ECONOMIC DEVELOPMENTS IN 2013
AND PROSPECTS FOR 2014

October 2013

MINISTRY OF FINANCE

Note: This Report has been prepared based on the macroeconomic scenario agreed with Troika during the first review mission, in July 2013. Based on this scenario economic growth in 2013 will be reduced by 8,7%. More recent data show less decline in GDP, around 7,7%.

CONTENTS

I. INTRODUCTION

The impact of the debt crisis in the EU and particularly in the euro area, but also the delay in the decision-making at national level, exacerbated the macroeconomic imbalances and structural problems faced by the Cyprus economy.

The fiscal and structural problems, the exposure of Cypriot banks to the Greek economy, as well as the non-viable credit expansion, led to the loss of confidence of investors to the Cyprus economy, resulting to the increase of the cost of sovereign lending at prohibitive levels. The Republic of Cyprus applied for support to the European Stability Mechanism and the International Monetary Fund and after lengthy negotiations, an agreement was reached in April 2013. The agreement calls for a financial assistance up to 10 billion euro, in the context of an ambitious Macroeconomic Programme, which includes measures for fiscal consolidation, reform of the banking system and promotion of structural reforms in major sectors of the economy.

In this unfavourable economic environment, the Government`s main goals are the tackling of the problems of the banking sector, fiscal consolidation and the containment of unemployment through the support of economic activity. The planned reforms mainly aim at restoring investors` confidence in the Cyprus economy and returning the soonest possible in the international markets.

This Report presents the strategic goals and main objectives of the economic policy of the Government.

It is noted that during the Programme Period (until 2016), there is no obligation for the Republic of Cyprus to prepare Stability Programme or National Reform Programme, since the Programme agreed with Troika covers all these issues in-depth.

Moreover, in the Report there is analysis of the developments in the international economic environment, which is characterized by continuous fluctuations and challenges. In the present phase, the world economy is mainly influenced by the problems the banking sector is facing in the euro area and is characterized by subdued economic growth, high unemployment and uncertainty. As known, the international environment constitutes a decisive factor for the outlook of the Cyprus economy, given its open character and small size.

The main part of this Report focuses on the analysis of the economic developments during the current year. Reference concerning the economic outlook for the upcoming year, as well as for the Budget of 2014, follows thereafter.

II. STRATEGIC OBJECTIVES

The economic policy of the Government is based on five axes:

1. Macroeconomic stability
2. Restructuring of the banking sector – gradual abolition of capital controls
3. Economic growth and tackling of unemployment
4. Safeguarding social cohesion – better targeting of social expenditure
5. Serving the Citizen

Taking into account the above economic policy pillars, the Ministry of Finance has set the following strategic objectives:

- Fiscal consolidation with emphasis on restraining public consumption expenditure
- Combating tax fraud and improvement of the efficiency of the tax system
- Restructuring the productive base of the economy and enhancing competitiveness – exploiting comparative advantages in the tourism and professional services sectors and growth potential of energy sector
- Promoting entrepreneurship and attracting new investments for tackling unemployment in the medium- to long-term
- Modernizing and restructuring social insurance, inter alia, through the Minimum Guaranteed Income
- Reforming the health sector and introducing a National Health System
- Improving the efficiency of the public service and public organizations and exploiting of government property

The economic policy of the Government follows, in more detail:

1. Macroeconomic Stability

Fiscal Policy

The preparation of the 2014 Budget and of the Medium-Term Budgetary Framework 2014-2016, focuses on the correction of the fiscal imbalances as well as the reversion of the public debt's upward trend, through the creation of primary surpluses, in the medium-term. Despite the difficult economic circumstances, main priority remains the provision of resources for economic growth, modernization of the infrastructure of the economy, while in parallel safeguarding social cohesion.

The adoption of strict fiscal policy, especially regarding public expenditure, constitutes an essential condition for the creation of conditions for solid economic growth in the long-term.

In this context, the Council of Ministers approved the Medium-Term Budgetary Framework 2014-2016 (MTBF), aiming at containing the rate of increase of public expenditure.

Wage Policy

Wages, being the main source of income for workers, constitute a decisive element of demand, while being, at the same time, an element of cost for businesses, thus affecting competitiveness. Maintaining macroeconomic stability and the level of competitiveness of the Cyprus economy, requires that the labour costs adapt to productivity developments.

In the current juncture, it is expected that the subdued economic growth and challenges in public finances will exert pressure for wage adjustment, both in the private and public sector.

Monetary and Exchange Rate Policy

With the adoption of the euro on 1/1/2008, monetary policy is determined by the European Central Bank, whose member of the Board is the Governor of the Central Bank of Cyprus. The interest rate decisions are taken by the European Central Bank, based on the conditions and forecasts regarding the economy of the single market as a whole, having as primary objective the achievement of price stability. Also, the policy regarding the exchange rate is determined by the supranational institutions in the EU.

In the current juncture, borrowing interest rates for businesses and households in Cyprus remain at relatively high levels, in contrast with deposit interest rates, which have exhibited noteworthy reduction. Undoubtedly, this fact constitutes a drag on economic activity. The restructuring and the recapitalization of the banking sector, as well as the settlement of loans of viable businesses, constitute necessary preconditions for normalization of lending conditions and level of interest rates in Cyprus.

2. Economic Development and Social Cohesion

According to the agreed Memorandum of Understanding, the Cyprus economy will be in recession in 2013 and 2014, whereas a gradual recovery is expected in 2015. In this context, for the years 2013-2014, the main goal of the Government will be to limit, to the extent possible, the contraction of economic activity, through the Budget but also through supplementary measures to support growth and social cohesion.

For safeguarding social cohesion and taking into consideration the particularly difficult economic environment, the Government is currently implementing a series of measures, including better targeting of social expenditure for vulnerable groups. It is noted that social benefits, which are currently provided by various ministries, will be transferred to the Ministry of Labour and Social Insurance. In parallel the Minimum Guaranteed Income will be introduced, substituting, among other, Public Assistance. The Minimum Guaranteed Income, which will be applied in mid-2014, will be calculated on the basis of certain criteria, such as income, property, composition of family and any specialized needs that might exist in a household.

III. ECONOMIC ENVIRONMENT

1. World Economy

The world economy is still subdued, mainly because of the deceleration of the growth rate of the emerging economies, as well as from bigger than expected duration of the recession in the euro area. According to the latest forecasts of the International Monetary Fund (IMF) - October 2013 - the world economy is expected to grow by 2,9% in 2013 in real terms, in comparison with 3,2% in 2012. In 2014, growth is expected to be around 3,6%.

United States and Asia

In the US, according to the latest forecasts of the IMF, real growth is expected to be around 1,6% in 2013, compared with 2,8% in 2012, while for 2014 is forecasted to be around 2,6%. Generally speaking, the US economy exhibits a better picture compared to the EU economy.

The developing countries of Asia (China, India, ASEAN-5[1]) exhibit comparatively high growth rates. According to the latest forecasts of the IMF, China continues to show the biggest growth, with a rate in 2013 being similar to the previous year (7,6%), while in 2014 it is expected to be around 7,3%. India comes next with growth rate of 3,8% in 2013 compared with 3,2% in 2012, while in 2014 growth is forecasted to be around 5,1%. More recent data show some deceleration of growth rate, particularly for India.

In 2013, Japan is expected to exhibit positive growth rate for the second consecutive year, following the recession in 2011, of around 2%. The IMF expects Japan to grow by 1,2% in 2014.

Russia

The Russian economy continues to grow with positive rates due to the domestic demand, even though over the years there is some restrain in the level of growth. The IMF, expects growth to be around 1,5% in 2013 compared with 3,4% in 2012, while in 2014 growth is forecasted to be around 3%.

European Union

In the European Union (EU) and in the euro area, there have been some positive signs of recovery, such as the positive growth rate of the second quarter of 2013 compared with the previous quarter, after a long period of negative growth.

According to the latest forecasts of the IMF, EU is not expected to grow in 2013, whereas the euro area is expected to exhibit a negative growth rate of around 0,4%. In 2014, an improvement is expected, with growth reaching 1,3% in the EU and 1% in the euro area.

[1] Indonesia, Malaysia, Philippines, Thailand, Vietnam.

Confidence in the European economy has been notably improved, even though financial conditions have not been in such condition to be able to strengthen the efforts for economic growth.

The labour market is still fragmented in the EU, facing a number of challenges, especially in Ireland and the countries of the South, without good prospects for a quick recovery, given the subdued economic growth.

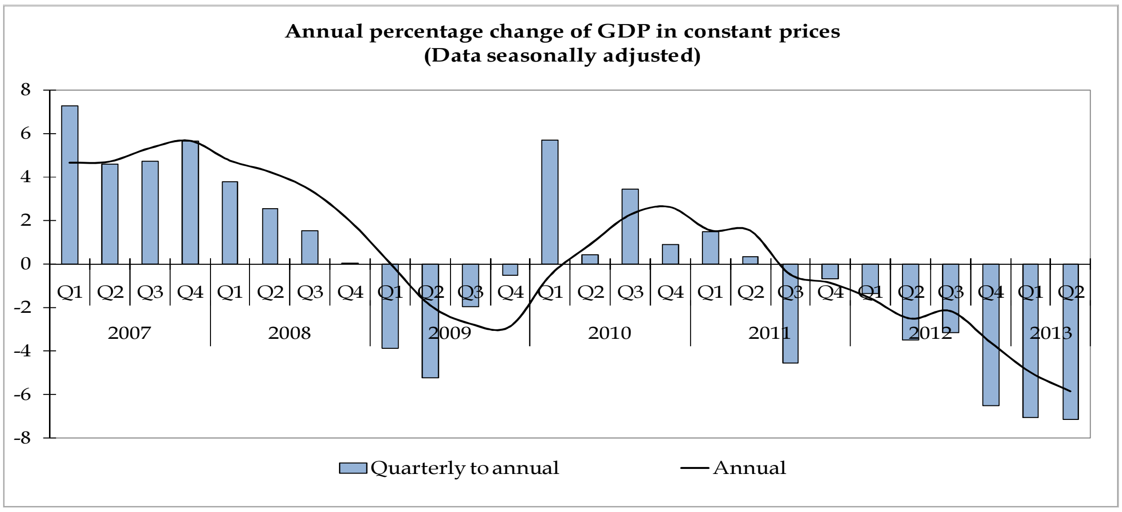
2. Cyprus Economic Growth Rate 2013

The Cyprus economy, after the March 2013 events, presented further deterioration during the first semester of 2013. Based on estimates of the Statistical Service, the seasonally adjusted GDP, in constant prices, declined by 1,8% during the 2nd quarter of 2013 compared to the 1st quarter of 2013. On an annual basis the seasonally adjusted GDP declined by 5,8% during the 2nd quarter of 2013 compared to the same quarter of 2012. The recession was not as deep and sharp as was the forecast included in the macroeconomic adjustment programme.

