Ministry of Finance

Stability Programme 2019-2022

April 2019

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 2019-2022 as approved by the Council of Ministers on 17th April 2019. 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 8th 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 but slower path, firmly establishing a period of sustained expansion based on solid economic indicators. According to the latest estimates published on 15th March 2019 by the Statistical Service of Cyprus, the economy expanded at an accelerated rate of 3.9% in real terms in 2018, following the real growth rate of 4.5% in 2017 and a 4.8% in 2016. Over the course of the programming period, economic activity is expected to remain strong, 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.

The decrease in the unemployment rate to 8.4% of the labour force in 2018 was the biggest exhibited in the EU, while employment increased by 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.

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.

Meanwhile, efforts towards advancing the structural reform agenda are going in order to improve competitiveness and build resilience. In summary the reform priorities, presented in detail in the National Reform Programme, aim at:

- Increasing the efficiency of the Public and Local Administration.
- Improving the efficiency of the Judicial System.
- Continuing the implementation of the reformed Insolvency and Foreclosure Frameworks.
- Reducing further the high level of non-performing loans and private debt.
- Boosting productive investment, enhancing competitiveness and improving the business environment.
- Improving the quality of Active Labour Market Policies, particularly for young people.
- Further promoting the reform of the education and training system.
- Implementing the health care reform.
- Promoting social and environmental sustainability.

This Stability Programme outlines the fiscal policy strategy for the period 2019-2022 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 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 3.2% of GDP in 2018, compared to a surplus of 1.8% the year before. This is excluding the effect of the one-off fiscal burden of €1,659 mn, that was the result of the sale of part of assets and liabilities of the Cyprus Cooperative Bank Ltd (CCB) to the Hellenic Bank, which when including it, budget balance turns negative at 4.8% of GDP. Over the medium term, nominal balance is projected to be in surplus at 3.0% in 2019, 2.6% in 2020 and hover around 2.3% of GDP during the period 2021-2022. The still strong fiscal performance is driven by favourable revenue developments, mainly due to the economic performance and further improvement in the labour market conditions, partly compensating the expected increases on the expenditure side, mainly stemming from the decision for the gradual abolition of wage cuts, as of July 2018. It is worth mentioning that the baseline scenario does not take into account expected proceeds from KEDIPES[1], which is an upside risk to the projections.

The nominal budget surplus corresponds to sizeable primary surpluses over the programming period 2019-2022, averaging at 4.6% of GDP, thus, 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 2.4% of potential GDP in 2018 and is forecast to remain in surplus averaging 0.7% over the period 2019-2022, overachieving 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 2018 increased by about 6.8 p.p. to 102.5% compared to 95.8% the year before. In absolute terms, general government debt increased by €2.5 bn reaching €21.3 bn by the end of 2018 compared to €18.8 bn by the end of 2017. This increase is attributed to the bond issuance in favour of ex Cyprus Cooperative Bank, of the amount of €3.19 bn in order to facilitate the sale of the bank. However, during 2018 the government proceeded also with the early repayment of the loans towards the Cyprus Cooperative Bank (at the time in the Hellenic Bank balance sheet) and to the Central Bank of Cyprus for the amounts of €324 million and €483 million respectively, thus reducing the increase of public debt stemming from the abovementioned issuance of bonds. In 2019 general government debt is estimated to fall at 95.7% of GDP, and continue its downward trend declining to about 89.1%, 83.0% and 77.5% by the end of 2020, 2021 and 2022 respectively, in full respect of the debt rule in the preventive arm of the SGP.

As always, the authorities will continue to monitor fiscal developments and in case of deviation stand ready to adopt the necessary corrective measures, in order to fully comply with the Stability and Growth Pact obligations.

[1] The sale process of part of the assets and liabilities of the Cyprus Cooperative Bank Ltd (CCB) to the Hellenic Bank resulted in the establishment of two new entities, namely the Cooperative Asset Management Company Ltd (SEDIPES) and Cyprus Asset Management Company Ltd (KEDIPES), which are both classified within the General Government sector as of September 2018.

2. ECONOMIC OUTLOOK

2.1 MACROECONOMIC DEVELOPMENTS 2018

2.1.1 GLOBAL ECONOMY

According to the European Commission Winter Forecast 2019, world economic growth remained at the same levels as 2017 (3.9%), with varying growth rates across countries and regions.

Economic growth in the EU slowed down in 2018 compared with 2017 (2.1% versus 2.4%), mainly reflecting fading support from the external environment. Similarly, the euro area economy grew at a rate of 2.1% in 2018, compared with 2.4% in 2017. Although all Member States recorded positive economic growth in 2018, economic performance is still uneven across countries.

The economy of UK, which is an important trade partner for Cyprus, grew by 1.3% in 2018 compared with 1.7% the year before, amid heightened uncertainty regarding its decision to exit the E.U.

The unemployment rate in the euro area stood at around 7.9%, its lowest level since 2009, with improved labour market conditions across all Member States but substantial differences in unemployment remain.

Inflation in the EU and euro area accelerated in 2018 (2.0% and 1.8% respectively), amid improving labour demand conditions and stronger economic activity.

The euro has weakened somewhat against the dollar, since the end of September 2018 when it traded above the 1.17 level. Euro's depreciation came to a period of broad-based strengthening of the US dollar, which had benefited from a solid short-term US economic outlook in the context of stimulating US fiscal policy, as well as from prospects of tighter US monetary policy in the near-term. This contrasted with increasing evidence of a more pronounced-than-expected deterioration of the economic outlook for the euro area. A less supportive relative monetary policy stance between the ECB and Fed is likely to have contributed to the weakness of the euro exchange rate vis-à-vis the US dollar.

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. In numbers, the pound traded in the range of 0.85-.90 against the euro during 2018.

2.1.2 DOMESTIC ECONOMY

According to latest estimates published on 15th March 2019, the economy expanded at an accelerated rate of 3.9% in real terms in 2018, following a positive growth rate of 4.5% in 2017. Growth in 2018 was mainly driven by private consumption and net exports. Domestic demand grew by 3%, mainly driven by private consumption, which grew in real terms by 3.7%. Gross fixed capital formation was influenced by significant decreases in investment in transport equipment (SPEs) and recorded a decrease of 7.1%. Imports, in real terms, grew at a rate of 2% mirroring the trend of domestic demand, while exports, in real terms, also grew at a rate of 3.3%.

From a sectoral perspective, the economy's expansion was mainly due to the strong performance of construction, wholesale and retail trade, professional, scientific and technical activities, accommodation and

food service activities, transport and storage and manufacturing. Negative growth was recorded in the financial and insurance activities.

The accelerated rate of growth of the economy in 2018 was reflected in a higher rate of growth of employment, reaching about 4%. Employment growth was stronger in the sectors of construction, accommodation and food service activities, wholesale and retail trade, professional scientific and technical activities and manufacturing. Unemployment declined further and averaged at 8.4% of the labour force in 2018, after peaking at 16.1% in 2014 and subsequently falling to 14.9% in 2015, 12.9% in 2016 and 11.1% in 2017.

Compensation per employee, compared to the preceding year, increased in 2018 by 0.1%, following an increase of 0.7% in 2017 in contrast to a contraction of 1.1% in 2016 and a marked contraction of 1.2% and 3.6% in 2015-2016, respectively. As a consequence, nominal unit labour costs marginally increased in 2018 by 0.3%, following an increase of 0.6% and a decrease of 1.3% in 2017 and 2016, respectively.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), turned positive reaching 0.8% in 2018 from 0.7% in 2017. Inflation is driven by developments in international oil prices, with a significant impact on domestic prices of energy products. The HICP, excluding energy and unprocessed food and, in 2018 remained essentially at the levels of 2017.

According to the latest Balance of Payments data for 2018, Cyprus' current account balance improved in 2018, recording a deficit of €1,460.9 million (7% of GDP), compared with a deficit of €1,642.5 million (8.4% of GDP) in 2017. This development was attributed to the trade balance of goods, in particular exports of goods, mostly ships, which, during the year under review, recorded a higher increase than the respective imports. The aforementioned development was mitigated, mainly by the decrease recorded in services and, to a lesser extent, by the decrease recorded in primary and secondary income.

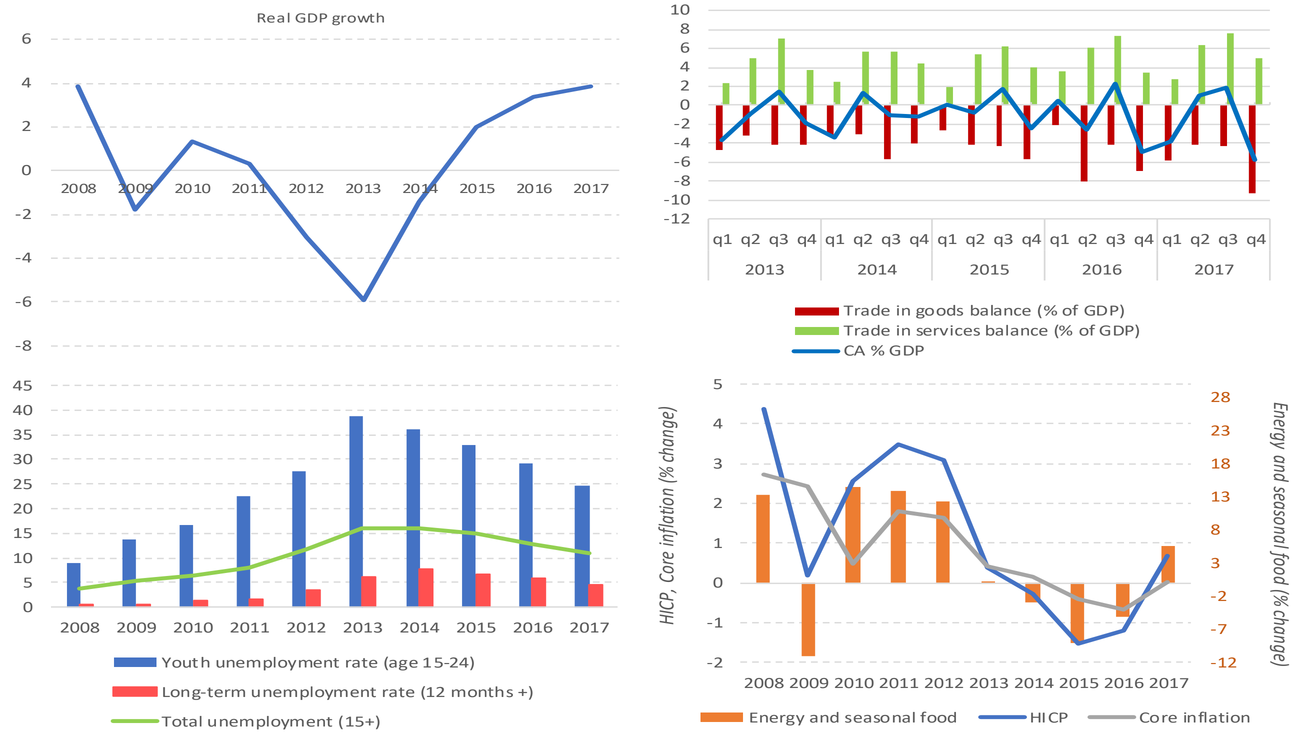
Table I: Selected economic indicators, 2016-2018, y-o-y %

	2016	**2017***	**2018***
GDP (constant prices)	4.8	4.5	3.9
Public consumption	-0.8	3.1	4.3
Private consumption	4.5	4.1	3.7
Gross Fixed Capital Formation	41.8	29.0	-7.1
Exports	4.6	6.0	3.3
Imports	6.6	12.2	2.0
Tourist arrivals (000's)	3,186.5	3,652.1	3,938.6
Tourist arrivals growth	19.8	14.6	7.8
HICP	-1.2	0.7	0.8
Labour productivity growth (persons)	0.2	0.2	-0.1
Employment growth	4.6	4.3	4.0
Compensation per employee	-1.1	0.7	0.1
Unemployment rate (Labour Force Survey)	12.9	11.1	8.4

Source: Statistical Service

**Provisional Data*

Figure 1: Economic trends



Source: Statistical Service and Central Bank of Cyprus

The international investment position remained virtually the same in 2018, showing a net liability position at €23,774.2 million, compared with €23,784.7 million the previous year. Foreign direct investment recorded a decrease in 2018 while portfolio investment and other investment registered an increase, nullifying the above decrease.

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 €102,533.2 million in 2018, compared with €108,512.2 million in 2017. This improvement was mainly due to the debt decrease of monetary financial institutions (excluding the CBC) and, to a lesser extent, the decrease in intercompany lending.

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 2008-2018 with the significant amelioration that took place between 2010-2015. In 2016- 2018 CA deficit widens to -5.1%, -8.4% and -7.0% respectively.

When excluding SPEs, however, the CA deficit actually improves. According to published data by the Central Bank of Cyprus, the CA deficit in 2018, the CA deficit excluding SPEs amounts to -4.5% of GDP.

