REPUBLIC OF CYPRUS

STABILITY PROGRAMME

OF THE

REPUBLIC OF CYPRUS

2012-2015

Ministry of Finance

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STABILITY PROGRAMME
OF THE
REPUBLIC OF CYPRUS

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 2012-15. The SP has been prepared in line with the revised 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.

This Programme incorporates measures in response to the Council Recommendation to Cyprus, issued on the 13th of July 2010 under the Excessive Deficit Procedure (EDP), with a view to correct the excessive government deficit, by 2012 at the latest. Furthermore, the programme incorporates the national policy response to the Council recommendations on last year's update of the Stability Programme 2010-2014 of Cyprus.

In line with the standard national procedure, this Programme is the product of consultations with political parties and social partners. During these consultations, a consensus on the significance of achieving fiscal consolidation and reducing the fiscal deficit in a sustainable manner has emerged. The Government of the Republic of Cyprus ("the Government") remains engaged in a continuous dialogue with political parties and social partners, with a view to safeguarding the systematic monitoring of the implementation of the SP, successful delivery of the programme's targets and the promotion of the reform agenda.

The SP 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 Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as ambitious yet credible. These are based on a prudent macroeconomic scenario while, a safety margin has been incorporated in the design of the fiscal consolidation programme. Nevertheless, given the challenging period the euro area is going through, uncertainty is high while the balance of risks is clearly tilted on the downside. Therefore, close monitoring is deemed necessary for the timely implementation of the Programme to ensure its successful outcome. The Government remains committed in safeguarding the successful delivery of its Programme's targets. For this reason, it stands ready to intervene and introduce additional corrective measures, should this be warranted by adverse developments.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The overriding objectives of the Government of the Republic of Cyprus are to enhance growth and the standard of living of all citizens, in particular of low-income groups, placing due attention to reducing poverty and social exclusion, to maintain macro-financial stability, implement structural reforms that improve the functioning of the market mechanism and ensure that the government sector provides, adequately and efficiently, services to the public. Acknowledging the crucial role of sound public finances in attaining these objectives, the Government attaches particular importance on securing a timely and durable correction of its excessive deficit. Efforts in delivering these objectives take place on a backdrop of a particularly uncertain international economic environment. In particular, the continuing turbulence in sovereign debt markets, the recapitalisation process in the European banking sector, together with subdued investor sentiment, persistent fiscal challenges and low growth environment, pose substantial challenges to economic policy-making.

In the context of crisis response at the European level, a number of important measures have been agreed and implemented, such as the introduction of the "Six Pack" legislation for enhancing economic governance and other measures for crisis resolution management in the financial sector. With a view to further strengthening economic governance, the "Two Pack" legislation, for countries in Excessive Deficit Procedure and for countries experiencing challenges in the financial sector, has been promoted. More recently, a new "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" has been adopted, which includes important provisions for conducting fiscal policy. The Government of the Republic of Cyprus supports these initiatives, as well as any measure to improve economic governance at both national and European level, as these are a prerequisite for sustainable growth and job creation.

Cyprus is currently facing multidimensional challenges. Firstly, to pursue fiscal consolidation through measures of permanent nature mainly on the expenditure side that would ensure a sustainable correction of the excessive deficit by the end of the current year, the deadline set by the Council, and set the public debt-to-GDP ratio on a declining trend over the medium term. Secondly, to secure conditions for sustainable and inclusive economic growth and job creation, through addressing structural weaknesses. Moreover, Cyprus needs to ensure the smooth recapitalisation of its banking sector, which is highly exposed to the Greek market. The Government is committed in taking effective action and delivering successful outcomes in all three fronts that would also be conducive in Cyprus regaining access to the international financial markets for its financing.

Fiscal policy

Over the programme period, fiscal policy will be determined, to a great extent by the obligation to correct the excessive deficit by the end of 2012 at the latest and subsequently reversing the rising trend of debt-to-GDP ratio. Moreover, fiscal policy will be determined by the implementation of the provisions of the new enhanced economic governance framework. In this context, the Government proceeds with the enactment of a legislation introducing a rules-based budgetary framework, with strong fiscal rules building on the provisions of the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" and on the provisions of the corresponding Directive. The enactment of the said legislation envisaged to be finalised during the first semester of the year will set the grounds for fiscal policy administration. In particular, according to the provisions of the legislation, the budgetary position of the general government shall be balanced or in surplus. Moreover, the country shall ensure rapid convergence towards its medium-term objective (MTO), which for Cyprus is defined as a balanced budget in structural terms. In this context, and despite the economic crisis and the slowdown of economic activity, this SP reaffirms its ambitious Medium-Term Objective of a balanced budget.

It is clear that in order to respect the revamped governance framework, a prudent and significantly strict fiscal policy must be conducted. The Government is firmly committed to adopt the necessary measures, mainly on the expenditure side, and to a lesser degree from the revenue side, in, as much as possible, a socially equitable manner and with a structural nature, in order to respond successfully.

The Government has already implemented a series of fiscal consolidation measures of permanent nature, with the bulk on the expenditure side. These included measures aimed at controlling the public wage bill, inter alia via controlling public sector hiring and a reduction in civil servant employees, imposing a two year freeze on wage increases, including on Cost of Living Allowance as well as imposing ceilings on certain spending categories, thus ensuring that overall public expenditure will remain below projected nominal GDP growth and consequently public revenues.