The deterioration in growth in the 2nd quarter of 2013 compared to the previous quarters is mainly due to the negative growth rates of the secondary sector of the economy (construction and industry) as well as the sectors of trade and banking.

For the first half of 2013 the reduction in the production volume is estimated at around 5,4%.

For 2013 as a whole, the rate of economic growth is forecasted to be negative and to be around 8,7%[2] according to the forecast included in the macroeconomic adjustment programme.



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2 Based on more recent data, the rate of economic growth of the Cypriot economy in 2013 will stand in less negative levels, compared with the forecast included in the macroeconomic adjustment programme.

The latest monthly figures show a decline in economic activity, but not to the extent projected in the MoU and from international organizations. Negative indications are present in the sectors of manufacturing, construction, trade and banking:

- Confidence indicators have stabilized at low levels and present a less unfavourable picture. In September 2013 the economic climate presented an improvement with the Economic Sentiment Indicator (ESI) increased by 1 point compared to the previous month, remaining though at negative levels.

- The general index of industrial production fell by 13,6%, in January-July 2013, compared to the same period last year.

- Building permits, in volume, have decreased by around 25,1% in January-June 2013, compared to the same period last year due to the ongoing correction in this sector.

- Local sales of cement have decreased by around 32,2% in January-September 2013, compared to the same period last year.

- Property sales have decreased by around 45% in January-September 2013, compared to the same period last year.

- The turnover volume index of retail trade (except automotive fuel) has decreased by around 10% in January-June 2013, compared to the same period last year.

- Tourist arrivals have decreased by 5,3% in January-August 2013, compared to the same period last year, but revenues from tourism are expected to remain at last year's levels, a satisfactory performance under the circumstances.

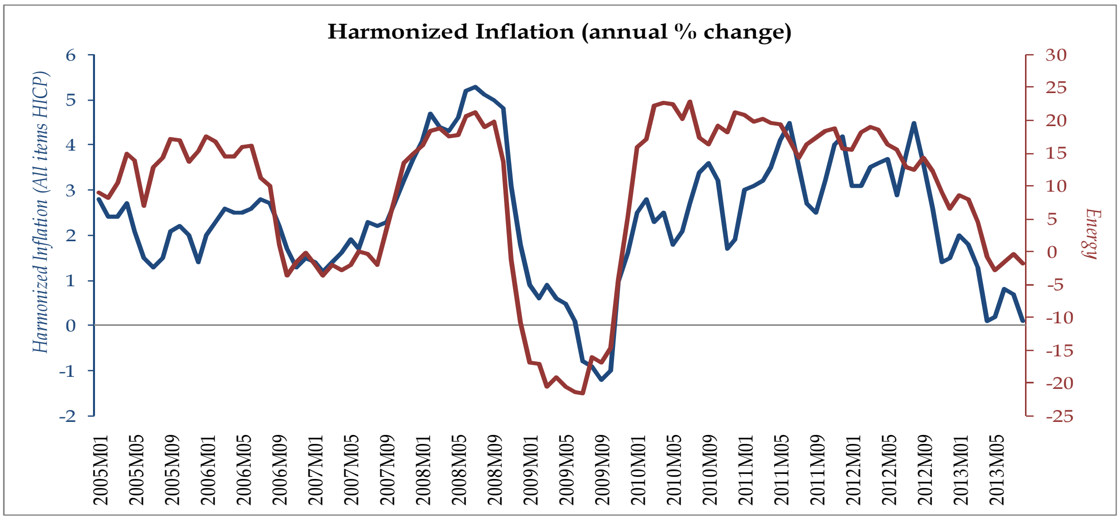
- In the transport sector, the registrations of motor vehicles decreased by around 34,1% in January-August 2013, compared to the same period last year.

- In the services sector, in January-June 2013, the turnover value index decreased by 9,3% in the sector of accommodation and food service activities, decreased by 7,9% in the sector of computer programming, consultancy and related activities, decreased by 7% in the sector of legal and accounting activities and decreased by 28,9% in the sector of architectural and engineering activities, technical testing and analysis, compared to the same period last year.

On the demand side, in the first half of 2013, estimates of the Statistical Service show a significant reduction in public and private consumption and a more significant reduction in gross fixed capital formation (reduction in investment in transport equipment, investment in machinery and equipment and investment in construction) as well as decrease in inventories. In contrast the external sector contributes positively to growth.

3. Inflation

During the first eight (8) months of 2013, harmonized inflation averaged at 0,86% compared to the same period of the previous year and is estimated to average around 1% for the full year 2013. Core inflation is stable and in low levels, reflecting the conditions of a low demand for consumption, while indicating the expectations for a prolonged weak economic activity. The relatively low inflation within the year 2013 is mainly attributed to the increase in the price of vegetables, as well as the increase in the price of health care. At the same time, significant decreases were recorded in the price of electricity, as well as in the price of fruits. During the period January-August 2013, crude oil price (Brent) in dollars was lower by 3,6% compared to the same period of the previous year, and lower by 6% in euros. The weight of the components of the Harmonized Consumer Price Index, which are directly affected by the oil price fluctuations (operation of personal transport equipment, electricity), is 9,5%.



4. Labour Market

The continued economic crisis that is affecting the Cyprus economy and the negative growth rates in 2013 have adversely affected the creation of new jobs and the employment rate and, thus, the rate of unemployment.

According to the latest data from the Labour District Offices, the average number of registered unemployed in September 2013 was reduced to 47.017 persons compared with 48.451 in the previous month and increased by 13.151 compared with the same month of the previous year.

Based on the 2nd quarter of 2013 Labour Force Survey results, the number of unemployed reached 68.306 persons or 15,5% of the labour force while in the 2nd quarter of 2012 was 11,3%. In the end of 2013 the unemployment rate is estimated to rise to 17%. The unemployment is very high in construction, the banking sector and the newcomers in the labour market. Furthermore, one out of three unemployed remains without a job for more than one year, whereas in 2012 was one out of four, reflecting a further increase in the long-term unemployment.

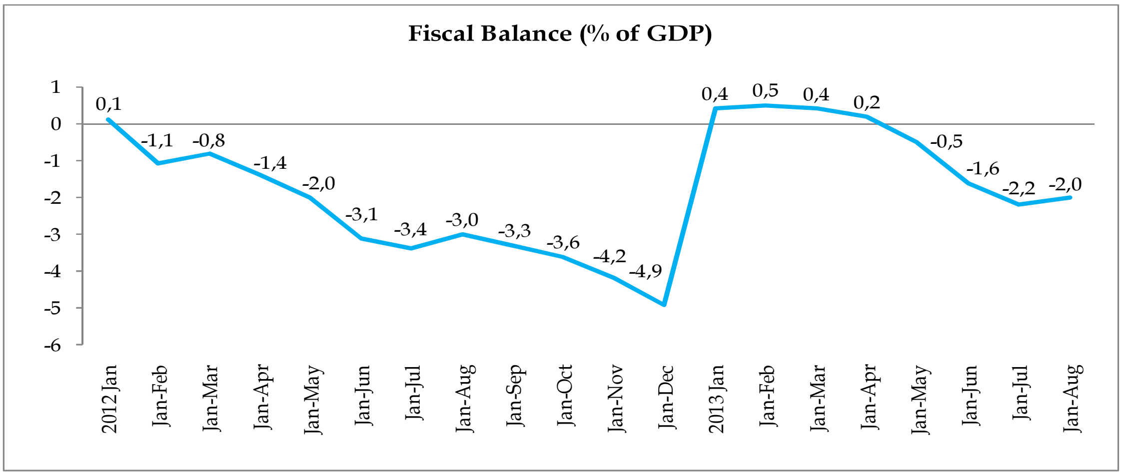
Employment in the 2nd quarter of 2013, based on the Labour Force Survey results denoted a negative performance. Moreover, the employment of foreigners from other countries and Europeans was reduced by 8% until April 2013 compared to 2012.

The average monthly earnings for the 2nd quarter of 2013 in relation to the 2nd quarter of 2012 were reduced by 1,6%. The reduction in earnings follows the economic recession that hit the Cyprus economy.

5. Fiscal developments in the period January–August 2013

The fiscal balance during the period January-August 2013 showed improvement, compared to the corresponding period of 2012.

Specifically, the fiscal balance during the reporting period showed a deficit of around 2% of GDP, compared to a deficit of 3% of GDP over the corresponding period last year, mainly due to temporary and non-recurring factors. In absolute numbers, the fiscal deficit during the reporting period amounted to €336,4 mil. compared to €541,4 mil. for the same period of 2012. The primary balance[3] showed a surplus of €103,8 mil. compared to a deficit of €74,4 mil. for the corresponding period of 2012.



Government revenue during the period January-August 2013 shows a marginal decrease compared to the corresponding period last year. The decline rate of government revenues during the reporting period was about 0,9% compared with a growth rate of 1,4% in the corresponding period last year.

Public expenditure depicts a decrease of 5,2% compared to a decrease of 1,6% in the corresponding period of 2012.