Table II: Balance of Payments, 2008-2018

in per cent of GDP	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Exports of Goods	12.0	13.1	13.9	15.3	15.6	15.0	15.9	16.2	14.0	13.3	16.9
Imports of Goods	42.2	34.7	36.8	35.5	33.6	31.2	31.9	33.0	35.1	37.5	38.0
Goods Balance	-30.1	-21.6	-22.9	-20.2	-18.0	-16.2	-16.0	-16.7	-21.0	-24.2	-21.1
Services Balance	17.4	16.3	15.6	17.2	16.5	18.0	18.0	17.5	20.4	20.7	18.9
Primary Income Balance	-2.5	-1.3	-3.0	0.0	-3.0	-4.7	-3.6	0.6	-2.0	-2.7	-2.8
Secondary Income Balance	-0.3	-1.1	-1.0	-1.1	-1.4	-2.1	-2.7	-2.9	-2.4	-2.1	-2.0
Goods & Services Balance	**-12.8**	**-5.3**	**-7.3**	**-2.9**	**-1.5**	**1.8**	**2.0**	**0.8**	**-0.6**	**-3.5**	**-2.2**
Current Account Balance	**-15.5**	**-7.7**	**-11.3**	**-4.1**	**-6.0**	**-4.9**	**-4.3**	**-1.5**	**-5.1**	**-8.4**	**-7.0**
CAB (without SPEs)	…	…	…	…	…	…	**-5.8**	**-1.0**	**-0.4**	**-3.1**	**-4.5**

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 2018 amounted to -€8.5 bn or -43% of GDP. In 2018, the net IIP amounted to -€7.9 bn or -38.2% 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 three systemic domestic banks (Bank of Cyprus (BOCY), Hellenic Bank (HB) and RCB) which, together, represent a share of 72% in total deposits, while the remaining market consists of three Greek subsidiaries with a market share of about 16% and other smaller credit institutions.

The main banking institutions have been recapitalized 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 European 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 recapitalization and restructuring efforts, the infusion of equity capital and retained profits, the overall solvency ratio improved by a substantial margin.

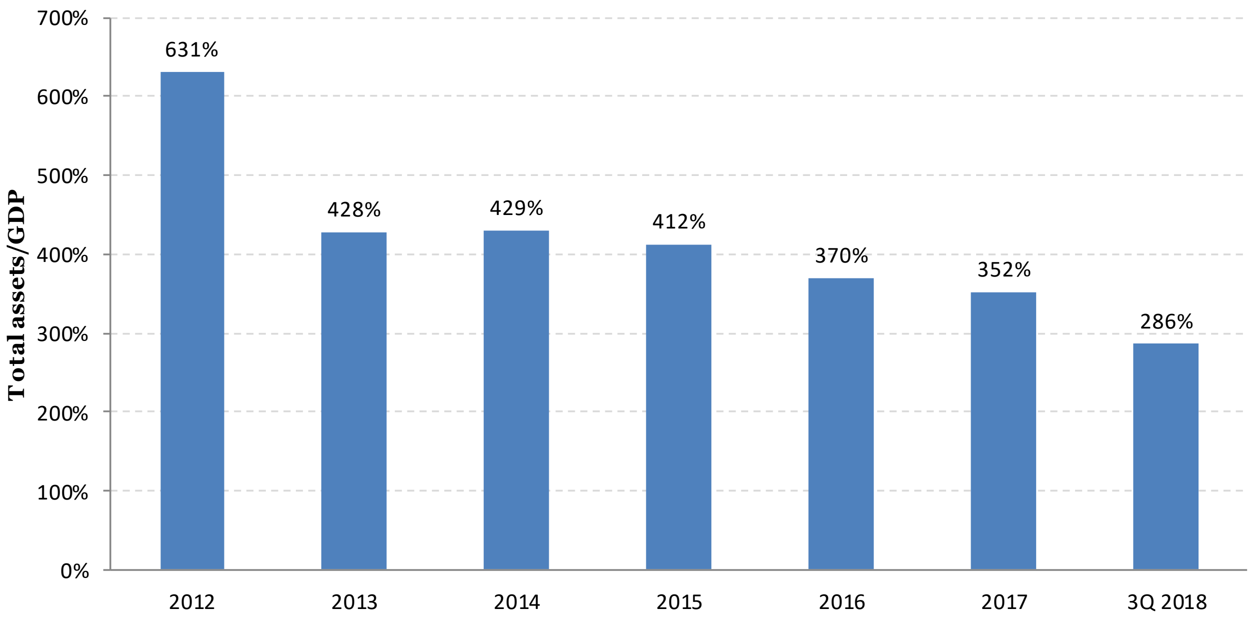
The state owned Cyprus Cooperative Bank was sold during 2018 to the Hellenic Bank. Hellenic Bank took over almost the entire performing loan portfolio, all government bonds and all private customer deposits. On 3 September 2018, the CCB surrendered its banking licence and applied and received a license to operate as a credit acquiring company which took over the biggest share of the bank's NPL portfolio (EUR 5.7 billion) and a real estate assets portfolio. The CCB sale and wind-down resulted in a consolidation of the banking sector and

a reduction of the stock of NPEs in the banking sector (by shifting the NPE to the publicly owned asset management company).

As a result of de-risking via the sale of Greek operations and other overseas subsidiaries, decrease in domestic bank lending, bad debts write-offs, NPEs carve out of CCB and sale of BOCY NPEs portfolio, the Cypriot banking sector downsized significantly in the past 6 years. The current size of the banking sector is close to EU average size.

The large decrease in the size of the banking sector in 2018 was mainly due to the legal transfer of €9 bln of CCB's assets to the remaining residual entity called KEDIPES, which is state owned asset management company (thus outside the banking system) and the sale of a large loan portfolio of €2.8 billion (of which 2.7 billion are NPEs) by the Bank of Cyprus to Apollo fund.

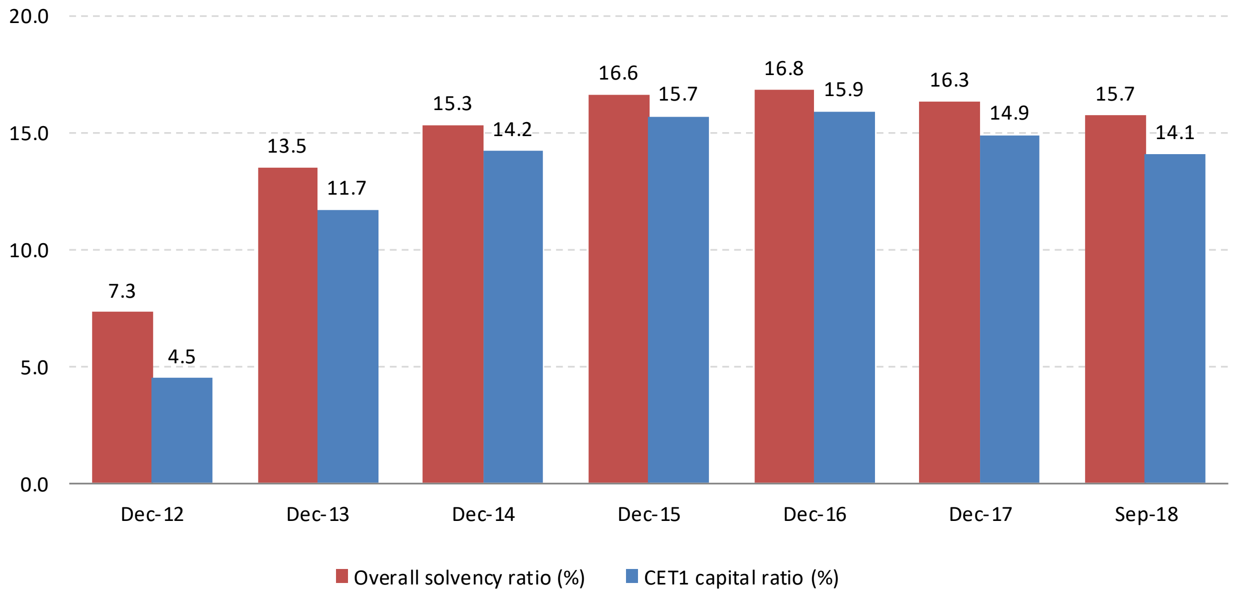
Figure 2: Size of the banking sector



Source: Central Bank of Cyprus

The main indicators of the financial sector show noteworthy improvement in particular in terms of capitalization and liquidity. Banks' strategies are based on further de-risking and deleveraging through the disposal of non-core operations, focusing on domestic operations (core businesses) and at the same time consolidating their capital and liquidity positions. The profitability of credit institutions though, continues to be adversely affected by the prolongedperiod 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 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.

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

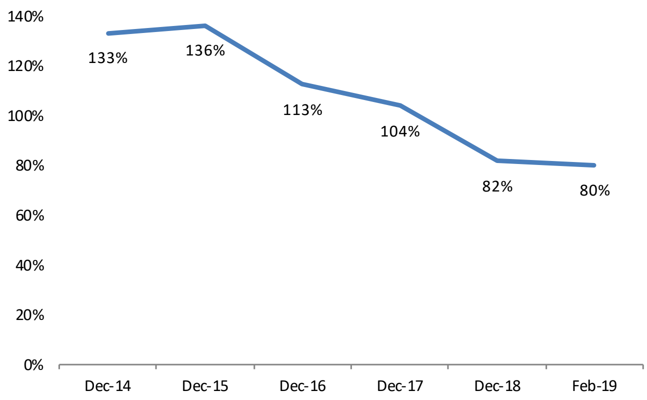


Source: Central Bank of Cyprus

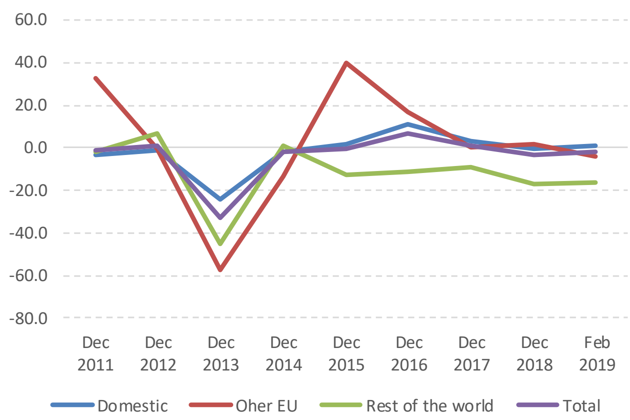
The deposit base continues to remain at satisfactory levels. The outstanding amount of deposits amounted to €47.7 bln in February 2019 compared to €49.4 bln by end December 2017.

Figure 4: Deposits

Evolution of loans to deposits ratio



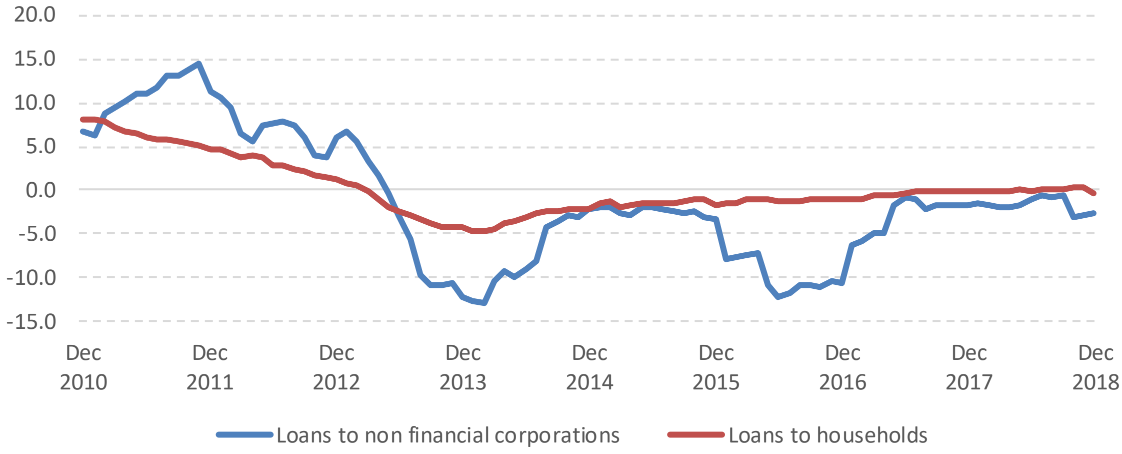
Evolution of deposits (annual growth rates)



Source: Central Bank of Cyprus

There has been a steady upward trend in new loans supported by historically low domestic interest rates, favourable macroeconomic conditions and rising demand. During 2018, total new loans (including renegotiated loans) to households reached €1.5 bln (decomposed into €1.354,8 mln pure new loans and €140 mln renegotiated loans), compared to €1.3 bln of 2017 (€1.087 mln pure new loans and €195 mln renegotiated loans). The total loans of 2018 consist of €175,1 mln consumer credit loans, €958,7 mln for house purchase and €221 mln for other lending purposes (€187 mln, €858 mln and €237 mln for 2017 respectively).