Additionally, a number of structural fiscal reforms are underway, which should lead to better planning of spending, easier control of expenditures and to considerable savings on interest expenditure:

- The implementation of a binding Medium-Term Budgetary Framework (MTBF), which will institutionalize expenditure rules, will give to fiscal policy a more medium-term perspective, more independence to spending ministries and, at the same time, increase their accountability;
- The introduction of binding fiscal rules through primary legislation;
- Enhancement of public debt and cash management systems;

- A restrictive stance in public sector wage setting process, including the reduction of salary scales for newcomers in the broader public sector by 10%;
- Abolition of the occupational pension scheme for new employees in the broader public sector;
- Targeting of social schemes based on income and economic criteria.

Economic growth

At the current juncture, the challenge for governments across the EU is to balance the need to support weak economic activity and growth prospects on the one hand, with the need to consolidate public finances on the other. On this basis, the Government of the Republic of Cyprus places particular emphasis on the quality of public spending through the reduction of current expenditure and the reallocation of resources in favour of productive, capital expenditure, as well as, targeted social spending. Placing emphasis on infrastructure is particularly important at the current economic juncture, given the continuing contraction of the construction sector.

In this regard, a package of measures has been recently adopted by the Council of Ministers with the aim of boosting economic growth. The measures are grouped into a number of categories, such as measures that support employment (retraining of unemployed individuals, schemes for the support and promotion of employment), public and private investments and enhancing the role of Cyprus as an international business and financial centre providing high value added services. The Government acknowledges the fact that, the impact of some of these measures will be realised over the medium term, in the outer years of the programming period of the SP. Suffice to say that, for prudent reasons, the anticipated impact from these measures on economic growth has not been incorporated in our central reform scenario.

The Government's medium-term strategy also includes an ambitious programme of structural reforms, including a frontloading of measures to increase competitiveness and support employment. These reforms, which also underpin Cyprus` commitments under the **Euro Plus Pact**, are discussed in detail in the Cyprus NRP, whereas the SP includes a description of a number of other structural budgetary reforms, which are underway. These include, inter alia, the following:

- Reforming the Cost of Living Adjustment system within the first semester of the year, without affecting the low income groups, with the aim of improving the effectiveness and limiting in parallel the impact on public finances. To this end extensive consultations with stakeholders, respecting the tripartite framework of wage setting in Cyprus, are taking place; at the same time the need to increase productivity should not be overlooked;
- Maintaining a business friendly taxation regime and extending double tax treaties;

- Reducing red tape and administrative burden, in line with the Better Regulation policy initiative of the EU.

Financial Stability

Another important pillar of the Government`s policy Framework is safeguarding financial stability. To this end, a number of initiatives have already taken place, such as:

- A Memorandum of Understanding has been signed by all supervisory authorities and the Ministry of Finance, and a domestic committee has been established and is operational with the mandate of overseeing financial stability developments in Cyprus.
- Enactment of the Law on the Management of Financial Crises**.** The purpose of this Law is to enable the Council of Ministers - following a proposal by the Central Bank of Cyprus and after taking into account the opinion of the respective supervisory authority- to take, in a period of a financial crisis, measures (i) to address solvency problems of the financial system and/or (ii) to enhance the capital base and/or the balance sheet of financial institutions in the Republic of Cyprus, under conditions that should comply with the Community Rules on State Aid.
- Enactment of a Law on the Establishment of an Independent Financial Stability Fund. The purpose of this Law is the establishment of an independent Financial Stability Fund, financed by contributions of credit institutions, with a view to enhancing the current crisis management and resolution framework in Cyprus and thus contributing to the safeguarding of financial stability. It is emphasised that the Fund does not aim at bailing out or preventing the failure of credit institutions. The objective of the Fund is to support and resolve credit institutions and maintain public confidence in the financial system, as well as minimising moral hazard.

Macroeconomic imbalances

The medium term economic strategy of the Government also includes appropriate responses regarding the macroeconomic imbalances of the economy, as recently identified by the European Commission. On the 14th of February 2012 and in accordance with the provisions of the new European Semester, which calls for the introduction of a new surveillance mechanism for macroeconomic imbalances, the Commission published its first Report.

As noted in the Report, the role of the Alert Mechanism is to work as an initial screening device, where the Commission identifies developments in Member States considered to warrant further in-depth analysis to determine whether imbalances actually exist and whether they are harmful. The Commission Report identified

Cyprus as one of the countries, where an in-depth study is warranted. Currently, the Commission prepares its analysis on the basis of which, if appropriate, policy recommendations will be addressed to the country, either under the preventive or the corrective arm of the procedure.

Box 1. Alert Mechanism Report: Case of Cyprus

Regarding the case of Cyprus, the Report states the following:

"Cyprus: with the values of many indicators above indicative thresholds an economic reading of the scoreboard points to wide-ranging challenges as regards both the external and internal side. The Cypriot economy has been characterised by persistent current account deficits over the past decade mainly driven by buoyant domestic demand. The evolution of the Cypriot current account shows large disparities in the trade of goods and services reflecting a shift of the Cypriot economy towards the tertiary sector. The negative trade balance in goods is only partly compensated by the surplus recorded in services trade. Cyprus recorded price competitiveness losses in the years ahead of the crises but this trend has been more contained in later years. The highly leveraged private sector has continued to unwind its large level of outstanding debt, which however, it coexists with substantial assets.