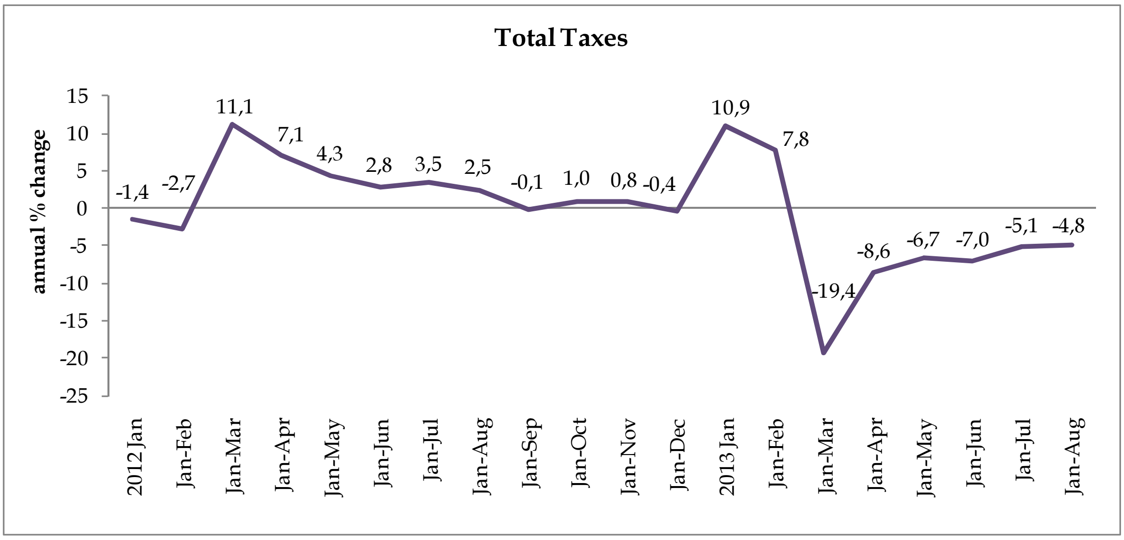
[3] The primary balance is the budget deficit (revenue – expenses) excluding interest payments.

More specifically, during the period January-August 2013, the picture of the public finances of the Central Government and Social Security Funds, on a cash basis, compared to the same period in 2012 is as follows:

5.1 Revenue

Public revenues showed a marginal decrease of 0,9% reaching €4.082,5 mil. for the reporting period, compared to €4.120,7 mil. for the corresponding period of 2012.

Tax revenues reached €3.406,6 mil. for the months January-August 2013, compared to €3.578,9 mil. the corresponding period of 2012, depicting a decrease of 4,8%.



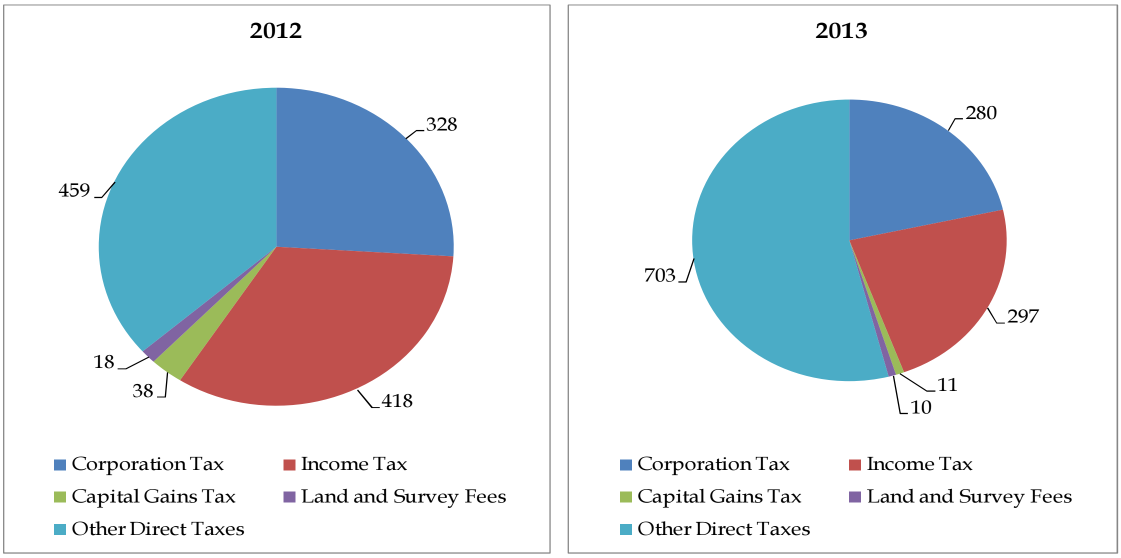
5.1.1 Tax Revenue

5.1.1.1 Direct Taxes

Specifically, during the reference period, direct taxes increased marginally to €1.301,5 mil. compared to €1.261,2 mil. the corresponding period in 2012, an increase of 3,2%. The increase was primarily due to increases generated as a result of the fiscal consolidation measures, such as salary cuts of the public sector, increase of the bank levy for credit institutions and other direct taxes, despite the decline in revenues from the income tax for natural persons, reduced receipts from the capital gains tax, and lower receipts from corporate tax.

At the same time, revenue from fees from the Department of Lands and Surveys, linked to direct taxation, decreased by 45,5% in the first eight months of 2013 and have been limited to €9,8 mil. from €18 mil. in 2012, reflecting the reduced activity in the construction sector and real estate market.

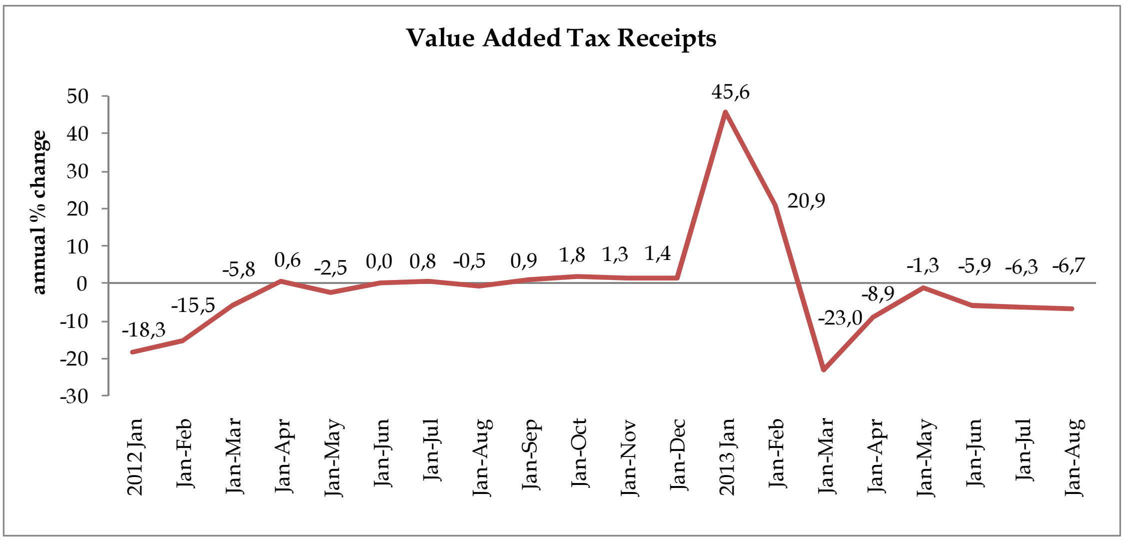
Allocation of Direct Taxes 2012 vs 2013 (January-August)



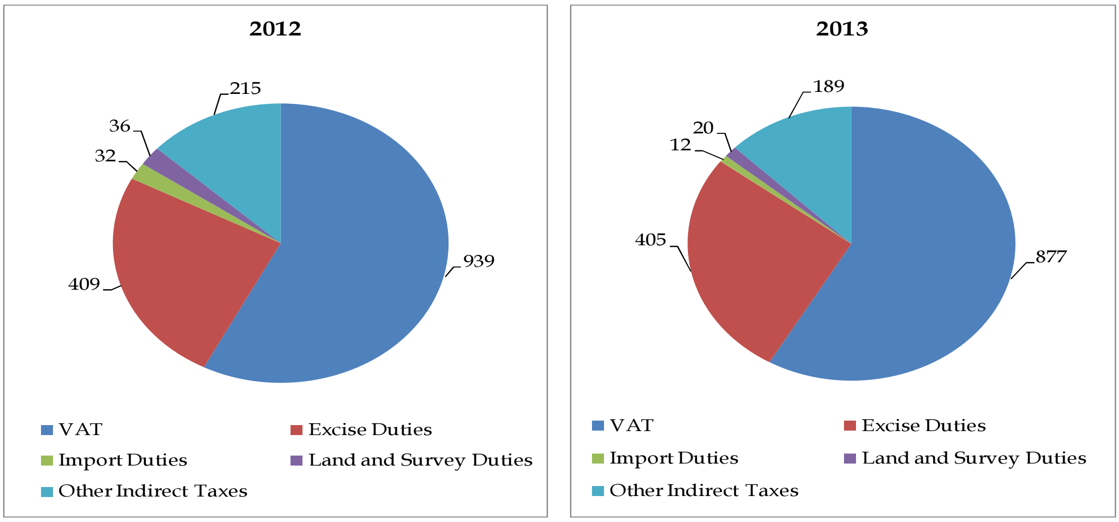
5.1.1.2 Indirect Taxes

During the period under review indirect taxes decreased to €1.503 mil. in 2013 compared to €1.631,8 mil. in 2012, recording a decrease of 7,9%, despite, increased excise rates on alcohol, tobacco and petroleum products.

Specifically, revenues from VAT receipts decreased at a rate of 6,7% and were limited to €876,5 mil. compared to €939,3 mil. the corresponding period of 2012. This development is mainly due to the decrease in activity in the construction sector and the domino effects on consumption together with a reduction in imports.

