2. Total expenditure at unchanged policies		7,289.3	37.9	37.4	37.2	36.6	35.7

Table 2c. Amounts to be excluded from benchmark

	2017 Level (€ million)	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP	2021 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	109.5	0.6	0.8	0.5	0.5	0.5
2. Cyclical unemployment benefit expenditure	-3.9	0.0	-0.1	-0.2	-0.1	-0.1
3. Effect of discretionary revenue measures	-82.5	-0.4	0.1	0.0	0.0	0.0
4. Revenue increases mandated by law	0.0	0.0	0.0	0.2	0.0	0.0

Table 3. General Government expenditure by function

% of GDP	**COFOG Code**	**2016**	**2021**
1. General public services	1	7.5	6.7
2. Defence	2	1.5	1.4
3. Public order and safety	3	1.7	1.6
4. Economic affairs	4	2.6	2.3
5. Environmental protection	5	0.3	0.5
6. Housing and community amenities	6	1.5	1.4
7. Health	7	2.6	2.8
8. Recreation. culture and religion	8	0.9	0.8
9. Education	9	6.0	5.4
10. Social protection	10	13.7	12.8
11. Total expenditure (=item 3=22 in Table 2a)	TE	38.3	35.7

Table 4. General government debt developments

% of GDP	ESA Code	2017	2018	2019	2020	2021
1. Gross debt		97.5	105.6	100.0	94.6	88.0
2. Change in gross debt ratio		-3.6	12.6	-1.0	-0.9	-2.0
Contributions to changes in gross debt						
3. Primary balance	B.9+D.41	4.4	4.5	4.7	4.6	4.6
4. Interest expenditure	D.41	2.6	2.8	2.9	2.9	2.7
5. Stock-flow adjustment		-1.8	14.3	0.8	0.9	-0.1
of which:						
- Differences between cash and accruals		-0.6	0.0	0.0	0.0	0.0
- Net accumulation of financial assets		3.0	-1.3	14.3	0.8	0.9
p.m.: Implicit interest rate on debt		2.6	2.6	3.1	2.9	3.0
6. Liquid financial assets8		28.5	25.8	38.9	37.9	37.1
7. Net financial debt (7=1-6)		78.1	71.7	66.7	62.0	57.5

Table 5. Cyclical Developments

% of GDP	ESA Code	2017	2018	2019	2020	2021
1. Real GDP growth (%)		3.4	3.9	3.8	3.6	3.2
2. Net lending of general government	B.9	1.8	1.7	1.7	1.8	1.9
3. Interest expenditure	D.41	2.6	2.8	2.9	2.9	2.7
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		1.9	2.5	3.1	3.2	3.2
contributions:						
- labour		1.0	1.1	1.3	1.2	1.1
- capital		1.1	1.5	1.7	1.8	1.8
- total factor productivity		-0.2	0.0	0.1	0.2	0.3
6. Output gap		1.1	2.4	2.9	2.9	2.8
7. Cyclical budgetary component		0.6	1.2	1.5	1.5	1.4
8. Cyclically-adjusted balance (2 - 7)		1.2	0.4	0.2	0.2	0.5
9. Cyclically-adjusted primary balance (8 + 3)		3.8	3.3	3.2	3.1	3.2
10. Structural balance (8 - 4)		1.2	0.4	0.2	0.2	0.5

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

Table 6. Divergence from previous update

	ESA Code	2017	2018	2019	2020	2021
Real GDP growth (%)						
Previous update		2.9	2.9	2.7	2.7	n.a.
Current update		3.9	3.8	3.6	3.2	3.0
Difference		1.0	0.9	0.9	0.5	
General government net lending (% of GDP)	B.9					
Previous update		0.2	0.4	0.4	0.4	n.a.
Current update		1.8	1.7	1.7	1.8	1.9
Difference		1.6	1.3	1.3	1.4	
General government gross debt (% of GDP)						
Previous update		104.0	99.7	94.6	88.8	n.a.
Current update		97.5	105.6	100.0	94.6	88.0
Difference		-6.5	5.9	5.4	5.8	