It should be emphasized that the net financial position of Cypriot households is comfortably positive. The deterioration of the economic outlook and the fiscal situation as well as the implications from the exposure of the banking sector to Greece add to concerns on the challenges involved in adjusting to imbalances in other sectors of the economy.

The Alert Mechanism Report constitutes a comprehensive analysis of Members States external and internal competitiveness. Although a lot still remains to be done in order to enhance the understanding behind the preliminary evidence of the Scoreboard and the accompanying economic analysis, it does form a solid basis on which to form an in-depth analysis.

Current Account position

A particular feature of the balance of payments of Cyprus is the income account, which is greatly affected by the role of Cyprus as an international business and financial centre. More concretely, the profits of these international organizations are statistically treated as outflows from the income account, thus burdening the current account balance, however in parallel, in the capital account a corresponding inflow is recorded in the form of reinvested earnings. The table below shows that the "statistical" treatment of profits of international organizations operating from Cyprus are sizeable and they burden the current account balance, however from an analytical prospective they do not reflect either the competitiveness or the sustainability position of the country. Excluding the effect of this element, the current account position of the country appears more manageable.

It should be mentioned that the current account deficits have been financed though non debt flows.

The trade balance of goods, exhibits persistent deficits, attributed to competitiveness problems of the manufacturing sector, the re-allocation of production factors in favour of the services sectors in line with the comparative advantages of Cyprus and the overheating of the economy, before the financial crisis.

In more recent years, the trade balance has improved, on account of both the containment of the potential GDP growth, but also the cyclical slowdown of economic activity.

The services account is showing surpluses, which ameliorate but do not offset the deficit in the goods balance. Important drivers have been the noteworthy performance in the exports of business and financial services, reflecting the comparative advantages of Cyprus as an international business and financial centre.

The balance of goods and services, which is deemed to be a better indicator for the competitiveness of the economy improved substantially during recent years from a deficit of 11.4% of GDP in 2008 to a deficit of 3.6% in 2011. Part of this deficit is attributed to higher oil imports and higher imports of defence equipment and is not directly linked to competitiveness issues.

	2007	2008	2009	2010	2011
CURRENT ACCOUNT (CA)	**-1.865,0**	**-2.679,0**	**-1.808,0**	**-1.711,9**	**-1.855,1**
% GDP	***-11.8***	***-15.6***	***-10.7***	***-9.9***	***-10.4***
TRADE BALANCE (TB)	**-1.039,6**	**-1.953,4**	**-929,6**	**-1.081,6**	**-639,8**
% GDP	***-6.6***	***-11.4***	***-5.5***	***-6.2***	***-3.6***
Trade balance in Goods	**-4.710,4**	**-5.554,8**	**-4.292,4**	**-4.664,1**	**-4.342,9**
% GDP	***-29.8***	***-32.4***	***-25.5***	***-26.9***	***-24.5***
Trade balance in Services	**3.670,7**	**3.601,4**	**3.362,8**	**3.582,5**	**3.703,2**
% GDP	***23.2***	***21.0***	***20.0***	***20.7***	***20.8***
GDP	15.829,7	17.157,1	16.853,5	17.333,6	17.761,4
Oil (Imports)	895,2	1.244,6	880,6	1.156,1	1.382,5
Defence (Imports)	13,3	26,3	8,6	115,5	64,7
Net Re-invested earnings	-386	-6	-1.009	249	-1.074
Normalised Current Account as % of GDP					
CA with Normalised Oil	-11.7	-13.8	-10.8	-8.5	-7.9
CA with Normalised Defence	-11.9	-15.6	-10.8	-9.4	-10.3
CA excluding re-invested earnings	-9.3	-15.6	-4.7	-11.3	-4.4
Total effect of normalisation	-9.4	-13.9	-4.9	-9.5	-1.5
Normalised Trade Balance as % of GDP					
TB with Normalised Oil	-6.5	-9.5	-5.6	-4.8	-0.8
TB with Normalised Defence	-6.7	-11.4	-5.6	-5.8	-3.4
Total effect of normalisation	-6.6	-9.5	-5.7	-4.3	-0.6

Looking forward, the underlying current account position of the country is expected to improve, on the account of the continuing satisfactory performance of export of services (tourism, financial services and business services) and the expected containment of the

domestic demand, reinforced through the fiscal consolidation and the subsequent improvement of the public savings investment balance.

From a policy perspective this process is envisaged to be supported by fiscal consolidation, the moderate wage settlements, which will improve the prospects mainly for tourism, as well as the policies already implemented to reinforce the role of Cyprus as a business centre.

Net International Investment Position

The Net International Investment Position (NIIP) deteriorated markedly in the period 2007-2011. From a positive NIIP of 11.7% of GDP in 2007, it became negative in 2008 at -15.1% and deteriorated further at -30.4% in 2009, -43.4% in 2010, until by 2011 NIIP fell to -80.7% of GDP. Although part of NIIP developments are explained by current account deficits, price, exchange rate and other changes, a remaining difference remains to be explained by losses due to price changes of Cyprus portfolio holdings in Greek government debt securities (PSI). Particularly, in 2011 a significant part of the deterioration in the NIIP is due to the PSI.

The PSI has admittedly had a pronounced effect on the level of the NIIP of the country. Therefore, it should be acknowledged that sustained improvement in the current account balance is necessary to enhance the sustainability position of the country.