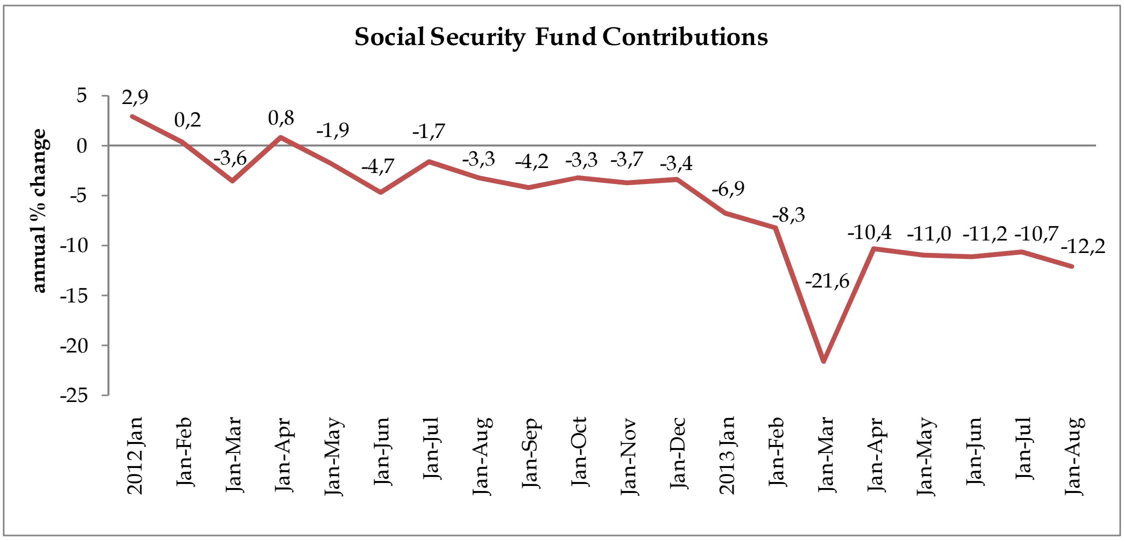


Allocation of Indirect Taxes 2012 vs 2013 (January-August)



Contributions to the Social Insurance Fund

The contributions to the Social Insurance Fund show a decrease of 12,2% reaching €602 mil. in the reporting period compared to €685,9 mil. the corresponding period the previous year. This decrease reflects reductions in earnings combined with a reduction in employment.



5.1.2 Non-tax revenue

Non-tax revenue amounted to €655,3 mil. compared to €496,4 mil. in the first eight months of 2012, an increase of 32%. This increase was due to temporary royalty revenues for the extraction of hydrocarbons in Cyprus' EEZ and increased dividends from the Central Bank.

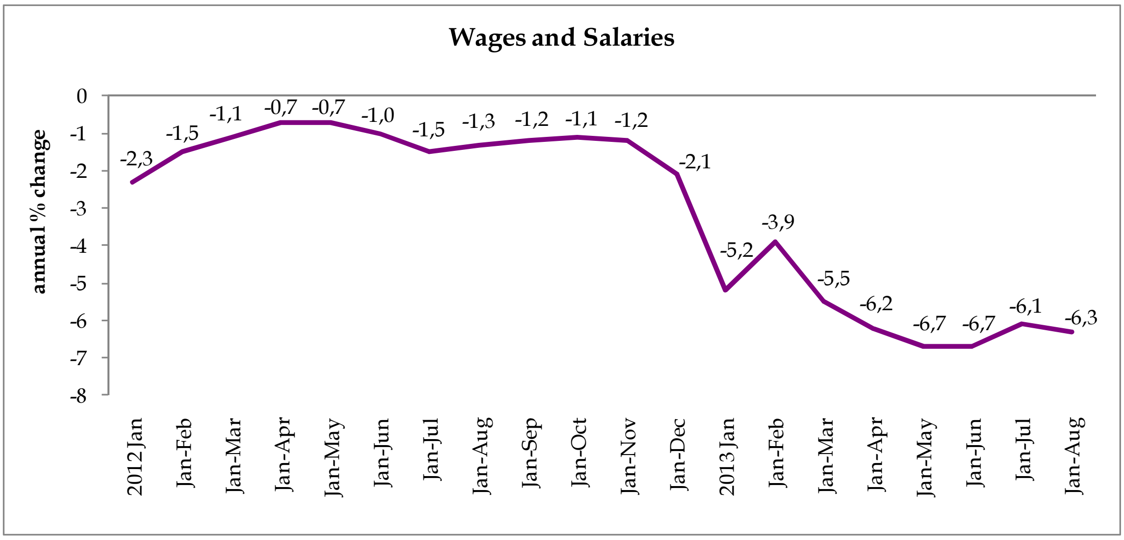
5.2 Expenditure

Public spending decreased at a rate of 5,2% during the months of January-August 2013 compared to the corresponding period of 2012. In absolute terms, public spending reached €4.418,9 mil. in 2013 compared to €4.662,1 mil. in the corresponding period of 2012.

Specifically, capital expenditures, other current transfers, purchases of goods and services and spending on salaries and wages, have been reduced due to the implementation of measures adopted within the framework of the macroeconomic adjustment program. Spending on pensions and gratuities and expenditure of the Social Insurance Fund depict an increase due to the increased number of early retirements and beneficiaries of unemployment allowances, redundancy allowances and pensions respectively.

Wages and Salaries

Specifically, salaries and wages decreased at a rate of 6,3% during the reference period of 2013 compared to the same period of 2012, reaching €1.117,4 mil. from €1.192,3 mil. the previous year. The reduction in expenditure on wages and salaries is mainly due to the decrease in employment due to acceleration in the number of early retirements.



Goods and Services

Expenditures for purchases of goods and services[4] have decreased by 7,8% reaching €268,3 mil. in January-August 2013 compared to €291 mil. the corresponding period of 2012.

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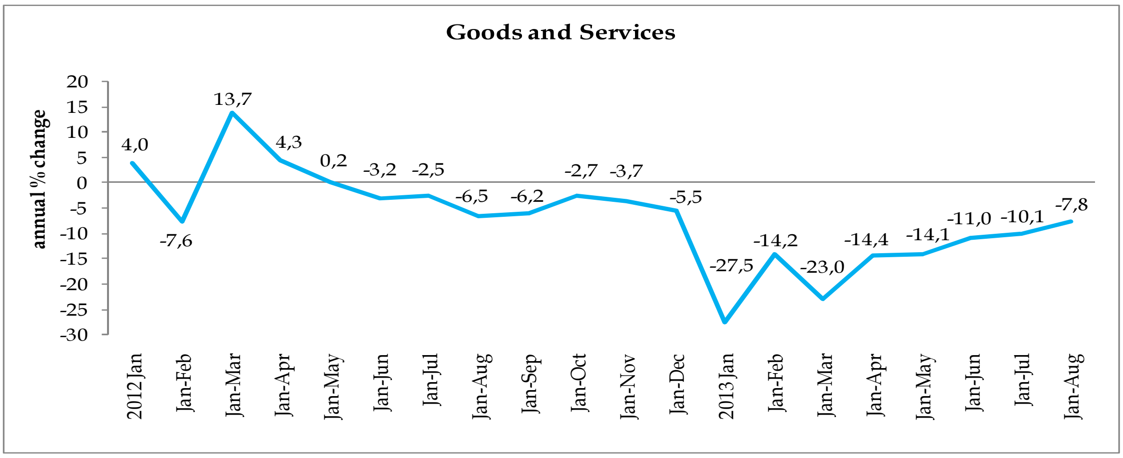
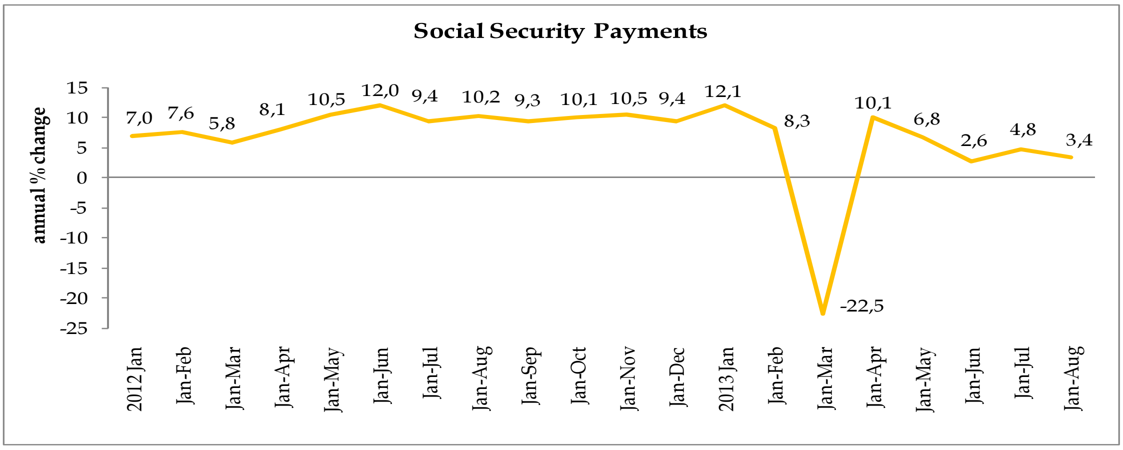
[4] Expenditure on goods and services cover costs for purchase of medicine and vaccines, buying water, personnel training/conferences, publications and publicity, etc.