Figure 5: Loans to non-financial corporations and households (annual growth rates %)

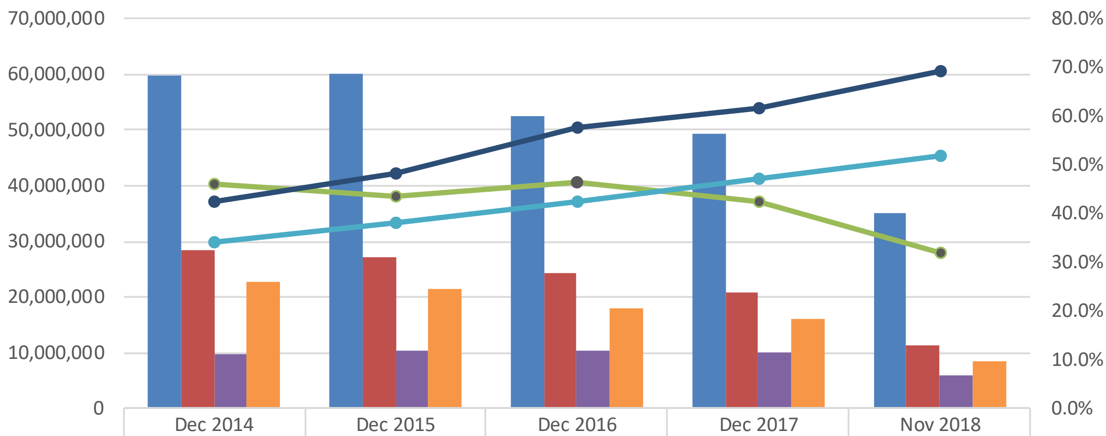


Source: Central Bank of Cyprus

Non-performing exposures (NPEs)

Addressing the high level of NPFs in the banking system, is a key priority. The amount of non-performing exposures (NPEs), excluding the overseas operations of Cyprus credit institutions, despite the observed progress, remains high at 32% of total loans at end-November 2018 compared to a much higher 42.5% at end-December 2017. In nominal terms, total NPEs for all credit institutions (excluding their overseas operations) decreased by 46.1% to €11.3 bln at end-November 2018, compared with €20.9 bln at end-December 2017.

Figure 6: NPEs (including overseas operations of CCIs)



	Dec 2014	Dec 2015	Dec 2016	Dec 2017	Nov 2018
Total Loans, € 000	59,749,172	60,179,618	52,511,151	49,218,939	35,146,392
NPEs €000	28,382,601	27,289,517	24,344,630	20,902,202	11,249,998
Impairments	9,632,527	10,438,297	10,317,503	9,884,870	5,850,256
90 DPD €000	22,704,065	21,566,576	17,866,479	16,026,507	8,447,136
NPE to Total loans	46.1%	43.5%	46.4%	42.5%	32.0%
Impairment/NPEs	33.9%	38.3%	42.4%	47.3%	52.0%
Impairment/90DPD	42.4%	48.4%	57.7%	61.7%	69.3%

Source: Central Bank of Cyprus

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. Credit institutions continue their efforts towards restructuring their NPEs in cases were viable settlements are possible.

To this end, the core domestic banks have partnered with foreign debt specialists: Pepper Cyprus (fully owned subsidiary of Pepper Europe (UK) and Apollo fund (Project Helix)) entered into a co-operation agreement with Bank of Cyprus, Altamira Asset Management (Cyprus) (joint venture of Spanish Altamira Asset Management with the Cyprus Cooperative Bank (currently KEDIPES)) and APS Debt Servicing Cyprus (joint venture of Czech APS Holding) and B2 Kapital with Hellenic Bank.

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

Policy strategy for the reduction for NPEs

The Government has set as a priority to effectively tackle the NPE challenge, the most pressing issue facing the financial sector and the economy. To this end a comprehensive strategy has been designed and is being implemented.

The policy strategy for the reduction of NPEs is enshrined in the following three pillars:

- Strengthening the effectiveness of the legal framework related to the management of non-performing exposures.
- Addressing the most challenging portfolio of NPEs (mortgage loans or SME loans having the primary residence of the borrower as collateral) through burden sharing between creditors and debtors and a financial support by the Government ("ESTIA" Project).
- Addressing challenges faced by the state owned credit acquiring company (former CCB).

The three pillar strategy is expected to lead to a significant reduction in the banking sector NPEs stock, via:

- A reduction of €5.68bn resulting from a carve out of CCB's NPEs.
- A reduction of €3.4 bln from loans eligible to participate in ESTIA Project.
- Sale of NPEs portfolios - Bank of Cyprus sold a €2.7bln portfolio in August 2018.
- Additional reductions through the implementation of the strategic plans in cooperation with specialized service providers.

Based on the above it is feasible to achieve a reduction of NPEs stock in the banking sector down to 25% of total loans by end 2019 (ratio had reached 46% in December 2016).

The first pillar focuses on the legal framework applicable for the management of NPFs. To this end, consultations have taken place among stakeholders as well as the IMF and the European Commission in order to identify specific provisions as well as processes of the framework that affect its effectiveness. As a result, a comprehensive list of legal amendments was enacted in July 2018, focusing among others, on improvements of practical nature, establishment of an efficient secondary loan market and the creation of an effective, efficient, and transparent foreclosure framework to act as a credible deterrent to strategic defaulters.

One important feature of the foreclosure framework is the introduction of electronic auctions. Currently the Ministry of Finance is in the process of finalizing the Ministerial Degree, setting out relevant procedures for the conduct of electronic auctions.

In parallel the Association of Cyprus Banks is in the final stages of negotiations with a platform development company for the design of the relevant electronic platform, while the Ministry of Finance is in the process of assigning to a consulting firm the preparation of the profile of the "Administrator of e-auctions", a relevant code of conduct, as well as a process for the licensing and monitoring of the "Administrator of e-auctions" which will be incorporated in a subsequent Decree of the Minister of Finance.

The objectives of the above mentioned legal amendments 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.

More specifically the major provisions of the amendments are as follows:

a) Foreclosure Framework
- Clarification that old court decisions for the sale of property can be implemented under the new foreclosure procedure.
- Widen the means of servicing of notices to the debtors.
- Shortening the time period within which a reserve price is applied when foreclosing property.
- Enhance the right of the bank to participate in the foreclosure process.
- Regulate the provision of information to prospective buyers.
- Allow for electronic auctions.

b) Sale of Loans
- Allow for split of mortgages.
- Amendments on definitions to ensure that all credit facilities are included.
- Ensure the results of the transfer are regulated (transfer of rights, priority, continuation of proceedings, safeguarding of documents).
- Allow access of credit buyers to the data exchange mechanism for purposes of assessing the borrowers' indebtedness.

c) Insolvency Framework
- Removal of impediments to the restructuring process.

- Amendments of definitions to ensure effective restructurings.
- Removal of all protection in case a borrower who receives state subsidy defaults.

d) Securitization

- Ensuring the proper functioning of the securitization market.
- Vesting the CBC the power to authorize, regulate and supervise the activity of securitizations.
- Limiting to the securitization of credit facilities originated or acquired by credit or financial institutions or by credit acquiring companies.

e) Courts' Law

According to the draft law (currently at legal vetting), specific judges will be appointed who will be responsible for handling of (i) financial disputes arising between the borrower and the creditor regarding the amount of the credit facility which is delayed or exceeded and (ii) foreclosure related disputes. Applications or appeals filed with the District Court in relation to paragraphs (i) and (ii) shall be examined and completed within 60 days of their submission.

All the above legal amendments were approved by the House of Representatives on July 8th 2018 with the exception of the Courts' Law.

The second pillar of the Government's strategy addresses the most challenging segment among NPEs in the entire banking sector, that of mortgage non-performing exposures collateralized with the primary residence. In order to enable eligible households with these types of exposures to start repaying their loans, the Government announced a temporary incentive scheme, Project ESTIA. Through burden sharing, the scheme would incentivize eligible households/SMEs, enabling them to meet their obligations to the extent possible, thus contributing to the stabilization of the banking sector. The State will provide financial assistance to the participating borrowers, covering one third of borrowers' restructured loan repayment obligations, while borrowers will have to fulfil a number of criteria., including 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 maximum total eligible portfolio that satisfies the above criteria is calculated at €3.4 bln. The scheme can lead to a maximum reduction of the NPE ratio by around 17%. The implementation of the scheme would involve from a fiscal perspective maximum annual payments amounting to €33 mln on average over a period of 25 years (an accumulated expense of €814 mln). The scheme is expected to become operational in the second half of 2019.

Under the third pillar, the Government, as the main shareholder of the CCB has proceeded with the sale of part of the bank's assets and liabilities to Hellenic Bank. The remaining assets (NPEs and other non-core assets) as well as the Government Deposit and some other liabilities remained with the residual entity in order to be managed with the view to claw back to the extent feasible the state's support.

The transactions pertaining to the above sale were determined and agreed to with the supervisory entities such as the SSM/ECB, the Central Bank of Cyprus and the DG Competition/European Commission. On 19th June 2018, the European Commission's DG Competition approved the state aid for financing the orderly market exit of the former CCB as compatible with EU state aid rules.

According to the EC's decision, the residual entity surrendered its banking license at the Closing of the Transaction and exited the market, while its subsidiary, which has been established under the Company's Law,

has been licensed by the CBC as a credit acquiring company for the sole purpose of managing the assets that remain in its perimeter, with a view to maximizing their value.

After the legal transfer of €8,34 billion of CCB's assets to the residual entity, the banking sector in terms of asset size is estimated to fall from 321% to 280% of GDP, at end 2018. A further decline by year end is likely, given the continuous deleveraging.

Following the removal of €5,68 billion of CCB's NPEs and €0,5 billion CCB's PEs from the banking system, the NPE to gross loans ratio in October 2018 declined from 38.9% at end August 2018, to 32.1%. (IMPACT ON NPEs)

The debt trajectory is expected to resume its downward trend and decline to below 90% of GDP by end-2020. The annual budget balance will be negatively impacted by a number of factors - inter alia increased costs of debt servicing (annual estimated impact at 0,4%) and the application of the ESTIA Scheme (annual estimated impact at 0,1%). The above is expected to be partly compensated by the income generated by the residual entity. Based on the projected cash flows of the residual entity, the average annual net operating income of the residual entity is estimated at €250 million representing about 1,25% of GDP. The anticipated proceeds of the residual entity are not factored in our calculations and are viewed as an upside risk to our baseline scenario. The aggregate banking system provision coverage increased from 47.3% at end Dec. 2017 to 52% at end November 2018.A further decline to NPEs levels is expected in 2019, given the improved legal framework and the effects of the implementation of the ESTIA scheme.

Spreads – secondary market yields

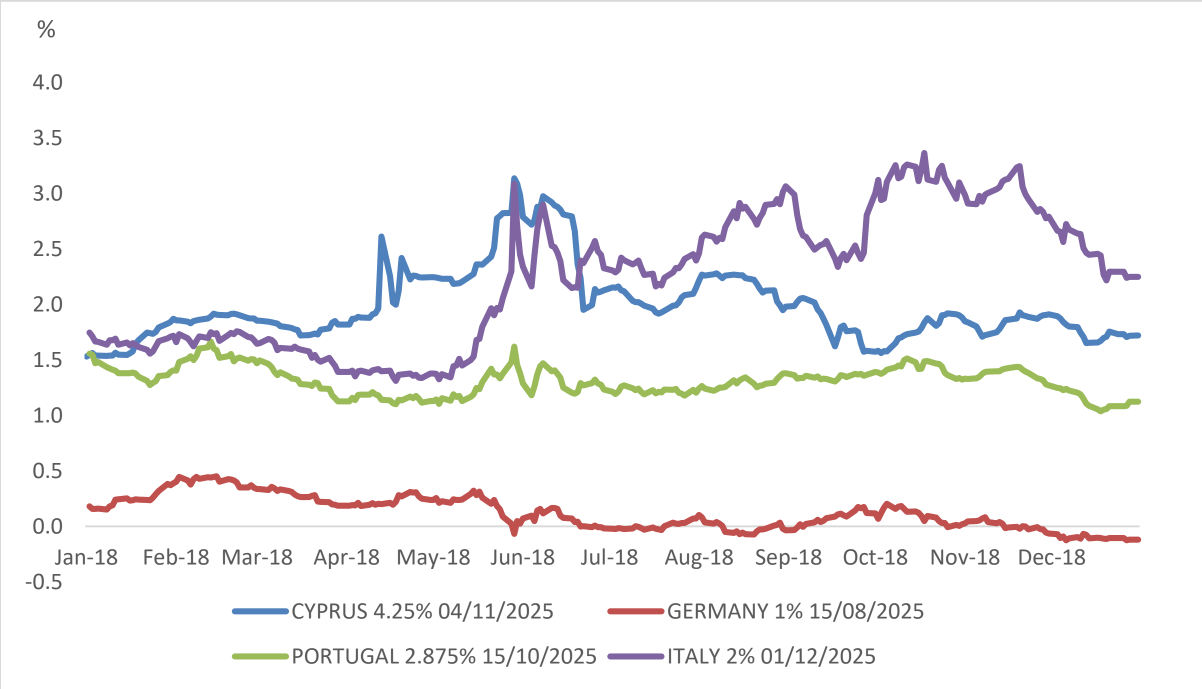
In the first and fourth quarter of the year the government yields of Cyprus followed largely the path of the other eurozone sovereigns, while in the second and third quarters the Cyprus-related developments seemed more predominant in shaping the secondary market yields.