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	**37.6**	**42.0**	**37.1**	**35.1**	**34.0**	**33.3**	**33.2**
Of which: age-related expenditures	**15.4**	**18.3**	**17.9**	**16.1**	**15.0**	**14.3**	**14.2**
Pension expenditure	6.0	6.9	9.2	8.8	8.5	8.1	8.1
Social security pension	4.0	4.8	7.1	7.4	7.4	7.8	8.0
Old-age and early pensions	2.9	3.6	5.8	6.0	6.1	6.4	6.7
Other pensions (disability. survivors)	1.1	1.2	1.3	1.4	1.4	1.3	1.3
Occupational pensions (if in general government)[1]	2.0	2.1	2.1	1.4	1.0	0.3	0.1
Health care	2.6	3.0	2.6	2.4	2.2	2.2	2.1
Long-term care	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Education expenditure[2]	5.9	6.9	5.0	3.9	3.3	3.0	3.0
Other age-related expenditures	0.7	1.3	0.8	0.7	0.7	0.7	0.7
Interest expenditure[3]	…	…	…	…	…	…	…
Total revenue	**40.8**	**37.3**	**39.0**	**38.6**	**38.7**	**38.6**	**38.2**
Of which: property income	0.6	1.4	0.8	0.8	0.8	0.8	0.8
Of which: from pensions contributions (or social contributions if appropriate)	5.8	7.0	7.3	7.5	7.6	7.5	7.1
Pension reserve fund assets	32.7	36.2	35.9	32.6	30.4	28.6	20.8
Of which: consolidated public pension fund assets (assets other than government liabilities)	…	…	…	…	…	…	…
Systemic pension reforms	…	…	…	…	…	…	…
Social contributions diverted to mandatory private scheme	…	…	….	…	…	…	…
Pension expenditure paid by mandatory private scheme	…	…	…	…	…	…	…
Assumptions							
Labour productivity growth	0.4	0.3	1.0	1.0	1.3	1.7	1.6
Real GDP growth	4.8	1.3	3.2	2.3	2.3	2.0	2.0
Participation rate males (aged 15-64)	82.9	80.4	79.4	80.2	80.0	80.5	80.9
Participation rates females	65.4	67.4	71.3	74.0	74.4	75.4	76.3
(aged 15-64)	73.9	73.6	75.2	77.0	77.1	77.9	78.6
Total participation rates (aged 15-64)	3.9	6.3	6.5	5.0	5.0	5.0	5.0
Unemployment rate (15+)	12.4	12.7	16.7	20.3	22.8	26.6	31.7
Population aged 65+ over total population	0.4	0.3	1.0	1.0	1.3	1.7	1.6

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

Table 7a. Contingent liabilities

% of GDP	2017	2018
Public guarantees	10.6	10.1
Of which: linked to the financial sector	0.0	0.0

Table 8. Basic assumptions

	2017	2018	2019	2020	2021
EA: Short-term interest rate (3-months money markets)	-0.33	-0.32	-0.12	...	...
EA: Long-term interest rate (10-year government bonds, Germany)	0.32	0.57	0.77	...	...
USD/€ exchange rate (annual average)	1.13	1.23	1.23	1.23	1.23
Nominal effective exchange rate of the EU (% change)	1.86	6.83	0.18	...	...
World growth excluding EU (in PPP terms)	3.9	4.2	4.2	....	...
EU 28 GDP growth	2.4	2.3	2.0	...	...
Growth of relevant foreign markets [UK]	1.8	1.4	1.1	...	...
World import volumes. excluding EU	5.1	5.0	4.5	...	...
Oil prices (Brent. USD/barrel)	54.8	67.7	63.9	63.9	63.9