Expenditure of the Social Insurance Fund

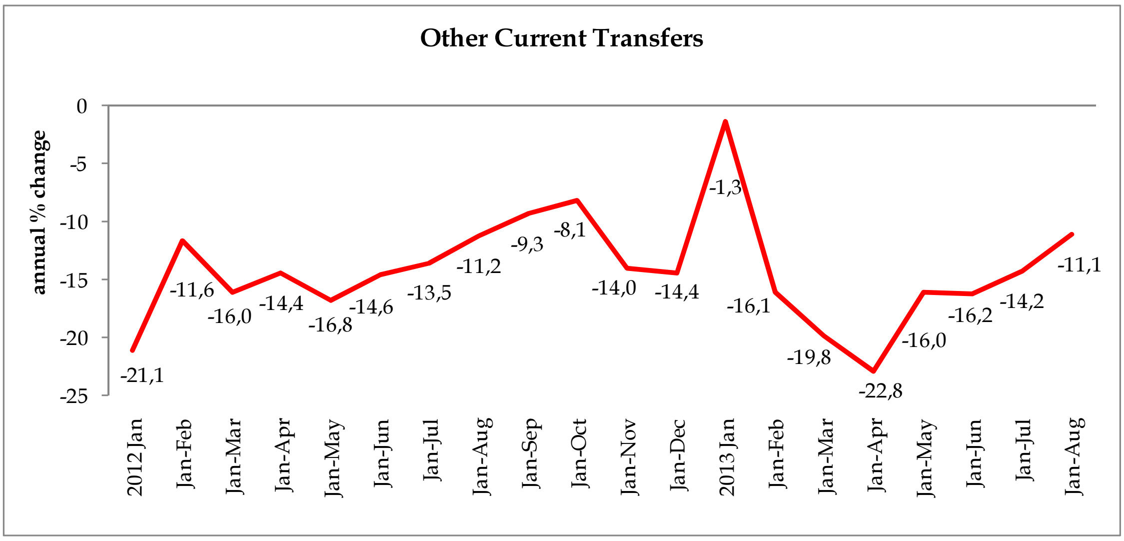
Payments from the Social Insurance Fund grew by 3,4% reaching €974,5 mil. in January-August 2013 compared to €942,1 mil. the corresponding period of 2012. The increase was primarily due to increases in spending on unemployment benefit, redundancy allowance and beneficiaries of old age pension.



Current Transfers

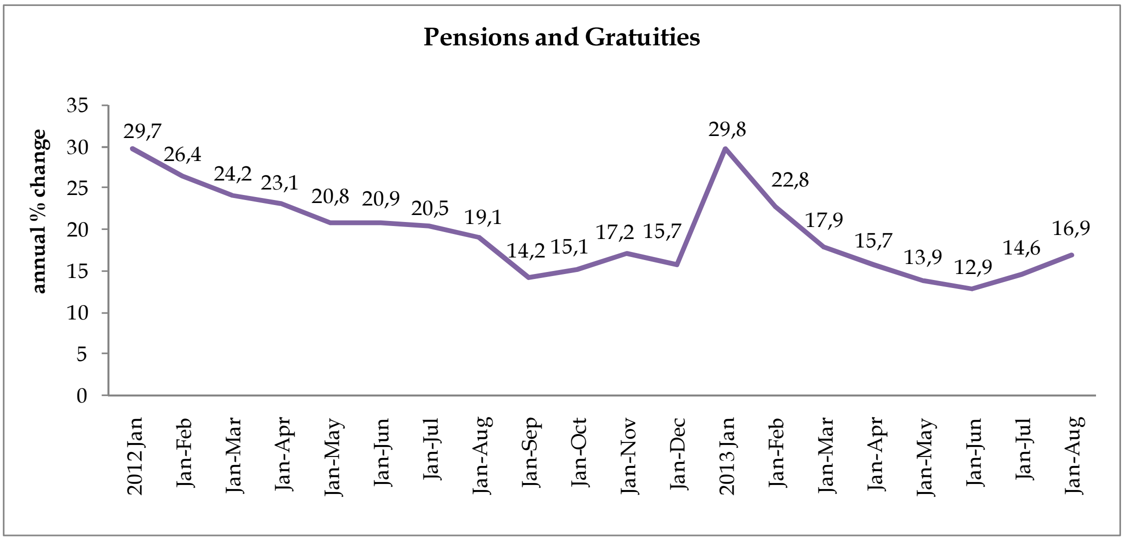
The category of other current transfers[5] decreased by 11,1% reaching €959,6 mil. for the period January-August 2013 compared to €1.079,5 mil. the corresponding period last year. The decreasing rate reflects the targeting of social welfare plans, the reduced transfers to state agencies and local authorities. Part of this decline can be attributed also to cyclical factors.

[5] Current transfers include, among other, expenses for pensions and gratuities, social pension, child benefit, student grants, public benefits, grants to semi-government organizations and Local Authorities, and financing the budget of the EU.



Pensions and Gratuities

Spending on pensions and gratuities grew by 16,9% compared to the corresponding period the previous year, reaching €413,7 mil. compared to €354 mil. the corresponding period of 2012. This increase is due to the acceleration in the growth of voluntary retirements.



Capital Expenditure

Capital expenditure during January-August 2013 depicted a decrease of 44,6% and reached €99 mil. compared to €178,7 mil. the corresponding period of 2012. This development is mainly due to the reduction of appropriations for capital expenditures and the delay in dealing with the obligation for land expropriation.

6. Financing 2013

The debt and financing transactions of 2013 are related mainly to financing from the European Stability Mechanism (ESM) and the International Monetary Fund (IMF) or to provisions of the Cyprus Economic Adjustment Programme.

The annual financing up to the 3rd quarter 2013 was €6.159 mil. The main source were the loans by the ESM amounting to €3 bil., which covered the government financing needs and in particular the debt maturities. The disbursements by the IMF amounted to €168 mil.

In July the state offered for exchange 18 domestic bonds that were due over 2013-2016 for new bonds of equal coupons due over 2019-2023. A total of €1 bil. was exchanged via the offer, fulfilling the relevant provision of the Economic Adjustment Programme.

In July the state rolled over up to July 2014 the zero coupon bank recapitalization bond of €1,89 bil. with a capitalization of yield so that the new nominal amount reached €1,99 bil. The bond was originally issued for the recapitalization of Laiki Bank and later transferred to the balance sheet of the Bank of Cyprus. It is noteworthy that the €1 bil. government guarantee provided to the Laiki Bank over 2012 was also transferred to the accounts of the Bank of Cyprus.

Throughout the year a €1 bil. stock of Treasury Bills at the very short-term tenors of 1 to 3 months has been rolled over on a continuous basis. The yields at around 5%, are at considerably high levels, although a small decline was marked over the third quarter. The short-term securities are expected to cover the remaining financing needs of the year.

At the end of the 3rd quarter the ESM disbursed bonds for the recapitalization of the cooperative sector for an amount of €1,5 bil. which corresponded to an equal increase in the public debt stock.

An important accomplishment of the year was the change in the terms of the bilateral loan from the Russian Federation, which had been granted over 2011-2012, with a reduction of the interest rate from 4,50% to 2,50% and a change in the maturity from 2016 to 2018-2021.

Finally, the sovereign credit rating was reduced to the levels of "C" which correspond to a highly risky investment. During the bond exchange the Republic was downgraded to a selective default grade. This rating was waived with the completion of the exchange. With the rating upgrade the government securities were reaccepted at the European Central Bank for monetary policy transactions with criteria specifically announced by the Bank.

7. Balance of Payments 2013

The current account deficit recorded a deterioration from 3,4% of GDP (€601,8 mil.) in 2011 to 6,9% (€1.217,1 mil.) in 2012 mainly due to the deterioration of the income account due to the decrease of income from direct investment (reduced profits or also losses of companies of Cypriot interests abroad). The goods and services balance recorded a significant improvement, with the deficit decreasing from 4,3% of GDP (€763,3 mil.) in 2011 to 3,1% (€545,9 mil.) in 2012 mainly due to the decrease in imports of goods.

According to preliminary balance of payments data for the first half of 2013, the current account recorded a deficit of €150,3 mil. compared to a deficit of €652,7 mil. the same period last year. This significant improvement is mainly due to the improvement of the goods balance where the deficit reduced from €1.904,1 mil. in the first half of 2012 to €1.381,6 mil. in the first half of 2013 due to the significant decrease in imports of goods. Although the surplus in the services balance reduced during the same period due to the decreases in exports of services, in total a small surplus was recorded in the balance of goods and services during the first half of 2013.

In 2013 as a whole, the currect account deficit is expected to reach around 2% of GDP.

8. Monetary Developments

This year 2013 was marked by the developments in the banking sector. The deposits of the private sector recorded a reduction in July 2013 of €20,7 bil. compared with the same month of the previous year and a reduction of €13,9 bil. compared to March 2013. The reduction reflects the agreement made by the Eurogroup for the recapitalization of the banking system which had a provision among others for the restructuring and consolidation of the two big Cypriot banks with the degree for impairment of existing deposits over €100.000, the continuing outflow of deposits that followed, as well as loan repayments.

Regarding credit, the annual growth rate of credit to the private sector in May 2013 recorded, for the first time in the last six years that comparable data are available, a negative rate of change which in July 2013 was at -8,3% compared with an increase of 10,1% in July last year. The rate of change in credit for housing loans was at around -3,7%, for consumer loans at -7,9% and for corporate loans at -11,2%. As can be seen from the data, both domestic households and domestic business move to redress the balance sheets.

On 2 May 2013 the Governing Council of the ECB decided to reduce its main interest rate by 0,25%. As a result, the main refinancing rate is now at 0,50%. According to the ECB the reduction is compatible with the limited inflationary pressures, while it is expected to contribute also and to the development prospects of the euro area.

In Cyprus, after the CBC informed the local financial institutions that as from May 2013 it will impose additional capital requirements in cases of offering higher deposit rates, a downward trend was recorded in deposit rates, which are in a converging path to the corresponding rates of the ECB. Despite the downward trend in deposit rates, interest rates on new loans do not record, at least like expected, the corresponding reductions and therefore they continue to diverge from the corresponding rates of the ECB. The main reason for this trend in lending rates is that, taking into account the current market conditions, the domestic financial institutions impose stricter conditions when granting loans to their customers, such as high interest rates.

9. Cyprus Economic Prospects for 2014

The Cyprus economy is expected to continue contracting in 2014 and show a negative growth rate of 3,9% according to the original provision included in the macroeconomic adjustment programme.

The environment of lack of confidence, the uncertainty, the fiscal challenges, the narrow liquidity and the general developments in the banking sector are expected to continue to negatively impact growth. The outlook for tourism is to maintain the levels of 2013.

On the supply side, the outlook is negative for most sectors of the economy, due to the shrinkage of the financial sector and the broader challenges that it faces, the reduced liquidity in the economy and the expected further decline in consumer demand and investments. Particularly likely to be affected adversely are the industry, construction and trade sectors. Beyond that, the negative trend is expected to continue in financial services, while other sectors of services will also face serious challenges, especially those related to trade and construction.