Export Market Shares

Despite the very challenging external environment, export prospects appear moderately positive. The main driver of growth is expected to be the tourism sector, following initiatives of the government and the private sector to expand into new markets, while extending the tourism period.

Furthermore, wage moderation, or even decreases are expected in some sectors of the economy. It is expected that the trend towards wage growth moderation will continue, driven by the economic slowdown, rising unemployment and public sector wage restraint that should spill over to the private sector. Moreover, the presence of foreign workers should also contribute to this respect. This is particularly relevant for the tourism sector, a tradable sector in Cyprus where wage competitiveness does play an important role.

A final note on wage developments concerns developments in relation to the Cost of Living Adjustment mechanism in effect in Cyprus today. The social dialogue between the Government and social partners is about to start imminently, and is to be completed within the first semester of 2012. The political commitment on the social dialogue on COLA comes in response to the Council Country Specific Recommendations 2011 on wage indexation, and also in relation to the commitments undertaken by Cyprus in the context of the Euro Plus Pact. The social partners will discuss all possible reform options towards a more efficient and equitable COLA system in Cyprus.

Private debt

Gross private sector indebtedness in Cyprus, as a percentage of GDP, is one of the highest in the EU. Concerning households, this is largely due to the fact that Cypriots have a high tendency for home ownership. In concrete terms, 73.8% of Cypriots owned their own residence in 2010, compared to 66.7% on average in the euro area. As a result, housing loans form the bulk of loans by households, with loans with a purpose to purchase the household main residence coming up to 74.7% of all loans in 2009.

The high indebtedness of non-financial corporations is explained by the fact that 99% of enterprises in Cyprus are SMEs. In fact, these are mostly very small family enterprises, operating in an environment that lacks a developed capital market to which they can resort to raise capital. As a result, lending from banks is their main source of funding.

The net financial position, which is what matters most in analysing the vulnerability/imbalances of the private sector, is less problematic than what the liability side on its own suggests. Moreover, with regards to the household housing loans, these are securitized with collateral and cash deposits. The collateral is usually land or the property itself. Although land prices/immovable property have somehow declined during the current economic crisis the drop has been rather contained at around 4% on average over 2009-2011.

Concluding remarks

Overall, during the pre-crisis period significant imbalances have built up. However, since 2008, due to the economic slowdown, the current account deficit almost halved between 2008 and 2010. The reduction would have been even more pronounced in the absence of one-off factors and rising oil prices, which affected 2010. It is noteworthy that this improvement took place in tandem with a significant deterioration of the fiscal position. This implies a significant improvement in the private sector's balance sheet, following years of rising private indebtedness and rapid credit expansion in the pre-crisis years. The substantial savings of the private sector are reflected in subdued consumption, shrinking investment thus, lower growth. The key challenge now is the reversal of the unfavourable fiscal outlook, while supporting growth and boosting competitiveness. The recent adoption and implementation of significant fiscal consolidation measures, in parallel with growth supporting initiatives, shall lead to further improvement of imbalances in the medium term.

2. ECONOMIC OUTLOOK

World Economy in 2011 and prospects for 2012

General outlook

In 2011 the return to an upward growth path in the global economy that started in 2010 lost steam, although the picture differs across economies and regions. The deterioration of the European economic situation, on the backdrop of the euro area sovereign debt crisis and banking sector challenges, alongside the earthquake in Japan in the beginning of last year, in tandem with increases in oil and commodity prices were amongst the main events that marked the year.

Developing economies continued to grow in 2011, amid inflationary pressures, although at more moderate rates compared to 2010. At the same time, most of the developing economies were affected by the subdued demand in high income countries and reduced capital flows. Growth in the advanced economies was much weaker, with events in the euro area concerning sovereign debt and the banking sector dominating the scene. Unemployment was on the increase in advanced economies, with youth and long-term unemployment especially becoming more of a problem.

According to the latest IMF projections, global growth is estimated to have been contracted to around 4% in 2011 from 5.3% in 2010, and is expected to stabilize at 3.5% in 2012. Moreover, world trade growth is estimated to have dropped from 12.9% in 2010 to 5.8% in 2011 and estimated to fall further at 4% in 2012.

European Union and the Euro Area

On the backdrop of a sluggish European economic growth outlook, the euro area is still facing challenges in the fiscal front, as the sovereign crisis is yet to be resolved, with many Member States in need of adoption of further consolidation measures. Although labour market conditions appear to have stabilised, only a small amount of unemployment has receded since the recessionary peak. The lacklustre unemployment outlook, especially in those Member States with macroeconomic and fiscal adjustment needs, and high levels of youth unemployment is a major concern. On the positive side, recent decisions at European Union (EU) level to strengthen economic and budgetary coordination and governance are expected to improve confidence levels.

According to the latest European Commission forecasts, growth in the EU is estimated at around 1.5% and in the euro area around 1.4% in 2011. In 2012 economic activity is projected to stagnate in the EU and to deteriorate mildly by 0.3% in the euro area. Inflation is set to subside gradually in 2012 both in the EU and the euro area to 2.3% and 2.1% respectively (from 3.1% and 2.7% in 2011).

Unemployment is generally on the increase, although diverse within Member States, and is expected to be negatively affected by the projected lower growth path.