The uncertainty around the cooperative bank caused a marked increase in the Cyprus government yields in the three-month period between April and June. Yields de-escalated over the summer after the agreement around the bank's split and sale and September marked a further drop in the Cyprus government yields after the first upgrade to investment grade category.

Consequently, the sovereign bond yield spreads for Cyprus vs. Germany increased during the second quarter of 2018 whilst thereafter yields exhibited more stability. By year end the spread level was around 185 bps compared to 140 bps at the beginning of the year. This development is attributed to the decline in German government bond yields.

During the first three months of 2019, continuing over the path of the last months of 2018, government bond yields across the eurozone exhibited a decline.

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



Source: Bloomberg

2.2 MACROECONOMIC OUTLOOK 2019-2022

2.2.1 GROWTH PROSPECTS 2019-2022

Medium-term Scenario 2019-2022

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 continued improved confidence, the return to the investable grade 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 improvement 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.

Domestic demand is expected to continue growing and remain the main driver of growth, while employment is expected to increase further with unemployment as a consequence continuing on its downward path. Imports are expected to grow in line with consumption and investments while exports are expected to remain rather low due to the US slowdown and the uncertainty surrounding Brexit which will affect exports of goods and services (tourism) mainly via the exchange rate channel. 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, 2018-2022

change in percent	2018	2019	2020	2021	2022
Real GDP	**3.9**	**3.6**	**3.2**	**3.0**	**3.0**
Government Consumption	4.3	3.6	3.4	3.0	2.8
Private Consumption	3.7	3.3	2.8	2.5	2.5
GFCF	-7.1	9.4	7.8	7.0	6.4
Exports	3.3	2.7	2.4	2.4	2.4
Imports	2.0	4.0	3.4	3.1	3.0
Deflator	1.6	1.0	1.2	1.5	1.5
Nominal GDP	5.5	4.6	4.4	4.5	4.5
HICP	0.8	0.5	1.2	1.5	1.5
CPI	1.4	0.5	1.2	1.5	1.5
Employment (persons)	4.0	3.5	3.0	2.5	2.5
Unemployment (LFS)	8.4	7.0	6.0	5.5	5.0
Compensation per employee	0.1	0.5	1.3	1.8	2.0

Source: Statistical Service and Ministry of Finance

For 2019, the economy is estimated to expand further, in real terms, at around 3.6%. This is primarily supported by a continued positive contribution of private consumption to growth supported by gross fixed capital formation, 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 3.2% in 2020 and then hover around 3% in 2021 and 2022. Inflation, measured by the CPI, is estimated to be marginally positive in 2019 exhibiting an increase of 0.5% and then projected to accelerate and increase by 1.2% in 2019 and rising further to 1.5% 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 although the external sector improves with less negative contribution in 2021-2022. Consumption will continue to provide a positive contribution to growth, and stay strong but with a slowdown compared to 2018, mainly due to improving employment developments rather than wages which will increase slowly. Investment growth is estimated contribute positively to growth this year compared to the decrease in 2018, 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 numbers for 2019 are anticipated to remain around 2018 levels over the record performance of 2018, fueled particularly by the UK, Germany and other European markets.

The current account deficit which had improved significantly in recent years, mostly due to a cyclical correction of the goods balance, in 2017-2018 deficit increased and remained high due to exports of goods, mostly ships, which, during the year under review, recorded a higher increase than the respective imports. In general, however, on average an annual deficit of around 5.3% of GDP was recorded for the period 2012-2018 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 2017-2018 levels, in absolute terms, during the period covered in this Stability Programme, while ship registration/deregistration will also remain at 2018 levels.

2.2.2 LABOUR MARKET

Labour Market

The expectations in the labour market are encouraging. In 2018, employment has expanded at a rate of 4% and it is expected to continue growing in 2019 at a rate of about 3.5%. In 2020, employment is projected to grow at a rate of 3%, while in 2021 and 2022 is forecast to record a more moderate rate of growth of about 2.5% respectively. At the same time, the unemployment rate is envisaged to maintain its downward path pursuing a similar pace as economic growth. Since 2015 onwards, the unemployment rate has been pursuing a declining path, decreasing from 14.9% of the labour force in 2015 to 8.4% in 2018. The declining path of unemployment is projected to maintain pace at a lower rate during 2019-2022, falling to 7.0% in 2019, to 6.0% in 2020, 5.5% in 2021 and to 5% in 2022. The reduction of the unemployment rate is triggered by robust economic growth fostered by significant capital investment and strong private consumption leading to a sustained job creation.

Table IV: Labour market developments

	2015	2016	2017	2018	2019	2020	2021	2022
Employment (persons) growth	1.5	4.6	4.3	4.0	3.5	3.0	2.5	2.5
Unemployment rate	14.9	12.9	11.1	8.4	7.0	6.0	5.5	5.0
Compensation per employee, growth	1.3	-1.1	0.7	0.1	0.5	1.3	1.8	2.0
Nominal unit labour cost, growth	0.8	-1.3	0.5	0.3	0.4	1.1	1.3	1.5
Real unit labour cost, growth	2.9	-0.1	0.0	-1.3	0.0	0.0	-0.2	0.0
Productivity (persons)	0.5	0.2	0.2	-0.1	0.1	0.2	0.5	0.5

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 it followed a downward path declining on average to about 20.2% in 2018. Similarly, long-term unemployment decreased to 2.7% in 2018, down from a peak of 7.6% in 2014.

Wages

Wage growth, as reflected in compensation per employee, in 2018 it has exhibited an insignificant increase of 0.1% and it is forecast to gradually accelerate and grow at a rate of 0.5% in 2019 and 1.3% in 2020. It is then projected to accelerate further to 1.8% in 2021 and 2% in 2022. Wage developments follow the steady growth of the economy denoting an improving labour market that is associated with moderate wages growth.

Productivity and ULC

Based on the aforementioned forecasts in the labour market, productivity is estimated to have been marginally negative in 2018 by 0.1%. In 2019, productivity is projected to turn positive to 0.1% and to 0.2% in 2020. In 2021 and 2022 productivity is expected to rise by 0.5% in each year signaling a moderate improvement.

Nominal Unit labour costs (NULC) are forecast to follow a similar path to compensation per employee. In 2018 NULC is estimated to have increased by 0.3% following an upsurge of 0.5% in 2017. NULC is forecast to exhibit an increase of 0.4% in 2019 and then increase by 1.1% in 2020 and by 1.3% in 2021 and 1.5%in 2022. The projections in NULC underpin that cost competitiveness shall be sustained at relatively satisfactory levels maintaining the good overall competitiveness performance of the Cyprus economy.

Real unit labour costs (RULC) in 2018 were negative falling by 1.3%. For the next years 2019-2022 it is projected that RULC will follow a steady pace.

2.2.3 PRICE DEVELOPMENTS

Harmonised Consumer Price Index (HICP)

During 2018, harmonized inflation averaged at 0.8%. For the period January-December 2018, the largest change, compared to the corresponding period of the previous year, was noted in category Housing, Water, Electricity, Gas and Other Fuels (5.9%). Harmonized energy inflation and seasonal food inflation was positive at 7.8% and 3.7%, respectively. As a consequence of these price increases, harmonized core inflation (overall index excluding energy and seasonal food) averaged to zero during 2018.

Consumer Price Index (CPI) - Price developments in 2018

In 2018 the Consumer Price Index (CPI) recorded an increase of the order of 1.4% compared to the year before. Analysis of CPI by economic activity indicates that this increase was mainly attributed to the prices of electricity and water, as well as of transport and petroleum products, which recorded an annual rate of growth of 9.3%, 6.6% and 6% respectively (total contribution to 2018 inflation of about 0.9 percentage points). The largest negative change during 2018 was noticed in category imported goods (-1.1%) with a negative contribution to inflation of about 0.3 percentage points.

Core inflation averaged at 0.4% during 2018, well below the headline inflation of 1.4%, indicating both the increases in energy and seasonal food prices (6.8% and 17.6%, respectively).

During the first two months of 2019, inflation averaged at 1.6%, where the most notable positive effects on the change of the CPI was recorded in categories fresh vegetables (increase 58.7%) and electricity (increase

27.6%), while fuels for personal transport equipment products had the largest negative effect (decrease 9.2%), stemming from the reduction of fuel prices by 5 cents per litter, as from December 2018.

Inflation is expected to remain positive during 2019 and average at about 0.5%, mainly impacted from the base effect of international energy prices, which recorded a high increase during the second semester of the year before.

Table V: CPI by Economic Activity

	2013	2014	2015	2016	2017	2018	Jan-19	Feb-19
GENERAL INDEX	**-0.4**	**-1.4**	**-2.1**	**-1.4**	**0.5**	**1.4**	**2.0**	**1.2**
LOCAL GOODS	-1.6	-3.4	-3.9	-2.7	1.4	2.0	10.3	7.2
Local Agricultural	-1.0	-3.7	1.0	0.4	-0.7	2.4	24.5	15.9
Local Industrial	0.9	-0.2	-0.5	-0.6	-0.7	-0.2	-0.5	0.5
Electricity and Water	-6.5	-9.2	-16.3	-13.8	12.1	9.3	27.4	16.6
IMPORTED GOODS	-0.2	-0.6	-0.6	-0.4	-1.0	-1.1	-1.0	-0.5
Imported Agricultural	-0.9	-2.0	0.7	-0.6	2.4	-5.2	-8.6	-4.1
Imported Industrial (Excl. petr.)	-0.1	-0.5	-0.6	-0.4	-1.1	-1.0	-0.8	-0.4
PETROLEUM PRODUCTS	3.3	0.3	-13.3	-7.6	7.1	6.0	-9.8	-7.9
SERVICES	-0.5	-0.9	0.0	-0.8	0.5	1.8	1.6	0.9
Rents	-6.7	-5.9	-1.2	-0.5	0.8	2.5	3.9	3.7
Repairs & maint. of dwellings	-0.5	-1.5	-2.0	1.1	1.8	4.5	3.1	3.1
Transport	1.9	3.4	2.1	-14.1	0.5	6.6	4.6	-2.5
Communication	1.3	2.0	1.0	-0.3	-1.0	-1.4	-5.0	-5.6
Insurance	3.0	-0.8	0.1	0.2	-2.5	0.8	-0.6	-0.6
Government services	2.7	9.1	0.7	-2.4	0.6	3.5	4.4	0.5
Education	-0.7	-3.5	-1.1	0.4	0.7	2.6	1.9	1.9
Medical care	-2.9	-1.7	1.0	1.6	1.1	0.8	1.0	1.0
Restaurants & Coffee shops	0.4	-1.4	0.2	0.3	0.7	1.7	2.3	2.3
Personal & Household services	-0.3	-1.1	-0.6	-0.1	0.8	2.0	2.7	2.6

Source: Statistical Service

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

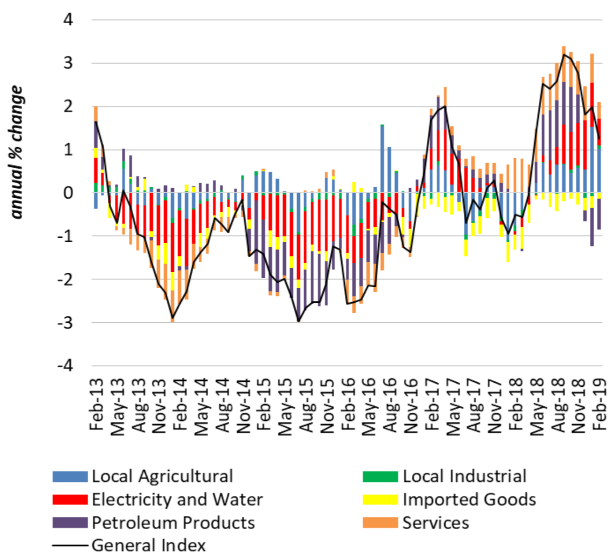
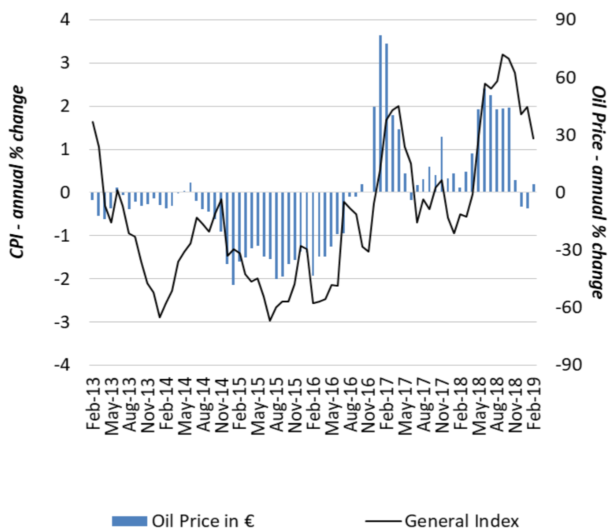


Figure 9: CPI evolution and Oil Price developments



Source: Statistical Service and Ministry of Finance

2.2.4 RISKS TO MACROECONOMIC OUTLOOK

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

- Growing global trade tensions and protectionism.
- Weaker than expected growth in the euro area.
- Lower than expected growth in Russia (a country with strong economic relations with Cyprus).
- Slower than expected growth in the UK and further weakening of the pound against the euro as a result of higher uncertainty, regarding the type of the exit from the E.U. (with deal or without deal).