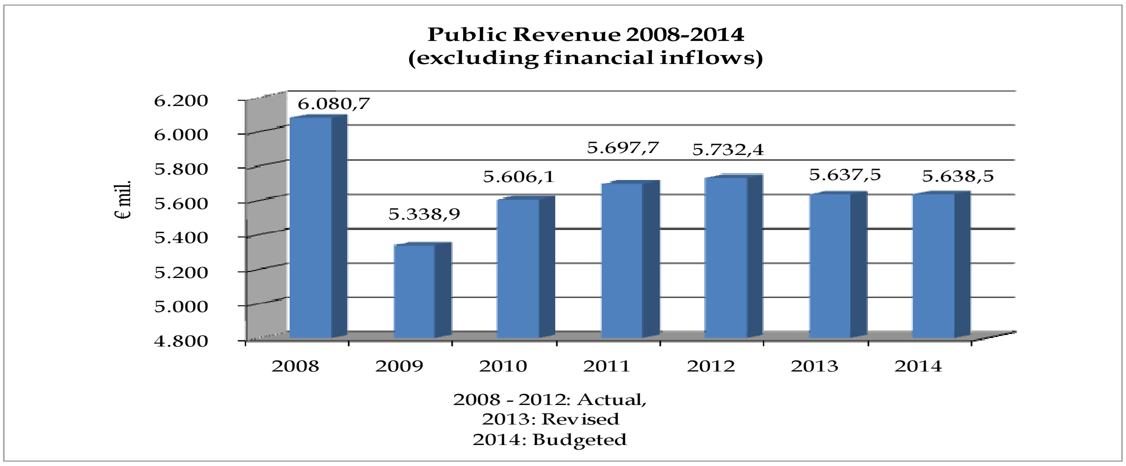
The unemployment rate is projected to show further deterioration and increase to 19,5% of the labour force. Inflation, based on the Harmonized Index of Consumer Prices (HICP), is expected to increase from 1% in 2013, to 1,2% in 2014. Following 2013, the current account deficit in 2014 is expected to improve and reach around 0,6% of GDP.

In summary, the projections of the Ministry of Finance appear in the following table:

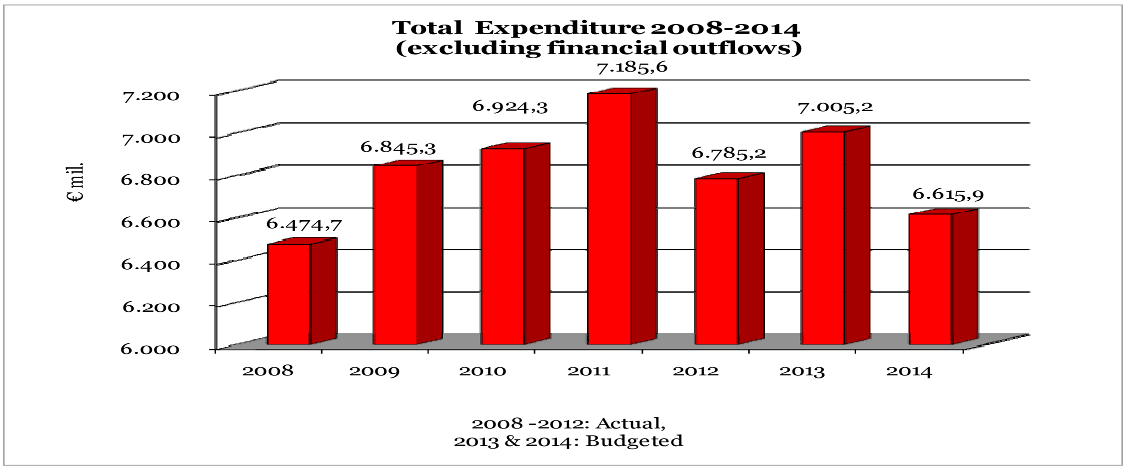
	2012	**2013**	**2014**
Growth Rate (%)	-2,4	-8,7	-3,9
HICP Inflation (%)	3,1	1,0	1,2
Unemployment (%)	11,8	17,0	19,5
Current Account Balance (% of GDP)	-6,9	-2,0	-0,6

IV. BUDGET 2014

Overall, in the draft budget for 2014, revenue forecasts, excluding financial flows, amount to €5.639 mil. compared to the revised revenue figures for 2013 of €5.637 mil.



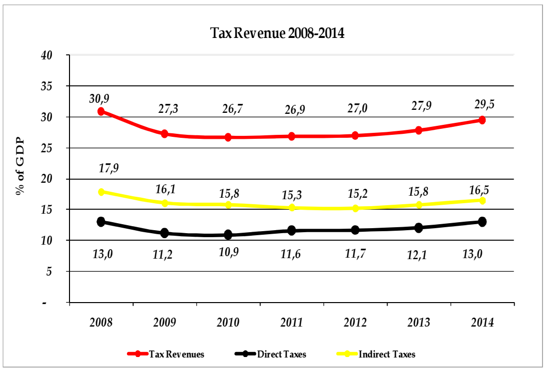
The total budgeted appropriations in the 2014 Budget, excluding financial flows, amount to €6.616 mil. compared to €7.005 mil. in 2013 depicting a decrease of about 5½%. **Total expenditure, excluding financial flows, interest payments, reserves and payments for previous years, is budgeted at €5.599 mil. compared to €6.225 mil. in the 2013 budget, a decrease of 10% or €626 mil. in absolute numbers.**

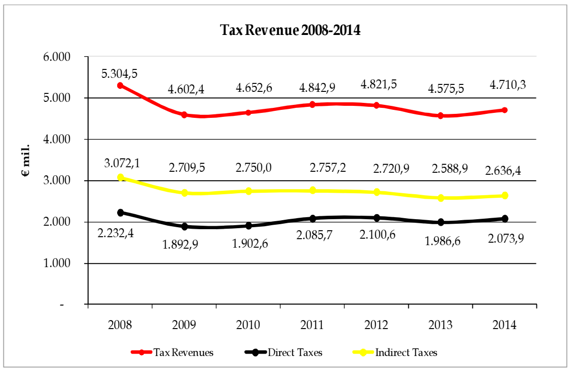


1. Revenue

Government revenues in recent years have shown a sluggish growth as a result of the negative economic climate prevailing in the economy. As a percentage of GDP, government revenues are budgeted to remain stagnant in absolute terms, due to the introduction of additional measures to support them, while as a percentage of GDP is expected to increase to 35⅓% in 2014 compared to 34⅓% in 2013 due to shrinking of GDP.

The main categories of revenue are the direct and indirect taxes and in total are budgeted for 2014 to €4.710 mil. and represent 83½% of total revenue. The remaining 16½% of income regard non-tax revenues, such as sales of goods and services and transfers, which for 2014 are budgeted at €929 mil.





Tax revenue in 2014 is forecasted to increase by 2,9% compared to an estimated decrease of 5,1% for 2013, and as a percentage of GDP tax revenues in 2014 are budgeted to increase to 29,5% compared to 27,9% in 2013. The increase is due to the imposition of measures from 1/1/2014 which are included in the macroeconomic adjustment program and analyzed in Part 3 Fiscal Forecasts for 2014 of Chapter IV Budget 2014.

In addition to the above, the Council of Ministers through the budget bill of 2014 authorized the following two measures that affect the strand of tax revenue relating to:

- Taxation of pensionable emoluments of widows.
- 3% contribution on the emoluments of Special Army Officers, the Special Constables and temporary staff for pension purposes.

Revenue from direct taxation as a percentage of GDP, is budgeted to rise to 13% in 2014 compared to 12,1% the previous year while revenue from indirect taxation, as a percentage of GDP, is budgeted to rise to 16,5% compared to 15,8% in 2013.

1.1 Direct Taxation

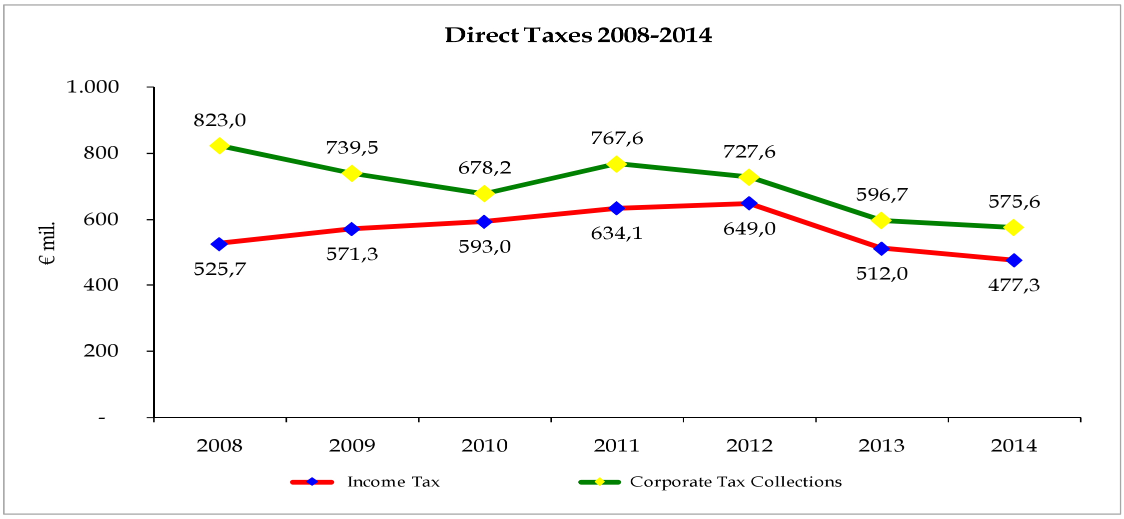
Revenue from direct taxation in 2014 in absolute terms, is forecasted to reach €2.074 mil. compared to revised revenue of €1.987 mil. in 2013, an increase of 4,4%. This increase results from the additional reduction of 3%, from 1/1/2014, on staff emoluments of the public sector and the introduction of contribution of 3% on the emoluments of special categories of personnel[6] for pension purposes, from taxation of widows pension, extending the coverage of the extraordinary contributions and salary reductions implemented in the second half of 2013 relating to the contribution of 1,5% of the emoluments of the personnel in the public sector health care and cascading reductions on earnings of the broader public sector.