Within the euro area, only France, Austria and Estonia recorded higher growth rates in 2011, compared to 2010. In France, estimated growth rose to 1.7% in 2011, increasing only marginally from 1.5% in 2010. Austria's growth is estimated to have risen to 3.1%, compared to 2.3% in 2010. Germany maintained a relatively high growth rate, with an estimated growth of 3.0% in 2011, compared to 3.7% in 2010. However, growth is projected to considerably contract in 2012, especially in the euro area, with six Member States going into mild recession, (Belgium (-0.1%), Spain (-1.0%), Italy (-1.3%), Cyprus (-0.5%), Netherlands (-0.9%), and Slovenia (-0.1%)). At the same time, Greece remains in recession, albeit projected to subside to -4.4% in 2012, compared to -6.8% in 2011, while in Portugal the recession is expected to worsen to -3.3% in 2012 compared to -1.5% in 2011.

In the rest of the EU, Sweden maintained a relatively high growth rate in 2011 (4.2% compared to 5.6% in 2010). In the UK, by far the most important trading partner of Cyprus, growth in 2011 is estimated to have increased by 0.7%, compared to 2.1% in 2010. In line with the Euro area developments, growth in the EU as a whole is projected to decline in 2012.

The US, Japan and Russia

The US economy in 2011 recovered moderately (1.7%) considerably lower than in 2010 (3.0%). Labour market conditions have improved modestly, mainly due to the sectors of manufacturing and services. The still somewhat weak labour market situation, together with the tight fiscal and the moderate credit conditions, will pose a drag on domestic demand, and therefore, in 2012, according to the IMF and OECD projections, growth is expected to be slightly higher than 2011 levels.

In Japan, the devastating earthquake in March of 2011 is estimated to have resulted in a contraction of the economy by 0.7%, despite picking up in the second half of the year due to reconstruction works. In 2012, the latest IMF estimations project growth in real terms by 2%.

The economy of Russia, a major economic partner for Cyprus, continued to grow in 2011, keeping the pace up from the recovery that started in the third quarter of 2010, partly due to increased oil prices and stronger domestic demand. Growth in real terms in 2011 came up to 4.3%, same as in 2010. According to the latest projections by the IMF, the growth dynamic of the Russian economy is expected to subside due to weaker domestic demand and investment, amid inflationary pressures and tighter credit conditions, with an overall growth of 4% in 2012.

Risks on the above forecasts remain tilted on the downside, as geo-political tensions impacting on oil price developments, due to supply shocks, are expected to continue in 2012. Commodity prices may exhibit further increases if production is adversely affected and as the effectiveness of the policy measures concerning the sovereign debt crisis in the EU still remain to unfold.

Cyclical Developments and Current Prospects in Cyprus

At the outset of the economic crisis, the Government of the Republic of Cyprus followed an expansionary fiscal policy, in order to mitigate the effects of the crisis. As a result, the economic downturn was less pronounced than the euro area average. However, the ongoing dismal external environment put pressure on growth and fiscal dynamics. Furthermore, structural problems surfaced which together with the adopted fiscal expansion, led to excessive fiscal deficits. The destruction of the main power generating unit in Vasilico in August 2011 led to additional challenges for the Cyprus economy. The Government responded to the urgent need for fiscal consolidation with the introduction of several packages of fiscal consolidation measures towards the end of 2011. All in all, the economy of Cyprus is estimated to have grown by 0.5% in 2011, according to preliminary estimates, compared to 1.1% in 2010.

Growth was mainly export-led, due to a buoyant performance in the tourism sector and sustained -although mild- expansion of the export-oriented business services sector. Export of goods also performed very well by showing an increase of 23.6% in nominal terms. In constant prices, total exports are estimated to have grown by 3.6% in 2011. On the other hand, in line with weak domestic demand, imports plunged by 5.0%. In particular, imports of goods were reduced by 0.9% while import of services were slightly increased by 0.1% in nominal terms.

Fiscal consolidation, coupled with confidence effects, a deteriorating labour market conditions, as well as tight credit conditions, all weighed on growth. Private consumption is estimated to have increased by 0.2%, whereas public consumption declined by 4.7%. Gross fixed capital formation, is estimated to have decreased by 13.8% in real terms. Investment in construction decreased by 9.3%, solely due to a decrease in housing construction (-21.5%). Similarly, investment in transport equipment exhibited a fall of 48.8% and investment in machinery and equipment exhibited a fall of 19.2%.

From a sectoral point of view, services continued to be the main engine of growth. The agricultural sector grew by 2.9%, whereas the secondary sector contracted as result of a continued decline in the construction sector (-10.3%), as well as the contraction in the manufacturing sector (-3%) and electricity sector (-6.4%). The contraction recorded in the latter two sectors is mainly attributed to the events of the destruction of Vasilico Power Plant in the summer of 2011, which impacted

negatively over the second half of 2011. The tertiary sector, on the other hand, exhibited satisfactory growth mainly as a result of a satisfactory performance in the hotels and restaurants sector (6.7%), information and communication (4.4%), financial intermediation (3.3%) and other business services (3.7%). However, value added in the retail and wholesale trade sector declined in 2011, as a direct result of subdued consumption.