Upside risks include the faster than anticipated acceleration of restructuring of NPLs, higher than expected increase of new lending to the economy and positive developments related with the exploration of new gas fields in the Cyprus Exclusive Economic Zone.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1 POLICY STRATEGY

In 2018, fiscal performance amid the good economic performance was better than anticipated in the previous update of the Stability Programme, excluding the impact of the sale of part of assets and liabilities of the Cyprus Cooperative Bank Ltd (CCB) to the Hellenic Bank, which is a one-off and exceptional measure. Windfall revenues, as the result of the favourable economic environment, were used for the early repayment of part of public debt, thus containing adverse debt developments, stemming from the issuance of bonds related to CCB. Supporting growth and cementing confidence in the economy is a primary goal of the government and fiscal policy represented in the Budget 2019 and the Medium Term Budgetary Framework reflects this by 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. The actions related to the CCB succeeded in restoring stability in the banking sector and contributed decisively in the strategy towards addressing the NPLs challenge.

3.2 GENERAL GOVERNMENT BALANCE FOR 2018

The budget balance of the General Government[2] was in deficit during 2018 of about €990 mn (-4.8% of GDP), including the one-off fiscal burden of €1,659.5 mn, that was the result of the sale of part of assets and liabilities of the CCB to the Hellenic Bank. Primary balance was also in deficit of €475 mn (-2.3% of GDP). Excluding the abovementioned one-off fiscal burden, nominal balance was in surplus of the order of 3.2% of GDP compared to 1.8% of GDP the year before, recording an improvement of 1.4 percentage points of GDP. Respectively, primary balance also improved by 1.4 percentage points of GDP, reaching 5.7% compared to 4.3% of GDP the year before.

Revenue

In 2018, total revenue as a percentage of GDP amounted to 39.7% compared to 38.9% the year before, recording an increase of about 0.8 percentage points of GDP. In value terms, total revenue increased by 7.7% compared to 2017. Tax revenue increased by 6.7% mostly due to an increase in taxes on production and imports. In more detail, taxes on production and imports increased by 8% due to the increase in VAT receipts by 13.5% compared to 2017, reflecting the improvement in economic conditions and the increase in private consumption fueled by the excellent performance in the tourist sector. Revenue from taxes on income and wealth increased by 4.6%, fueled by the strong performance of corporate tax receipts and capital gains taxes exhibiting a robust growth compared to the year before of 8.5% and 4.9%, respectively.

[2] The sale process of part of the assets and liabilities of the Cyprus Cooperative Bank Ltd (CCB) to the Hellenic Bank resulted in the establishment of two new entities, namely the Cooperative Asset Management Company Ltd (SEDIPES) and Cyprus Asset Management Company Ltd (KEDIPES), which are both classified within the General Government sector as of September 2018.

Revenue from social security contributions increased by 7.8%, reflecting the further improvement conditions in the labour market, namely employment and wage developments. On the other hand, revenue from property income decreased by 10.2%, primarily due to the lower dividend from the Central Bank of Cyprus (CBC) by about €35.7 million compared to the dividend received the year before, as well as from the absence of dividends from the Cyprus Telecommunications Authority (CYTA), as this was received at the beginning of the subsequent year. Finally, revenue from other sources, which consists of non-tax revenue, exhibited an increase of about 15.7%, mainly reflecting the continued pick-up in the rate of absorption from the EU's Structural and Cohesion Funds.

Expenditure

Total expenditure in 2018, as a percent of GDP, exhibited a sharp increase of 44.5% of GDP from 37.1% of GDP in 2017, stemming mainly from the liabilities undertaken by KEDIPES. In value terms, total expenditure increased by about 26.3%. Excluding the above-mentioned impact, public expenditure during 2018 recorded an increase of 2.3%. Compensation of employees exhibited an increase of about 4.3%, mainly attributed to increases in the employment in the education and health sector, as well as in the security forces, contributing 1.9 percentage points in the total increase of this expenditure category. The gradual withdrawal of the public sector's wage cuts as of 1st July 2018, as well as the granting of the cost of living allowance of 0.28% also contributed positively to the increase expenditure for compensation of employees. Despite these developments, as a percentage to GDP, compensation of employees decreased marginally to 11.8% in 2018 compared to 12% the year before.

Intermediate consumption increased at a rate of 15.4% mostly due to increased expenditures associated with water supply, as well as pharmaceuticals and other medical supplies. Part of the increase in this expenditure category is also stemming from expenses related to KEDIPES during the period September-December 2018, of about €32.9 mn. As a percentage to GDP, intermediate consumption increased by 0.4 percentage points, from 3.6% of GDP in 2017 to 4% of GDP in 2018.

Social payments increased at a rate of 3.4%, brought mainly by increased outlays related to old age pension of the order of 4%. This increase was partly offset by the decrease in unemployment benefits and redundancy payments in 2018 of the order of 13.6% compared to the year before. As a percentage of GDP, social payments decreased to 13.1% from 13.3% of GDP the year before.

Interest expenditure recorded an increase of 2.5% in 2018 compared to 2017, attributed to the issuance of domestic bonds in favour of the CCB of €3.19 bn in order to enable the transaction between ex CCB and Hellenic Bank. As a percentage of GDP, interest expenditure decreased by 0.1 percentage points, reaching 2.5% from 2.6% of GDP the year before. Gross fixed capital formation recorded a sharp increase of 119.6%, rising as a percentage of GDP to 5.3% in 2018 from 2.5% the year before associated with the sale of ex CCB.

3.3 BUDGET FOR 2019

As in the previous year, the Budget for 2019 reflects the policy of the government for a growth friendly fiscal stance, safeguarding the maintenance of robust primary surpluses, supporting a sustained reduction of public debt-to-GDP at a satisfactory pace. 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 2019 is estimated to amount to 3% of GDP, with the primary balance position reaching a surplus of about 5.3% of GDP.

A more detailed analysis on the revenue and expenditure components of the 2019 Budget is presented below.

Revenue

In accordance with the central macroeconomic scenario, total revenue in 2019 is anticipated to record a positive rate of growth of the order of 7.4% compared to 2018, estimated to increase as a percentage to GDP to about 40.7% of GDP from 39.7% the year before.

Tax revenue in 2018 is expected to exhibit a rate of growth of about 1.5% compared to 2018, resulting in a fall, as a percentage of GDP to 24.4% in 2019 from 25.2% the year before. This fall is brought by a decrease in revenues from taxes on production and imports, which are forecast to reach 15.2% of GDP compared to 15.9% of GDP the year before, exhibiting a zero growth rate, stemming mainly from the reduction of excise duties on fuels by €0.05 per litter, as from December 2018. Estimates include 0.1 p.p of GDP stemming from the abolition of the excise tax on vehicles. Taxes on income and wealth are estimated to increase by about 4.1% 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 marginally decline to about 9.2% compared to 9.3% the year before. The estimated impact of road tax reform is included in the projections, but its impact is negligible.

Social Security contributions are forecast to exhibit an increase in 2019 by about 28.8% compared to the year before. This high increase is a result of (i) the increase in social security contributions as from 1st January 2019, according to the relevant Law, estimated at about 0.4 percent of GDP, (ii) the contributions of the taxpayers and employers as from 1st March 2019 in the context of the introduction of the National Health System (NHS), estimated at about 1.5 percent of GDP, as well as from (iii) the continuous improved conditions in the labour market reflected in job creation and increasing nominal earnings.

Revenue from property income in 2019 is forecast to exhibit a marginal increase reaching 0.7 percent of GDP compared to 0.6 percent of GDP the year before. It is noted 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 2019 estimates since methodologically these revenues have been equally distributed, in accordance with the contract provisions, over a three-year period 2017-2019.

Finally, category “other revenue”, is estimated to record a decrease of 2.9% compared to the year before, taking into account the impact from the inclusion of KEDIPES in the General Government, as from September 2018. In terms of percentage of GDP, this revenue category is estimated to decrease from 5% in 2018 to 4.6% in 2019.

Expenditure

Total expenditure is estimated to exhibit a decrease of 11.2%, falling, as a percentage of GDP, to 37.8% compared to 44.5% the year before.

In more detail, compensation of employees is forecast to exhibit an increase of 7.1% in 2019 compared with the year before, brought mainly from the gradual abolition of wage cuts estimated at 0.2 percent of GDP, the contribution of the government to NHS as an employer, estimated at 0.2 percent of GDP, as well as from the unfreezing of promotions, the provision of Cost of Living Allowance (COLA) and annual increments. In percent of GDP, compensation of employees is forecast to exhibit an increase of about 0.3 p.p. reaching 12.1%.

Intermediate consumption is forecast to record an increase by about 6.5% mainly due to the fee payment of KEDIPES to Altamira Asset Management Cyprus Limited, as well as from other various expenses of KEDIPES, totaling to about 0.4 percent of GDP, which were partly included the year before. In addition, 0.1 percent of GDP is attributed to the expenses related to the Deputy Ministry of Tourism, established early 2019. These expenses in essence concern information campaigns, previously undertaken by the ex Cyprus Tourism Organization (CTO).

Regarding social transfers, these are estimated to increase by about 15%, mainly attributed to the social payments related to the NHS. The expected growth in pension outlays partly contributes to the increase of this expenditure category, which is partly offset by the expected 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 are estimated to record an increase of 1.3 percentage points, from 13.1% of GDP in 2018. Regarding the ESTIA scheme, an estimated cost of 0.1 percent of GDP accounts for the increase in social transfers. Finally, as mentioned previously, social transfers decrease by 0.1 percent of GDP, due to the transfer of abovementioned expenses by ex-CTO to the Deputy Ministry of Tourism.

Interest expenditure is forecast to record a decrease of 0.9% in 2018, falling as a percentage of GDP to 2.3% in 2019, from 2.5% the year before.

Gross fixed capital formation is forecast to exhibit a decrease of 3.2 percentage points of GDP, reaching 2.1% from 5.3% of GDP in 2018, as a result of the investment expenditure recorded the year before, corresponding to the share of the collateral received from the former CCB.

Other expenditure is estimated to exhibit a decrease of 11.5% and to contract as a percentage to GDP to 2.5% from 7.5%, related to the impact of KEDIPES.

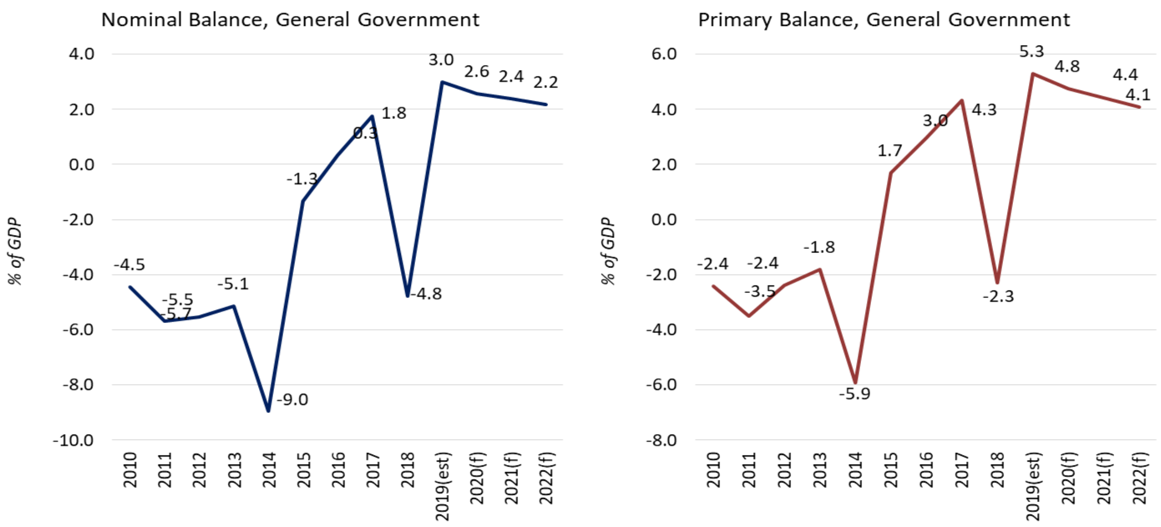
3.4 MEDIUM TERM BUDGET BALANCE 2020-2022

Over the medium term, the government aims at maintaining high primary surpluses, using windfall revenues to reduce debt or improve the cash position of the state thus locking in the benefits of overperformance, allowing debt-to-GDP to continue its downward path over 2020-22 at a satisfactory pace.