[6] It concerns the Five Year Volunteer Service, the Special Constables and temporary staff.

Specifically, revenues from direct taxation by subcategory are as follows:

a. Revenue from personal income tax

Forecasted to decrease in 2014 by 6,8% following the expected decline of 21% in 2013 and will reach €477 mil. compared to the revised revenue of €512 mil. in 2013 due to the decline in employment and the level of earnings.



b. Revenue from corporate tax

Forecasted to decrease in 2014 by 3,5% following the expected decline of 18% in 2013 and will reach €576 mil. compared to the revised revenue of €597 mil. in 2013.

c. Income from property taxes[7]

Forecasted to increase in 2014 by 23% and to reach €134 mil. compared with the revised revenue of €110 mil. due to the partial collection of property tax of 2013 in 2014.

d. Income taxes from motor vehicles

Forecasted to increase in 2014 by 15% and to reach €72 mil. compared to the revised revenue of €62 mil. in 2013 due to the modernization of the taxation of motor vehicles based on environmentally friendly principles, through the annual vehicle driving fee, the registration fee and excise duties on motor vehicles.

e. Other Direct Taxes[8]

Forecasted to increase in 2014 by 15,4% and to reach €815 mil. compared to the revised revenue of €706 mil. in 2013 due to the measures mentioned above.

[7] Revenue from property tax consist of, the capital gains tax and the taxes on dividends.

[8] Other direct taxes consist of «Special Contribution», «Defense Contribution», «Contribution for Widows and Orphans Pension», «Retirement Contribution», «Earnings Deductions», «Contribution for Health Care».

1.2 Indirect Taxation

Revenue from indirect taxes is expected to increase slightly in 2014 and reach €2.636 mil. compared to revised revenue of €2.589 mil. representing an increase of 1,8% due to the measures that were included and adopted within the macroeconomic adjustment program, compared to the expected decrease of 4,9% in the previous year.

Specifically, the main revenues by subcategory of indirect taxation are as follows:

a. Revenue from Import Duties
Forecasted to decrease in 2014 by 4% and limited to €21 mil. compared to the revised revenue of €22 mil. in 2013 due to the expected decrease in imports from third countries.

b. Revenue from Consumption Tax
Forecasted to increase in 2014 by 5,2% and reach €612 mil. compared to the revised revenue of €582 mil. in 2013 due to increased duties on motor fuels of 5 cents/liter.

c. Revenue from Value Added Tax
Forecasted in 2014 to increase marginally by ½% and reach €1.658 mil. compared to the revised revenue of €1.648 mil. in 2013 due to the increase in both the standard and the reduced rate of VAT by one percentage point from January 2014.

1.3 Non-tax revenue

Forecasted in 2014 to decrease to €928 mil. compared with the revised revenue of €1.062 mil. in 2013, a decrease of 12,6% due to non-retaining the temporary revenues of 2013.

2. Expenditure

Total expenditure, excluding financial transactions, interest payments, reserves and payments from previous years, are budgeted at €5.599 mil. compared to €6.225 mil. in the 2013 budget, a decrease of 10% or €626 mil. in absolute numbers. The total budgeted expenditure in the Draft Budget for 2014, excluding financial flows, amount to €6.616 mil. compared to €7.005 mil. in 2013, depicting a decrease of 5½%. Total expenditure, including financial flows, interest payments and reserves and payment of previous years, are budgeted at €7.740 mil. in 2014 compared to €9.812[9] mil. in the previous, depicting a decrease of 21%.

Total expenditure, excluding financial transactions as a percentage of GDP in 2014, is projected to decrease to 41,5% compared with 42,7% the previous year.

Specifically, in 2014, staff costs including pensions and gratuities are calculated to increase as a percentage of GDP, to 16,1% compared to 15,9% in 2013. Transfers are,

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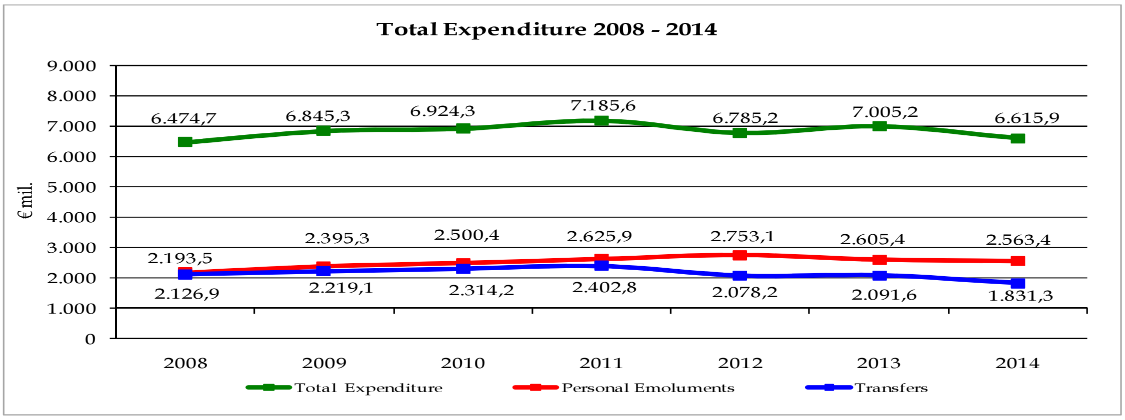
[9] Includes the supplementary Budget Law of 2013 concerning the payment of compensation of €299 mil. to the provident and pension funds that at the 26th of March 2013 had deposits in the ex Laiki Bank.

mainly due to the reduced appropriations within the framework of targeting social transfers, reduced as a share of GDP to 11,5% from 12,7% in 2013. Operating costs in 2014, as a percentage of GDP, are budgeted to show a decrease to 6,1% from 6,8% in 2013 and capital expenditure is budgeted to decrease to 3,1% compared to 3,5% the previous year. In contrast, public debt repayment, as a percentage of GDP, increases to 4,9% from 4,2% in 2013.

Details of the main categories of expenditure are as follows:

Personnel Expenditure

Personnel expenditure is the largest category of public spending, including pensions and gratuities. For 2014, personnel expenditure is forecasted to decrease to €2.563 mil. compared to €2.605 mil. in 2013, a decrease of around 1½%. Specifically, in 2014 personnel expenditure is expected to decrease by 6,4% compared to the previous year due to the decline in employment, freezing recruitment and repealing number of vacancies, while pensions and gratuities are budgeted to grow at a rate of 16,6% due to the expected increase in the number of early retirements.

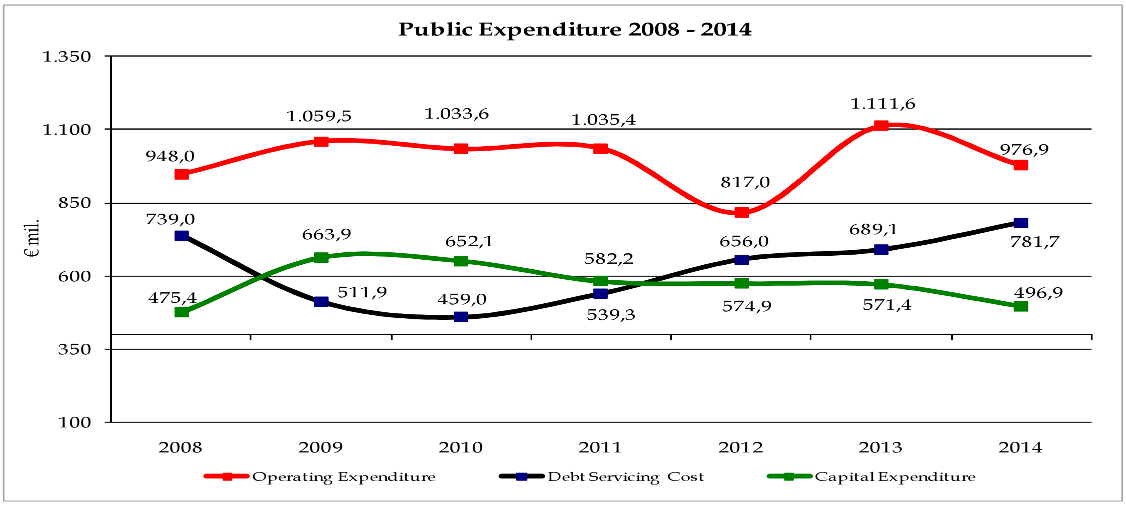


Transfers

The second largest category of spending is transfer payments consisting mainly of social benefits, state grants to semi-government organizations and Local Authorities, as well as contributions to the Social Security Fund and the EU budget. In 2014 , this category is expected to be reduced at a rate of 12,4% and reach €1.831 mil. compared to €2.092 mil. in 2013, due to the targeting of social transfer plans with savings up to €127 mil. and reduced grants for state agencies and committees as well as Local Authorities by €19 mil. and €13 mil. respectively.