Table I: Selected Economic Indicators 2009-2011

annual % change	**2009**	**2010**	**2011 est.**
GDP growth (constant prices)	-1.9	1.1	0.5
Private consumption	*-7.5*	*1.3*	*0.2*
Gross Fixed Capital Formation	*-9.7*	*-1.7*	*-13.8*
Exports	*-10.7*	*3.7*	*3.6*
Imports	*-18.6*	*4.9*	*-5.0*
GDP deflator	*0.1*	*1.7*	*2.0*
Tourist arrivals (000's)	2.141,2	2.173,0	2.392,2
Tourist arrivals (%)	-10.9	1.5	10.1
HICP	0.2	2.6	3.5
Productivity growth	-1.2	1.1	-0.1
Employment growth	-0.6	0.1	0.6
Nominal Earnings (%)	4.3	2.4	2.7
Unemployment rate (Labour Force Survey)	5.3	6.2	7.7
Trade balance of goods (% of GDP)	-25.5	-26.9	-24.5
Trade balance of services (% of GDP)	20.0	20.7	20.8
Current account balance (% of GDP)	-10.7	-9.9	-10.4

Following the downturn in the economic activity and the fall in employment in 2009, the tight labour market conditions followed led to a significant inflow of foreign workers and thus to an increase in employment in 2011. It is estimated to have increased by some 0.6% compared with the previous year, after a modest increase of 0.1% in 2010. The unemployment rate has averaged 7.7%.

Wage growth in 2011 remained moderate as overall earnings are estimated to have increased by 2.7% in nominal terms. As a consequence, real earnings actually decreased by 0.6%. Nominal unit labour costs are estimated to have increased by 2.8%, while real unit labour costs to have decreased by 0.5%.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), accelerated significantly in 2011 reaching 3.5%. The main drivers were oil price increases, as well as discretionary tax measures on certain consumer goods.

Harmonised core inflation, measured by HICP excluding seasonal food and energy and effects from taxation, increased by 1.8%, compared to 0.5% in 2010.

The current account deficit in 2011 deteriorated at 10.4% of GDP compared to 9.9% in 2010, mainly due to developments in the income account. Despite the adverse effects of oil price increases, the trade deficit of goods and services exhibited a considerable improvement in 2011, falling to 3.6% of GDP from 6.2% the previous year. This is largely due to further acceleration of goods exports by 23.6% after recording a growth of 13.6% in 2010. Export performance of services, in 2011, decelerated at 2.0% from 4.7% a year earlier. Similarly, imports of goods and services decelerated with imports of goods actually falling at a rate of 0.9% in 2011 (compared to an increase of 9.6% in 2010) and imports of services increasing marginally at a rate of 0.1% (compared to an increase of 2.1% in 2010). The income account deteriorated reaching a deficit of 5.7% of GDP in 2011 compared to a deficit of 3% of GDP in 2010. The deterioration in the income account is mainly attributed to the realisation of considerable losses by local financial institutions associated with their exposure to Greek Government Bonds and the agreement on their participation in private sector involvement initiative (PSI) along with losses by bank subsidiaries.

The financial system in Cyprus is in the midst of formidable re-capitalization efforts following the latest EU aid package to Greece and the PSI. However, credit growth inched up to 12% in 2011, from 9.3% a year earlier. The acceleration was particularly due to increased business credit, whereas consumer credit increased only moderately by 0.3%, as in the year before. At the same time, housing credit growth actually decelerated profoundly in 2011 (4.4% growth in 2011, compared to 14.3% in 2010).

Medium-term Scenario 2012-2015

Taking into account the high degree of uncertainty in the external environment, the difficulties faced by the financial sector, the fiscal consolidation efforts and the negative confidence climate, the medium-term scenario incorporated in the SP envisages a gradual recovery towards a lower, compared to pre-crisis period, potential GDP growth. This is a conservative scenario and it is in line with the European Commission's forecast.

The recent financial crisis has affected the potential output. According to the latest estimates by the European Commission, the potential growth is now estimated slightly above 1% on average during the period 2012-15 compared to around 3.5% on average during the pre-crisis period. The TFP contribution is at around -0.5%, the labour contribution at around 0.5% and the capital contribution at around 1% on average in 2012-15 from around 0.5%, 1.5% and 1.5%, respectively on average prior to the crisis.

Table II: External Growth Assumptions 2012-2013

	2012	2013
EU	**0.1**	**1.4**
UK	*0.6*	*1.5*
Germany	*0.6*	*1.5*
Greece	*-4.4*	*0.7*
Euro area	**-0.3**	**1.3**
Russia	**4.0**	**3.9**
USA	**2.3**	**2.0**

For the preparation of the underlying macroeconomic framework presented here, the following key assumptions have been made for 2012-15, which are based on information available with a cut-off date April 19, 2012 (Table 8):

- The recovery in the EU and Russia will gather pace in 2013 (see Table II with External Growth Assumptions) and continue thereafter until 2015.
- The price of crude oil (Brent crude), which averaged $111.5 per barrel in 2011, is assumed to reach $119.9 and $113.5 per barrel in 2012 and 2013, respectively and then stabilise at $112 per barrel in subsequent years.
- The dollar/euro exchange rate will average around 1.32$/€ in 2012-15.
- Based on the external assumptions for growth, it follows that tourist arrivals will increase by 2% in 2012 and on average by 3.5% thereafter. Revenues will increase by some 3% in 2012 and on average by 4.5% thereafter.
- Nominal earnings will rise by about 1.5% on average per annum and real earnings will decline by about 0.8% on average during 2012-15. Hence, real unit labour costs are projected to decelerate on average by 1.3% per annum over the same period.
- Employment will expand marginally by around 0.1% on average per annum over 2012-15, in line with the assumption that the inflow of foreign workers will moderate in the medium term.