Total revenue, as a percentage of GDP, is forecast to exhibit an increase of 4.8% in 2020, mainly as a result of the increased contributions related to the NHS as from 1st June 2020. In 2021 and 2022, total revenue is expected to increase by 3.9% and 3.3% respectively. As a percent of GDP, total revenue is forecast to reach 40.9% compared to 40.7% of GDP the year before, stemming from the abovementioned impact of the introduction of the NHS, and then gradually decline to 40.6% and 40.1% of GDP in 2021 and 2022, respectively. Taxes on production and imports is expected to average at 14.8% of GDP over the period 2020-2022, while taxes on income and wealth amount to 9.1% of GDP, on average, over the same period.

Total expenditure, as a percentage of GDP, is forecast to grow by 6% in 2020, resulting from the increased NHS related social transfers as from 1st June 2020. In 2021 and 2022, total expenditure is forecast to exhibit an increase of 4.3% and 3.9%, respectively, and average at 38.2% of GDP compared to 37.7% of GDP in 2019. The projected increase in compensation of employees remains on average at about 6.1% per year, taking into account the gradual abolition of wage cuts, as well as the government's increased contribution as an employer in the context of the NHS. Social payments are forecast to increase by 11.6% in 2020, stemming from the NHS impact mentioned above, and then grow by 5.2% on average over the period 2021-2022. Gross fixed capital formation as a percent of GDP is forecast to remain steady at 2% during the period 2020-2022.

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



Source: Statistical Service and Ministry of Finance

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 expenditure	2011	2012	2013	2014	2015	2016	2017	2022 f.
General public services	19.5	22.1	20.0	17.0	20.9	19.6	19.6	19.0
Defence	4.3	4.2	3.8	3.0	3.5	3.9	5.5	5.5
Public order and safety	4.9	4.8	5.2	3.6	4.3	4.4	4.5	4.5
Economic affairs	8.6	7.3	7.1	23.3	8.7	6.7	6.3	5.9
Environmental protection	0.7	0.7	1.1	0.5	0.9	0.7	0.8	1.4
Housing and community amenities	5.8	5.0	4.6	4.6	4.5	3.9	4.2	4.2
Health	7.3	7.2	7.4	5.5	6.4	6.8	6.9	7.7
Recreation, culture and religion	2.8	2.4	2.2	1.8	2.3	2.3	2.4	2.4
Education	16.0	15.2	16.3	12.4	14.9	15.6	14.8	14.4
Social protection	30.0	31.1	32.3	28.3	33.7	35.9	35.0	35.0
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 continue to grow, from 2.2% in 2018 to 2.8% in 2021 and 2.6% by the end of the programming period.

Table VII: Potential GDP and Output Gap estimations

	2017	2018	2019	2020	2021	2022
Real GDP growth	4.5	3.9	3.6	3.2	3.0	3.0
Potential GDP growth	2.2	2.2	2.6	2.8	2.8	2.6
Output Gap (% GDP)	0.3	1.9	2.9	3.3	3.5	4.0

Source: Ministry of Finance

As a result of real and potential GDP evolution, the positive output gap gradually widens during the programming period, from 1.9% in 2018 to 2.9% in 2019 and up to 4.0% in 2022.

The cyclically-adjusted budget balance (CAB) is estimated to have registered a deficit of -5.8% of GDP in 2018 due to the one-off measures of the order of -8.1% of GDP during that year. For the programming period 2019-2022 the CAB returns to positive values and as the positive output gap widens, the CAB surplus is projected to amount to 1.5% of GDP in 2019, 0.8% in 2020, 0.6% in 2021 and 0.1% in 2022. 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	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP growth (%)	4.5	3.9	3.6	3.2	3.0	3.0
Net lending of general government	1.8	-4.8	3.0	2.6	2.4	2.2
Interest expenditure	2.6	2.5	2.3	2.2	2.0	1.9
One-off and other temporary measures	0.0	-8.1	0.0	0.0	0.0	0.0
Potential GDP growth (%)	2.2	2.2	2.6	2.8	2.8	2.6
Output gap	0.3	1.9	2.9	3.3	3.5	4.0
Cyclical budgetary component	0.1	1.0	1.5	1.7	1.8	2.1
Cyclically-adjusted balance	1.6	-5.8	1.5	0.8	0.6	0.1
Cyclically-adjusted primary balance	4.2	-3.3	3.8	3.0	2.6	2.0
Structural balance	1.6	2.4	1.5	0.8	0.6	0.1

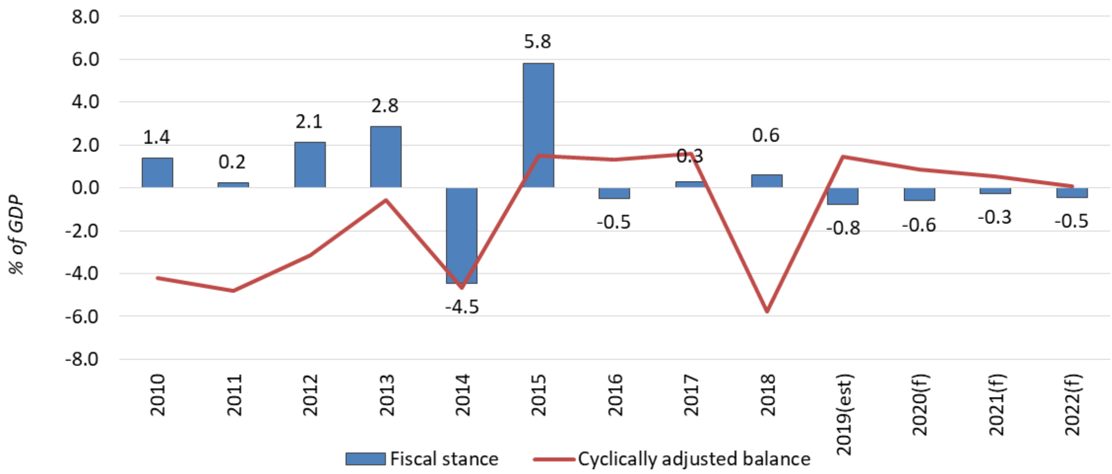
Source: Statistical Service and Ministry of Finance

Therefore, the structural balance during the period 2018-2022 overachieves the medium-term budgetary objective by the same magnitude in percentage points of GDP. This ensures the respect of the medium-term

objective in 2018, as well as up to 2022. Fiscal stance is negative over the medium term, largely due to a very significant in size cyclical budgetary component. The output gap estimations adopted in this Stability Programme are those derived from the common methodology continue to be much more positive than what the fundamentals of the Cyprus economy imply, considering the trend in employment, unemployment and inflation dynamics.

In view of 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) covers a 3-5 year horizon and is endorsed by the Council of Ministers. The presently active Strategy covers the period 2016-2020.

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.

Each guideline is disaggregated into qualitative and quantitative targets and actions.

Financing actions in 2018

The developments around public financing and debt management over the course of 2018 were impacted by the important events around Cyprus Cooperative Bank, the second largest Cypriot bank. In particular, nine domestic bonds were issued in April 2018 for the amount of €2.35 billion and due between 2033-2038 to

facilitate the sale of the bank. These bonds were replaced in July by five different bonds due in the period 2018-2022 for the amount of €3.19 billion. Additionally, cash of €351 million was deposited and remained at the residual entity.

The main source of financing the government needs in 2018 was through the issuance of a 10-year Euro Medium Term Note (EMTN) of €1.5 billion at a coupon of 2.375% and yield rate of 2.4%. The orderbook size reached €4.75 billion from high quality investors, including pension funds/insurance companies and sovereign wealth funds, following the upgrade to investment grade category a few days earlier.

The regular 13-week Treasury Bill auctions of €100 million per auction continued over 2018. At year end there were in total €252 million outstanding compared to a target of €300 million. The decline in the participation at the treasury bill auctions was a result of the banking sector consolidation and the continuous negative yield recorded at auctions. Indeed, the yield of Treasury Bills throughout the year averaged -0.22% and reached a record low of -0.27% in June 2018.

Long-term loans of €56 million were provided by the European Investment Bank and the Council of Europe Development Bank for infrastructure projects, while sales of retail bonds reached €120 million.

During the course of 2018 the first instalments for the €2.5 billion loan granted by the Russian Federation totaling €625 million were made. The loan is due in further six installments up to September 2021. Additionally, the government proceeded with the early repayment of the loans towards the Cyprus Cooperative Bank (at the time in the Hellenic Bank balance sheet) and to Central Bank of Cyprus for the amounts of €324 million and €483 million respectively. These payments shifted the share of marketable debt in the total debt stock from 40% in the beginning of the year to 52% by year end 2018.

In September yields marked a structural downwards shift after the first rating upgrade of the sovereign to investment grade status. The decline in yields continued over the course of the fourth quarter. The new bond issued in September performed well in the secondary market closing about 10 basis points tighter than its launch.

While debt management operations for government financing contributed positively to Cyprus' debt portfolio risk metrics, these were at the same time impacted mostly negatively from the issuance of debt to accommodate the sale of Cyprus Cooperative Bank.

Table IX: Net annual financing by source in 2018 (€ million)

	€ million
Government Securities	**4228**
Treasury Bills	52
Retail bonds	81
Domestic bonds	2595
EMTNs	1500
Loans	**(1449)**
Total net annual financing	**2779**

Source: PDMO

The weighted average maturity of debt declined from 7.0 years at the beginning of the year to 5.9 years at the end of 2018. The respective figures for marketable debt were 4.9 years and 4.4 years. The share of total debt carrying fixed interest rates increased from 54% at the beginning to 62% at the end of the year. The weighted average cost of outstanding debt is estimated at 2.3%, broadly stable vis-à-vis the previous year.

As presented in Table IX, the net annual financing by source reached €2779 million in 2018. The net financing shows the year's debt issuance minus the debt redemptions.

Financing in 2019

The financing needs of 2019 amount to €1.6 billion and comprise only debt redemptions as the fiscal balance is in surplus.

Table X: Financing plan for 2019

Financing needs	**€ billion**
Short term treasury bills	0.3
Long-term bonds	1.3
Long-term loans	0.7
Fiscal needs	(0.7)
Total	**1.6**
Financing sources	**€ billion**
Treasury Bills	0.3
EMTN	1.0
Others (Retail bonds, EIB/CEDB loans)	0.2
Total	**1.5**

Source: Public Debt Management Office
Note: Figures may not add due to rounding

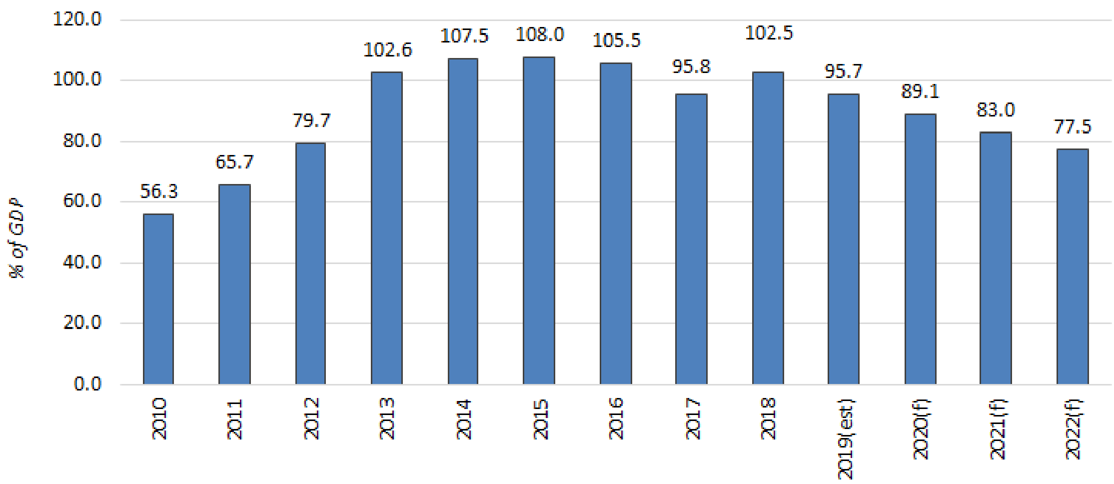
The main financing action of the year 2019 has been the issuance of a 15-year benchmark Euro Medium Term Note in February. The bond carries a coupon of 2.75% and was priced at 99.903% which translates to a yield of 2.758%. This issuance, at the longest tenor in the international markets by the Republic of Cyprus, received the largest orderbook of investor interest exceeding €8.0 billion. The issuance contributed to the main objectives of the Strategy in particular through the lengthening of the sovereign yield curve and broadening of the investor base.

The remaining annual financing will be covered by a mix of funding through Treasury Bills, retail bonds and long-term loans. The cash reserves at year end 2019 are estimated to be adequate to cover the financing needs of the first nine-month period of 2020, as per the current policy.

The grade of completion of the financing plan 2019 at the end of the first quarter was 87% with cash buffers sufficient to cover the financing needs of the next 9-month period.