Operating Expenses

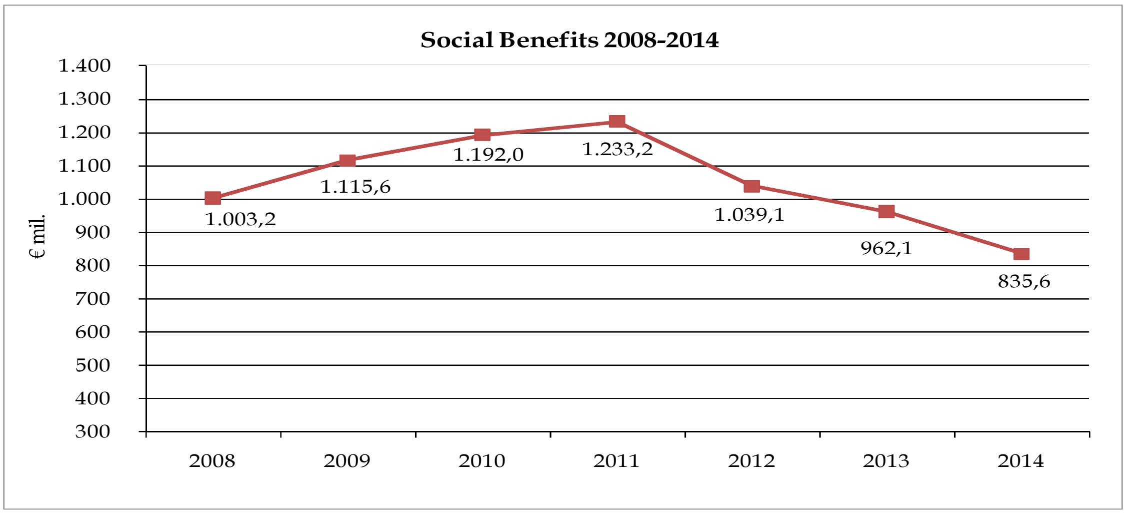
Operating expenses are projected to decrease to €977 mil. in 2014 compared to €1.112 mil. in 2013, a decrease of around 12% due to renegotiation of rents, reduced appropriations for elections and reduced appropriations for the purchase of water and drugs.



Capital Expenditure
Capital expenditures are budgeted to fall to €497 mil. compared with €571 mil. in 2013 due to completion of major development projects and due to limited funds to purchase equipment.

Servicing Public Debt
Spending on debt service (interest) for 2014, is budgeted to grow at a rate of 13,4% and reach €782 mil. compared to €689 mil. in 2013 due to increased level of government debt.

Social Benefits - Expenditure
Within the framework of the government's economic policy to consolidate public finances and the continuous effort to improve social cohesion and in particular to strengthen vulnerable population groups we have a significant increase in targeting social spending (i.e. direct allowances to beneficiaries). In the draft budget for 2014, social benefits are budgeted to decrease by 13%. In absolute numbers they are forecasted to reach €836 mil. compared to €962 mil. the previous year.



3. Fiscal Forecasts for 2014

The targets set and included for the primary balance in the macroeconomic adjustment program is a maximum primary deficit of 4¼% of GDP in 2014 then a decrease to 2,1% of GDP in 2015 and by 2016 the deficit reverses to a surplus of 1,2% of GDP as follows:

Year	Primary Balance (€ mil.)	Percentage of GDP
2013	-395	-2,4
2014	-678	-4¼
2015	-344	-2,1
2016	204	1,2

To achieve the above targets, several measures have been agreed and included in the macroeconomic adjustment program, covering both the revenue side and the expenditure side as follows:

Revenue measures:

- Extension of the temporary contribution from total gross salaries and pensions of public servants and private sector until 31 December 2016 as follows: €0-1,500: 0%, €1,501-2,500: 2,5%, €2,501-3,500: 3%, and >€3,501: 3,5% (overall implication €58 mil.).
- Increase of the standard VAT rate from 18% to 19% (overall implication €37 mil.).
- Increase of the reduced VAT rate from 8% to 9% (overall implication €9 mil.).
- Increase the excise tax on motor fuels (gasoline and diesel) by 5 cents per liter (overall implication €29 mil.).
- Increase in the contributions of employees and employers in GSIS by two additional percentage points on pensionable earnings, i.e one (1) percentage point from employees and one (1) percentage point from employers and two (2) percentage points in the case of self-employed.

Expenditure measures:

- Reduce the total expenditure of social transfers by at least €28,5 mil. through rationalization and better targeting of the child benefit, the student grant and by repealing social cohesion benefits provided by the Social Welfare Services.
- Reduction in the emoluments of employees, hourly staff and retired public and broader public sector employees by 3% (overall implication €55 mil.).
- Introduction of a fee on monthly transport passes for students and pensioners for public transport (overall implication €10 mil.).
- Implement on an annual basis the reductions implemented in the second half of 2013 relating to a contribution of 1,5% on the emoluments of the personnel of the public sector for the provision of health care and the staggered salary reductions of the public sector.

In addition, the Council of Ministers, taking into account that the risks to the economy persist with potential adverse effects on public finances and especially on the revenue side, together with the approval of the bill of the Budget Act of 2014 and the Medium-Term Budgetary Framework 2014–2016, it approved the adoption of additional measures beyond the measures that were included in the macroeconomic adjustment program as follows:

- Further rationalization of wage benefits (total budgetary savings €18 mil.).
- Taxation of widows pension that currently remains tax-free (total budgetary savings €8 mil.).
- Contribution of 3% for pension purposes of pensionable emoluments of Five Year Volunteer Service, the Special Constables and temporary staff (total budgetary savings €6 mil.).
- Targeting social pension on the basis of income criteria (total budgetary savings €10 mil.).

Further to the above, to achieve the budgetary targets set, the 2014 Draft Budget as well as the MTBF 2014-2016 achieve fiscal discipline with the operating and non-productive expenditure being reduced to the greatest extent possible, while there are increased appropriations for the completion of co-funded by the state budget projects, due to the imminent end of the programming period 2007-2013.

Based on the above, the 2014 fiscal deficit as a percentage of GDP, is projected to fluctuate, slightly below 7% compared to around 5½%[10] the previous year mainly due to the expected contraction of economic activity and the non-retaining of some temporary revenues of 2013. The next two years, according the current trends and policy, the fiscal deficit is projected to improve and be contained to around 4½% of GDP.

A similar picture is expected for the primary balance in 2014, which is projected to be in deficit, approximately 3% of GDP compared to 2½% the previous year. The next two years the primary balance is projected to improve and move closer to balance.

The public debt for 2014 is projected to reach €19.631 mil. from €18.767 mil. the previous year and as a percentage of GDP it is projected to increase to 123% from 114% the previous year. In 2015, public debt is projected, in absolute numbers to reach €19.406 mil., while as a percentage of GDP it is reduced to 119%, while for 2016, public debt in absolute numbers is projected to decrease to €19.139 mil. and as a percentage of GDP it is reduced at 113%.

[10] Excluding the compensation that will be given to the provident and pension funds that had deposits in ex Laiki Bank.

4. Medium-Term Budgetary Framework (MTBF) 2014-2016

Non-financial income for 2015 is expected to amount to €5.694 mil. and in 2016 is expected to amount to €5.825 mil. as follows:

	1 Revised 2013 € mil.	2 Budgeted 2014 € mil.	2:1 % Change	3 Budgeted 2015 € mil.	3:2 % Change	4 Budgeted 2016 € mil.	4:3 % Change
DIRECT TAXES	1.987	2.074	4,4	2.104	1,47	2.183	3,71
INDIRECT TAXES	2.589	2.636	1,8	2.722	3,24	2.815	3,43
PROCEEDS FROM GOODS SERVICES RENDERED	213	231	8,3	232	0,44	231	-0,32
RENTS, ROYALTIES AND OTHER INCOME	333	177	-46,9	172	-2,41	168	-2,27
TRANSFERS	221	222	0,4	227	2,50	235	3,40
OTHER OPERATING INCOME	184	142	-22,9	141	-0,65	140	-0,33
GRANTS	112	157	41,1	95	-39,42	52	-45,07
TOTAL	**5.637**	**5.638**	**0,0**	**5.694**	**0,98**	**5.825**	**2,30**

According to the table below, total expenditure, excluding financial flows, for the years 2015 and 2016, will reach €6.613 mil. and €6.516 mil. as follows:

Total Expenditure by Department 2013-2016 excluding financial flows

	Ministry	2013 € mil.	2014 € mil.	% Change	2015 € mil.	% Change	2016 € mil.	% Change
01	CONSTITUTIONAL POWERS	56	54	-4,1	53	-0,9	53	-0,1
02	CONSTITUTIONAL SERVICES	25	22	-9,4	23	1,1	22	-1,5
03	INDEPENDENT SERVICES	11	11	-4,3	10	-1,3	10	-0,9
11	MIN. OF DEFENCE	347	319	-8,1	310	-2,7	294	-5,2
12	MIN. OF AGRUCULTURE, NATURAL RESOURCES AND ENVIROMENT	267	242	-9,3	243	0,4	218	-10,2
13	MIN. OF JUSTICE AND PUBLIC ORDER	299	271	-9,4	268	-1,1	262	-2,2
14	MIN. OF ENERGY, COMMERCE, INDUSTRY AND TOURISM	40	43	8,0	42	-3,5	39	-5,7
15	MIN. OF LABOUR AND SOCIAL INSURANCE	758	886	16,9	894	0,9	889	-0,6
16	MIN. OF THE INTERIOR	572	514	-10,1	471	-8,5	439	-6,7
17	MIN. OF FOREIGN AFFAIRS	79	75	-4,9	75	-0,8	75	0,3
18	MIN. OF FINANCE	2.828	2.274	-19,6	2.387	5,0	2.415	1,2
19	INDEPENDENT OFFICES	130	161	23,8	113	-29,6	115	1,6
20	MIN. OF EDUCATION AND CULTURE	967	924	-4,5	913	-1,2	900	-1,4
21	MIN. OF COMMUNICATIONS AND WORKS	327	278	-15,0	275	-1,0	255	-7,4
22	MIN. OF HEALTH	598	542	-9,3	535	-1,2	528	-1,3
Total		**7.304**	**6.616**	**-9,4**	**6.613**	**-0,1**	**6.516**	**-1,5**

5. Financing: Prospects for 2014

The annual financing needs for 2014, excluding the short-term debt obligations, are estimated to be about €1,8 bil. of which €1 bil. corresponds to the financing of the fiscal deficit and the rest to the long-term debt redemptions.

The aforesaid financing needs are planned to be covered via loans by the European Stability Mechanism and the International Monetary Fund. Furthermore, short-term Treasury Bills of around €1 bil. as well as the bank recapitalization bond of a nominal amount of €1,99 bil., originally issued for Laiki Bank, are expected to be rolled over.