This profile takes into account moderate optimistic exports. For other components of demand, notably investment in construction, the SP assumes further downward correction, which is offset by the investment plans expected to take place in the period 2012-15.

Against this background, the current account deficit is expected to register a gradual downward trend throughout the programming period, reflecting in particular the envisaged improvement of public sector savings investment balance.

In more detail, private consumption growth is projected to exhibit a moderate gradual increase over the medium term. The SP assumes that private consumption will grow by some 0.7% over the period 2012-15, compared with 2.6% in the period 2006-11. Real disposable income is projected to decline and then gradually increase towards the end of the projection period. Public consumption growth is expected to decline in the medium term, as a result of the adopted fiscal consolidation measures presented in the update SP. Compared with an average growth of around 2.8% over the period 2006-11, public consumption growth is set to decline by around 2.3% per annum over 2012-15.

Investment is expected to exhibit low growth over the medium term, owing mainly to the projected continuing correction of the construction sector. In 2012, the envisaged correction in construction investment is assumed to affect mainly the housing investment and, to a much smaller extent, the other construction investment, which is assumed to benefit and exhibit some growth from the reconstruction work in Vasilico power plant and from other infrastructure projects like the construction of an oil storage terminal by VTTI[1]. Overall, gross fixed capital formation will increase by 1.3% over the period 2012-15. Specifically, during 2012-15 investment in construction will expand on average by 1.3%, investment in machinery and equipment and investment in transport equipment by some 1.7% and 0.4% respectively per annum, following some very large adjustments during the period 2009-11.

Table III: Medium Term Framework, 2012-2015

annual % change	**2006-11**	**2012**	**2013-15**
GDP growth (constant prices)	2.1	-0.5	1.0
Private consumption	*2.6*	*-1.3*	*1.4*
Gross Fixed Capital Formation	*0.2*	*5.5*	*0.0*
Exports	*0.8*	*2.0*	*3.5*
Imports	*1.1*	*1.5*	*2.5*
GDP deflator	*2.7*	*3.0*	*2.1*
Tourist arrivals (000's)	2.321	2.440	2.607
Tourist arrivals (%)	-0.5	2.0	3.5
HICP	2.5	3.0	2.1
Productivity growth	0.8	-0.3	0.7
Employment growth	1.3	-0.2	0.3
Nominal Earnings (%)	4.2	1.0	1.7
Unemployment rate (Labour Force Survey)	5.2	9.5	9.0
Trade balance of goods (% of GDP)	-27.7	-25.0	-25.8
Trade balance of services (% of GDP)	21.5	21.9	23.9
Current account balance (% of GDP)	-10.9	-7.5	-5.7

[1] These two projects were the only ones taken into account.

Imports are assumed to moderately rebound in 2012 following the decrease of 5% in 2011. It is estimated that imports will increase by 1.5% in 2012, due to the increase in oil prices and as well imports for the reconstruction work in Vasilico power plant and the other infrastructure projects, and by around 2.5% on average thereafter. Exports are also forecast to increase in 2012 by some 2% and to further increase in the medium term by 3.5% on average. This moderate performance masks differences among sectors. For example, it is assumed that receipts from tourism will increase by some 3% in nominal terms and around 0% in real terms in 2012, as the world economy wrestles with the on-going recovery. A similarly modest growth is projected in transport services, following a contraction in previous years. Growth is expected to come mainly from the Russian market and to a lesser extent from UK, Germany, Scandinavian countries, as well as other new tourist destinations. Other business services are assumed to exhibit higher growth rates compared to financial services, which are expected to grow less, over the medium term.

This central scenario implies an improvement in the current account balance with the deficit falling on average to around 7% of GDP in 2012 and 2013 and a further improvement thereafter to around 5% of GDP by 2015. These projections are in line with the ones made by the IMF. The trade balance is expected to gradually improve reflecting an improvement in the export of services, mainly tourism, financial and other business services, and a smaller improvement in imports. The income account deficit is expected to decline inform the 2011 high, to levels closer to the ones prior to the PSI. Overall, forecasts in the Balance of Payments are based on the assumed fiscal consolidation. The improvement in the savings-investment balance comes from the implied improvement in the public sector balance and takes into account that the private sector balance, after the significant improvement in 2011, is likely to exhibit a moderate deterioration.

Based on this scenario, real GDP is projected to contract by some 0.5% in 2012 and gradually recover to around 1.5% by 2015.

In order to draw the picture from a sectoral perspective, the growth rates take into account the revised prospects in the economy reflected in lower potential GDP. The baseline scenario in this SP envisages positive growth in hotels and restaurants, but considerably more moderate following the very positive recent performance. Financial intermediation is assumed to grow at significantly lower rates than the historical trend of the sector. At the same time, construction is expected to continue to record negative growth, easing up towards the end of the medium-term horizon. The continued period of recession is assumed to have a direct impact on retail trade, real estate activities and other business activities, which phases out over the medium term.