As presented in Figure 11 below, the general government debt-to-GDP ratio in 2018 increased to 102.5% compared to 95.8% the year before. The increase was attributed to the bonds issued in favour of ex Cyprus Cooperative Bank of the amount of €3.19 bn, in order to facilitate the sale of the bank. In absolute terms, general government debt increased by €2.4 bn reaching €21.3 bn at the end of 2018 from €18.8 bn at the end of the previous year.

Figure 11: Debt ratio



Source: Ministry of Finance

Debt developments

General government debt is projected at €20.7 bn or as a percentage to GDP at 95.7% at the end of 2019, estimated to exhibit a decrease of about 2.3 percentage points of GDP vis-à-vis the year before, mainly attributed to a repayment part of the domestic bonds in favour of the ex-Cyprus Cooperative bank, of the order of €500 mn. Over the programming period 2020-2022, debt-to-GDP ratio is projected to continue its downward trend declining to about 89.1%, 83% and 77.5% by year end 2020, 2021 and 2022, 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).

Table XI: General government debt 2018-2022

in percentage of GDP	2018	2019	2020	2021	2022
Gross debt ratio	102.5	95.7	89.1	83.0	77.5
Change in debt ratio	6.8	-6.9	-6.6	-6.1	-5.4
Primary balance	-2.3	5.3	4.8	4.4	4.1
Interest expenditure	2.5	2.3	2.2	2.0	1.9
Stock-flow adjustment	7.0	0.6	0.0	0.2	0.3

Source: Ministry of Finance

The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called “snow ball” effect. The positive stock flow adjustment in 2018, equivalent to 7% of GDP, reflects the accumulation of liquid assets in the form of deposits related to the issuance of domestic bonds in

favour of ex-Cyprus Cooperative bank. In 2019, the stock flow adjustment is positive at about 0.6% of GDP owing to the accumulation of financial assets.

The contribution of SFA is projected to be zero during the year 2020, and marginally positive in 2021 and 2022 of about 0.2 and 0.3 percent of GDP respectively, implying, partly, accumulation of liquid assets in the form of deposits.

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.

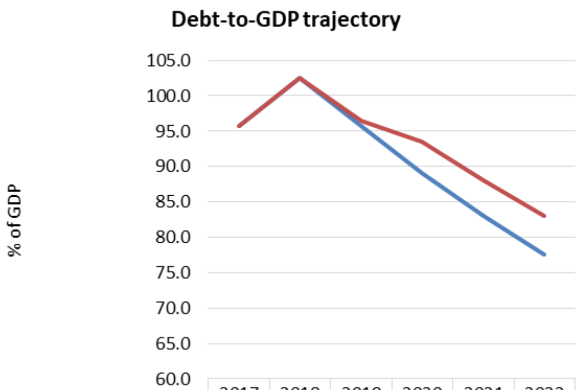
Sensitivity analysis

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 83% by 2022, compared to 77.5% under the baseline scenario.

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



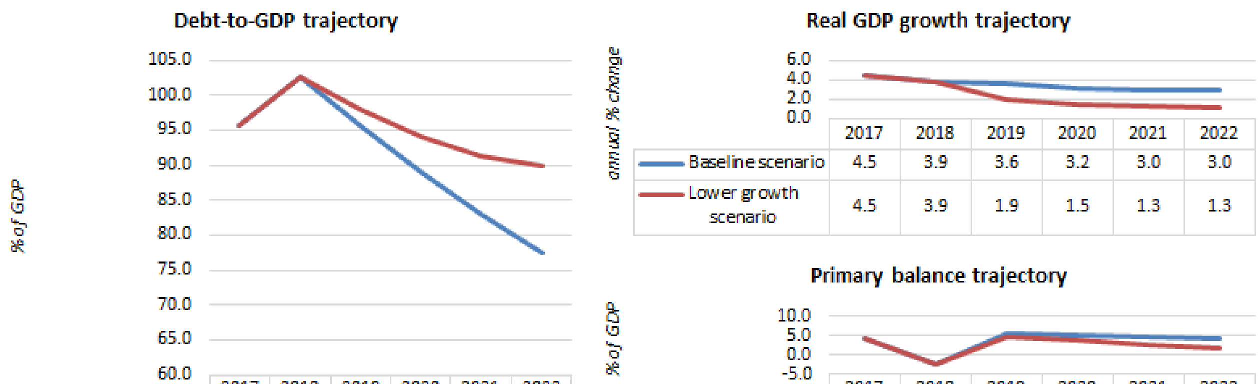
	2017	2018	2019	2020	2021	2022
Baseline scenario	95.8	102.5	95.7	89.1	83.0	77.5
Higher interest rate scenario	95.8	102.5	96.5	93.6	88.0	83.0

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 2017-2022. The debt ratio still projects a sustainable downward path over the medium term, declining to 89.9% by 2022.

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	2022
Baseline scenario	95.8	102.5	95.7	89.1	83.0	77.5
Lower growth scenario	95.8	102.5	98.0	94.2	91.4	89.9

Real GDP growth trajectory (annual % change)

	2017	2018	2019	2020	2021	2022
Baseline scenario	4.5	3.9	3.6	3.2	3.0	3.0
Lower growth scenario	4.5	3.9	1.9	1.5	1.3	1.3

Primary balance trajectory (% of GDP)

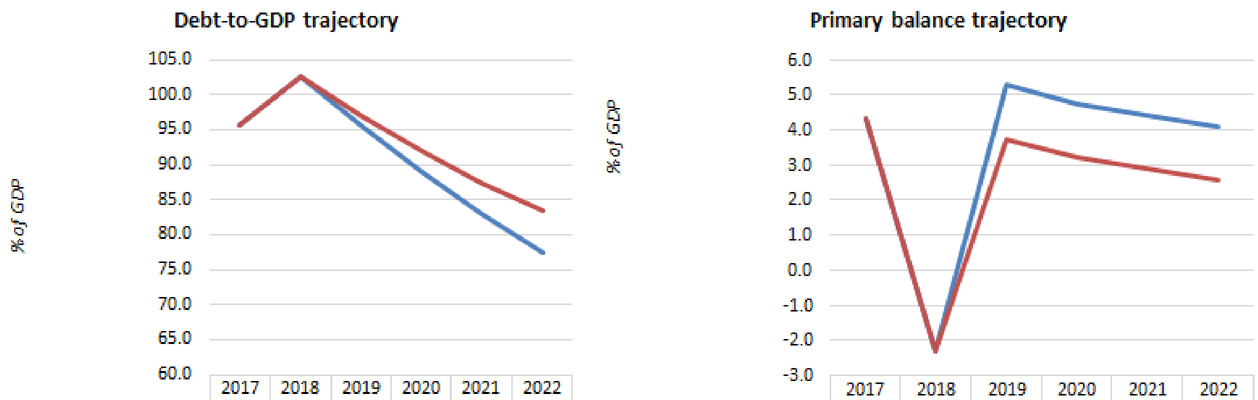
	2017	2018	2019	2020	2021	2022
Baseline scenario	4.3	-2.3	5.3	4.8	4.4	4.1
Lower growth scenario	4.3	-2.3	4.7	3.5	2.6	1.6

Source: Ministry of Finance

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

In the third scenario, primary balance as a percentage of GDP is reduced by half of the 10-year historical standard deviation for each year over the programming period. Under this scenario, even though the debt to GDP in 2022 is expected to be higher than the baseline, there is still a downward trend, where debt ratio declines to 83.5% by 2022.

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	2022
Baseline scenario	95.8	102.5	95.7	89.1	83.0	77.5
Lower primary balance scenario	95.8	102.5	97.2	92.1	87.5	83.5

Primary balance trajectory

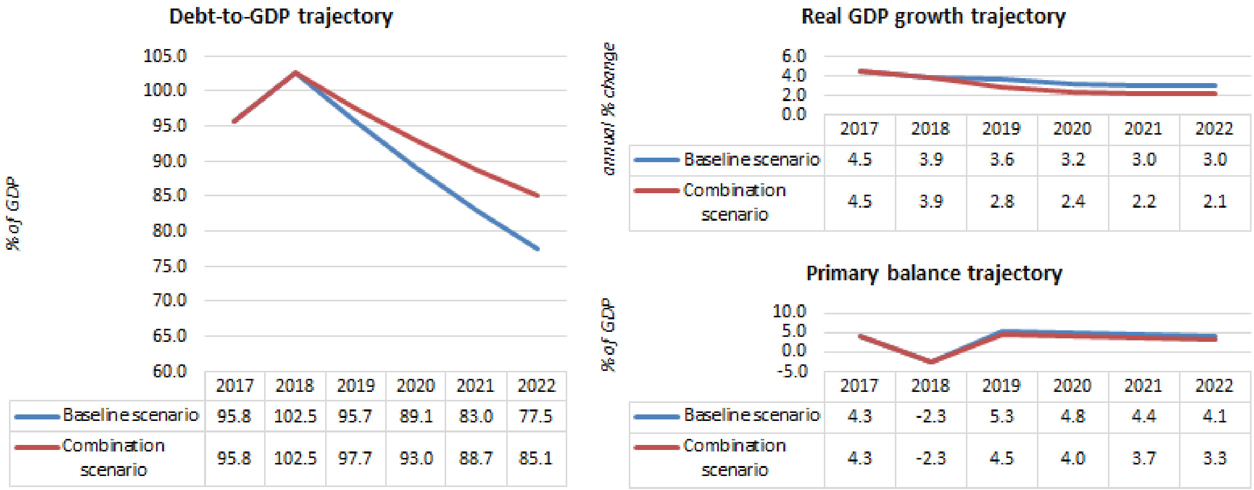
	2017	2018	2019	2020	2021	2022
Baseline scenario	4.3	-2.3	5.3	4.8	4.4	4.1
Lower primary balance scenario	4.3	-2.3	3.7	3.2	2.9	2.6

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 ¼ of their 10-year historical standard deviation. Under this scenario, even though the debt to GDP in 2022 is expected to be higher than the baseline, there is still a downward trend, declining to 85.1% by 2022.

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



Debt-to-GDP trajectory (% of GDP)

	2017	2018	2019	2020	2021	2022
Baseline scenario	95.8	102.5	95.7	89.1	83.0	77.5
Combination scenario	95.8	102.5	97.7	93.0	88.7	85.1

Real GDP growth trajectory (annual % change)

	2017	2018	2019	2020	2021	2022
Baseline scenario	4.5	3.9	3.6	3.2	3.0	3.0
Combination scenario	4.5	3.9	2.8	2.4	2.2	2.1

Primary balance trajectory (% of GDP)

	2017	2018	2019	2020	2021	2022
Baseline scenario	4.3	-2.3	5.3	4.8	4.4	4.1
Combination scenario	4.3	-2.3	4.5	4.0	3.7	3.3

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 2019-2022. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2022 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	8.9	8.7	8.3	8.0	8.0
Total Amount of Contributions[2]	7.0	7.1	7.3	7.5	7.3	7.0
Reserves of the GSIS	36.2	35.0	32.0	29.8	28.0	20.4

[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 7.5 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 8.3% of GDP in 2040 and 8.0% of GDP by 2060. At the same time, contributions increase from 7.0% of GDP in 2010 to 7.5% of GDP over the period 2040 and reach 7.0% 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 20.4% 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 14% of GDP in 2060.

Health care expenditure is projected to marginally decrease by 0.7 p.p. between 2016-2060, decreasing from 2.7% 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 5.9% in 2016 to about 2.9% 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 7.5% of GDP until 2040, and finally decrease to 7% of GDP in 2060.

As a result of the above, total general government expenditure will decrease from 38.3% of GDP in 2020 to 35% of GDP by 2060. General government revenue is projected to increase from 37% of GDP in 2010 to around 40.2% of GDP in 2060.

APPENDIX: STABILITY TABLES

Table 1a. Macroeconomic prospects

		2018	2018	2019	2020	2021	2022
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	20,290.2	3.9	3.6	3.2	3.0	3.0
2. Nominal GDP	B1*g	20,730.9	5.5	4.6	4.4	4.5	4.5
3. Private consumption expenditure	P.3	13,571.9	3.7	3.3	2.8	2.5	2.5
4. Government consumption expenditure	P.3	3,293.9	4.3	3.6	3.4	3.0	2.8
5. Gross fixed capital formation	P.51	3,937.0	-7.1	9.4	7.8	7.0	6.4
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0.1646	0.0	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	12,779.4	3.3	2.7	2.4	2.4	2.4
8. Imports of goods and services	P.7	13,469.4	2.0	4.0	3.4	3.1	3.0
Contributions to real GDP growth							
9. Final domestic demand		20.912,9	3.1	4.6	4.0	3.6	3.5
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	0.1646	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-690.0	0.7	-1.0	-0.8	-0.6	-0.5

Notes

(1) The chain-linking method, is not applicable to the variable "changes in inventories (incl. valuables)", since negative values are observed for certain years. This method is followed by all Member States and Eurostat.

(2) The volume measures (reference year 2010) is the result of the chain-linking method, as well as the application of the non-additivity approach, as required by Eurostat so the total GDP is not the same as the sum of its components φορ 2018.

(3) The chain-linking method, is not applicable to the variable "Changes in inventories (incl. valuables)", since negative values are observed for certain years. Due to this, for 2018 historical values for P.52 + P.53, and implicitly final domestic demand, are non-available. For the purposes of this Stability Programme, a Eurostat estimated figure is presented for P.52 + P.53 for 2018. Finally, figures in rows 9,10 and 11 do not sum up to figure in row 1 due to the application of the non-additivity approach in which discrepancies arise in individual elements and their total.

Table 1b. Price developments

	ESA Code	2018 Level	2018 rate of change	2019 rate of change	2020 rate of change	2021 rate of change	2022 rate of change
1. GDP deflator		102.2	1.6	1.0	1.2	1.5	1.5
2. Private consumption deflator		103.1	1.2	0.5	1.2	1.5	1.5
3. HICP[1] [2015=100]		100.2	0.8	0.5	1.2	1.5	1.5
4. Public consumption deflator		95.3	1.4	2.6	1.7	2.0	2.2
5. Investment deflator (GFCF)		102.2	2.6	0.8	1.5	2.2	2.7
6. Export price deflator (goods and services)		104.3	1.4	0.5	1.2	1.5	1.5
7. Import price deflator (goods and services)		101.6	0.0	0.4	1.5	1.9	2.1

Table 1c. Labour market developments

	ESA Code	**2018** Level	**2018** rate of change	**2019** rate of change	**2020** rate of change	**2021** rate of change	**2022** rate of change
1. Employment. persons (thousands)[1]		417.7	4.0	3.5	3.0	2.5	2.5
2. Employment. hours worked[2] (thousands)		745,938	3.6	3.5	3.0	2.5	2.5
3. Unemployment rate (%)[3]		36,617	8.4	7.0	6.0	5.5	5.0
4. Labour productivity. persons[4]		48,579.2	-0.1	0.1	0.2	0.5	0.5
5. Labour productivity. hours worked[5]		27.2	0.2	0.1	0.2	0.5	0.5
6. Compensation of employees (€ million)	D.1	8,946.6	4.3	4.0	4.3	4.3	4.5
7. Compensation per employee (in €)		24,248.8	0.1	0.5	1.3	1.8	2.0

[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	2018	2019	2020	2021	2022
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-7.0	-7.8	-8.2	-8.7	-9.2
of which:						
- Balance on goods and services		*-2.2*	*-3.3*	*-4.2*	*-4.9*	*-5.6*
- Balance of primary incomes and transfers		-4.9	-4.5	-4.0	-3.8	-3.7
2. Net lending/borrowing of the private sector	B.9	-2.2	-10.8	-10.8	-11.1	-11.4
3. Net lending/borrowing of general government	EDP B.9	-4.8	3.0	2.6	2.4	2.2
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Table 2a: General government budgetary prospects

% of GDP	ESA Code	2018*	2018	2019	2020	2021	2022
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-989.6	-4.8	3.0	2.6	2.4	2.2
2. Central government	S.1311	-1,149.6	-5.5	1.9	1.5	1.4	1.2
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	10.0	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	150.0	0.7	1.0	1.0	0.9	0.9
General government (S13)							
6. Total revenue	TR	8,225.7	39.7	40.7	40.9	40.6	40.1
7. Total expenditure	TE[1]	9,215.3	44.5	37.7	38.3	38.2	38.0
8. Net lending/borrowing	EDP B.9	-989.6	-4.8	3.0	2.6	2.4	2.2
9. Interest expenditure	EDP D.41	515.1	2.5	2.3	2.2	2.0	1.9
10. Primary balance[2]		-474.5	-2.3	5.3	4.8	4.4	4.1
11. One-off and other temporary measures[3]		-1,659.5	-8.1	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		5,221.7	25.2	24.4	24.1	23.9	23.7
12a. Taxes on production and imports	D.2	3,300.4	15.9	15.2	15.0	14.9	14.7
12b. Current taxes on income. wealth. etc	D.5	1,920.5	9.3	9.2	9.2	9.1	9.0
12c. Capital taxes	D.91	0.8	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1,842.8	8.9	10.9	12.1	12.2	12.2
14. Property income	D.4	132.7	0.6	0.7	0.4	0.4	0.4
15. Other[4]		1,028.5	5.0	4.6	4.2	4.0	3.8
16=6. Total revenue	TR	8,225.7	39.7	40.7	40.9	40.6	40.1
p.m.: **Tax burden** (D.2+D.5+D.61+D.91-D.995)[5]		7,064.5	34.1	35.4	36.3	36.2	35.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3,275.5	15.8	16.1	16.1	16.1	16.1
17a. Compensation of employees	D.1	2,456.3	11.8	12.1	12.4	12.6	12.7
17b. Intermediate consumption	P.2	819.2	4.0	4.0	3.7	3.6	3.4
18. Social payments (18=18a+18b)		2,708.8	13.1	14.4	15.4	15.5	15.5
of which Unemployment benefits[6]		75.7	0.4	0.3	0.3	0.3	0.3
18a. Social transfers in kind supplied via market producers	D.6311. D.63121. D.63131	6.8	0.0	0.0	0.0	0.0	0.0
18b. Social transfers other than in kind	D.62	2,702.0	13.0	14.3	15.3	15.5	15.5
19=9. Interest expenditure	EDP D.41	515.1	2.5	2.3	2.2	2.0	1.9
20. Subsidies	D.3	59.9	0.3	0.3	0.3	0.3	0.2
21. Gross fixed capital formation	P.51	1,095.3	5.3	2.1	2.0	2.0	2.0
22. Other[6]		1,560.7	7.5	2.5	2.4	2.2	2.1
23=7. Total expenditure	TE[1]	9,215.3	44.5	37.7	38.3	38.2	38.0
p.m.: Government consumption (nominal)	P.3	2,998.7	14.5	14.8	15.1	15.3	15.5

**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	2018 Level	2018 % of GDP	2019 % of GDP	2020 % of GDP	2021 % of GDP	2022 % of GDP
1. Total revenue at unchanged policies		8,159.7	39.4	38.9	37.9	37.5	37.0
2. Total expenditure at unchanged policies		7,489.8	36.1	35.7	35.1	34.9	34.7

Table 2c. Amounts to be excluded from benchmark

	2018 Level (€ mn)	2018 % of GDP	2019 % of GDP	2020 % of GDP	2021 % of GDP	2022 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	169.2	0.8	0.6	0.5	0.5	0.5
2. Cyclical unemployment benefit expenditure	-13.1	-0.1	-0.1	-0.1	-0.1	-0.1
3. Effect of discretionary revenue measures	81.0	0.4	1.9	1.1	0.3	0.1
4. Revenue increases mandated by law	-	-	-	-	-	-

Table 3. General Government expenditure by function

% of GDP	COFOG Code	2017	2022
1. General public services	1	7.3	7.2
2. Defence	2	2.0	2.1
3. Public order and safety	3	1.7	1.7
4. Economic affairs	4	2.3	2.2
5. Environmental protection	5	0.3	0.5
6. Housing and community amenities	6	1.6	1.6
7. Health	7	2.6	2.9
8. Recreation. culture and religion	8	0.9	0.9
9. Education	9	5.5	5.5
10. Social protection	10	13.0	13.3
11. Total expenditure (=item 3=22 in Table 2a)	TE	37.1	38.0

Table 4. General government debt developments

% of GDP	ESA Code	**2018**	**2019**	**2020**	**2021**	**2022**
1. Gross debt		102.5	95.7	89.1	83.0	77.5
2. Change in gross debt ratio		6.8	-6.9	-6.6	-6.1	-5.4
Contributions to changes in gross debt						
3. Primary balance	B.9+D.41	-2.3	5.3	4.8	4.4	4.1
4. Interest expenditure	D.41	2.5	2.3	2.2	2.0	1.9
5. Stock-flow adjustment		7.0	0.6	0.0	0.2	0.3
of which:						
- Differences between cash and accruals		0.0	0.1	0.0	0.0	0.0
- Net accumulation of financial assets		7.0	0.6	0.0	0.2	0.3
p.m.: Implicit interest rate on debt		2.7	2.4	2.4	2.4	2.4
6. Liquid financial assets8		30.8	30.0	28.7	27.6	26.8
7. Net financial debt (7=1-6)		71.8	65.7	60.4	55.3	50.8

Table 5. Cyclical Developments

% of GDP	ESA Code	**2018**	**2019**	**2020**	**2021**	**2022**
1. Real GDP growth (%)		3.9	3.6	3.2	3.0	3.0
2. Net lending of general government	B.9	-4.8	3.0	2.6	2.4	2.2
3. Interest expenditure	D.41	2.5	2.3	2.2	2.0	1.9
4. One-off and other temporary measures[1]		-8.1	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		2.2	2.6	2.8	2.8	2.6
contributions:						
- labour		1.3	1.3	1.2	1.0	0.7
- capital		0.9	1.1	1.2	1.3	1.4
- total factor productivity		0.0	0.2	0.4	0.5	0.5
6. Output gap		1.9	2.9	3.3	3.5	4.0
7. Cyclical budgetary component		1.0	1.5	1.7	1.8	2.1
8. Cyclically-adjusted balance (2 - 7)		-5.8	1.5	0.8	0.6	0.1
9. Cyclically-adjusted primary balance (8 + 3)		-3.3	3.8	3.0	2.6	2.0
10. Structural balance (8 - 4)		2.4	1.5	0.8	0.6	0.1

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

Table 6. Divergence from previous update

	ESA Code	2018	2019	2020	2021	2022
Real GDP growth (%)						
Previous update		3.8	3.6	3.2	3.0	n.a.
Current update		3.9	3.6	3.2	3.0	3.0
Difference		0.1	0.1	0.0	0.0	
General government net lending (% of GDP)	B.9					
Previous update		1.7	1.7	1.8	1.9	n.a.
Current update		-4.8	3.0	2.6	2.4	2.2
Difference		-6.4	1.2	0.8	0.5	
General government gross debt (% of GDP)						
Previous update		105.6	100.0	94.6	88.0	n.a.
Current update		102.5	95.8	89.1	83.0	77.6
Difference		-3.1	-4.2	-5.5	-4.9	

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	37.6	41.5	38.3	36.9	35.7	35.1	35.0
Of which: **age-related expenditures**	15.4	18.3	17.4	15.8	14.7	14.1	14.0
Pension expenditure	6.0	6.9	8.9	8.7	8.3	8.0	8.0
Social security pension	4.0	4.8	6.9	7.3	7.3	7.6	7.9
Old-age and early pensions	2.9	3.6	5.6	5.9	6.0	6.3	6.6
Other pensions (disability, survivors)	1.1	1.2	1.3	1.3	1.4	1.3	1.3
Occupational pensions (if in general government)[1]	2.0	2.1	2.0	1.4	1.0	0.3	0.1
Health care	2.6	3.0	2.5	2.3	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	4.9	3.9	3.3	2.9	2.9
Other age-related expenditures	0.7	1.3	0.8	0.7	0.7	0.7	0.7
Interest expenditure[3]	…	…	…	…	…	…	…
Total revenue	40.7	37.0	40.9	40.6	40.7	40.6	40.2
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	7.1	7.3	7.5	7.3	7.0
Pension reserve fund assets	32.7	36.2	35.0	32.0	29.8	28.0	20.4
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	0.6	0.9	0.2	1.0	1.3	1.7	1.6
Real GDP growth	5.1	1.3	3.2	2.3	2.3	2.0	2.0
Participation rate males (aged 20-64)	82.9	80.4	79.4	80.2	80.0	80.5	80.9
Participation rates females (aged 20-64)	65.4	67.4	71.3	74.0	74.4	75.4	76.3
Total participation rates (aged 20-64)	73.9	73.6	75.2	77.0	77.1	77.9	78.6
Unemployment rate (15+)	3.9	6.3	6.0	5.0	5.0	5.0	5.0
Population aged 65+ over total population	12.4	12.7	16.7	20.3	22.8	26.6	31.7

[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	2018	2019
Public guarantees	22.6	21.4
Of which: linked to the financial sector	13.4	12.2

Table 8. Basic assumptions

	2018	2019	2020	2021	2022
EA: Short-term interest rate (3-months money markets)	-0.32	-0.31	-0.26	...	...
EA: Long-term interest rate (10-year government bonds, Germany)	0.40	0.07	0.22	...	...
USD/€ exchange rate (annual average)	1.18	1.13	1.13	1.13	1.13
Nominal effective exchange rate of the EU (% change)	6.54	-2.03	-0.12	...	...
World growth excluding EU (in PPP terms)	4.0	3.8	3.8	...	...
EU 28 GDP growth	2.1	1.9	1.8	...	...
Growth of relevant foreign markets [UK]	1.3	1.3	1.2	...	...
World import volumes. excluding EU	4.7	3.0	3.6	....	...
Oil prices (Brent. USD/barrel)	71.5	68.9	67.6	...	...