Table IV: Sectoral growth rates

(annual % change)	**2011**	**2012**	**2013-2015**
Agriculture	2.9	0.1	0.1
Construction	-10.3	-9.6	-5.1
Retail Sector	-0.8	-2.9	-0.1
Hotels and Restaurants	6.7	1.0	0.8
Financial Intermediation	3.3	1.3	1.9
Real Estate Activities	4.2	-0.9	1.7
Other business activities (Professional, scientific and technical services)	3.7	-0.5	2.4

The inflation rate constitutes a major uncertainty given the large swings in the price of oil and other commodities. Based on the harmonised definition, inflation averaged 2.6% in 2010 and accelerated to 3.5% in 2011. Based on the external assumptions, oil prices are forecast to average $119.9 per barrel in 2012 and around $113.5 per barrel in 2013. The dollar/euro exchange rate is assumed to be around 1.32$/€ in 2012 and 2013. Inflation is forecasted to average 3% in 2012 owing to increases in oil prices, fuelling an increase in the charges of electricity consumption and to the increase of the standard VAT rate from 15% to 17% as of 1/3/2012 and then hover around 2% in the medium term.

In the labour market, the medium-term scenario envisages some employment gains at the end of projection period due to recovery back to potential, albeit relatively small compared to recent years. Thus, overall, the gainfully employed population is forecast to continue increasing at around 0.1% on average per annum in 2012-2015. The unemployment rate is projected to rise and reach 9.5% in 2012, stabilize in 2013 and decline slowly thereafter to 8.5%, in line with moderate growth recovery in 2014-2015. Productivity growth is expected to average some 0.5% per annum over the medium term, which is below the performance recorded over the period 2004-2008. Nominal earnings are expected to be contained and real earnings are forecasted to decline in the 2012-2014 period and remain stable in 2015, thus implying gradual improvement of wage competitiveness. Nominal unit labour costs will increase on average by some 1% in the period 2012-2015, compared to an increase of some 3.4% in the period 2006-2011, while real unit labour costs will decrease over the same period due to contained wages below inflation.

Box 2. Risks to medium-term forecasts

The risks to growth over the medium term are tilted on the downside.

External Environment

- The external environment is challenging and uncertain, the global recovery has stalled and the Euro area is expected to go in a mild recession in 2012. Recovery is expected to gather pace as from 2013. However, the impact on growth of major trading partners of Cyprus, including UK, may be lower, than assumed in the SP.
- Spillovers from potential worsening conditions in Greece can be substantial.
- Upward trend of commodity prices, especially oil prices.

Domestic Economy

- Likely improvement of confidence effects due to new measures could have a positive effect on private consumption and investment, stronger than envisaged in the SP.
- Strategic plans for attracting more tourists (from new destinations) and foreign investors, as well as construction and infrastructure projects can strengthen external demand and investment more than expected in the SP.
- Natural gas finding and exploitation of hydrocarbon oils can have positive effects on services, exports, it can reduce energy prices and provide to the state accrued revenues from the sale of exploration rights/license fees.
- Tightening credit conditions, together with already higher financing costs, can delay the rebound in consumption and investment as envisaged in the SP. In general the expected banking deleveraging is a downside risk.

3. GENERAL GOVERNMENT BALANCE AND DEBT 2011-2015

Policy Strategy

Taking into account the uncertainties surrounding the short – and medium term prospects, the main challenge of policy making in Cyprus at the current juncture is to address the macroeconomic imbalances and particularly in the area of public finances, through growth and employment -friendly fiscal consolidation, while maintaining social cohesion. Against this background, the government has adopted a strategy that will safeguard the sustainable correction of public finances, thus allowing for an improvement in long term fiscal sustainability, as required by the Stability and Growth Pact.

The general government budget balance deteriorated in 2011. It is estimated to have risen to 6.3% of GDP from around 5.3% in 2010, due to both revenue shortfall and expenditure overruns. The deterioration in public finances is attributed mainly to a deceleration in the rate of growth of public revenues brought by low growth and a tax-poor composition of economic activity. In particular, the sustained adjustment of the construction sector continued to weigh heavily on public revenues, which were also influenced by the dissipating effects of elapsing one-off revenue items of 2010. On the expenditure side, the acceleration in the growth rate of expenditure resulted, to some extent, from measures of one-off nature such as the compensating expenditure measures introduced targeting vulnerable groups in light of the application of the reduced VAT rate on foodstuffs and pharmaceuticals, the support provided to Cyprus Airways, as well as to employees of Eurocypria that were laid off. It should be pointed out that, in absolute terms, the actual expenditure level of 2011 deviated only marginally from forecast.

Despite the fact that, the widening of the deficit to 6.3% of GDP is well above the target set in the last Stability Programme, the Government's budgetary policy still aims at the correction of the excessive deficit by the end of 2012, in line with the Council recommendation. This policy will contribute to the stabilisation of the debt-to-GDP ratio and subsequently placing it on a downward path. To this end, the Government introduced a number of measures of permanent nature, mainly on the expenditure side. These measures include:

- Adoption of a restrictive Budget, with the imposition of spending ceilings for line Ministries for Central Government for 2012;
- A freeze on wages, salaries and pensions in the broader public sector for a period of two years;
- A reduction of wages and salaries by 10% for new entrants in the broader public sector;

- A reduction of the number of personnel in the broader public sector by 5,000 over the next five years (one recruitment for every four retirements);
- The introduction of income and economic criteria on social schemes;
- An introduction of contributions (for existing personnel) towards the non-funded public pension scheme in the broader public sector; and
- Abolition of the non-funded public pension scheme for newcomers in the broader public sector.

It is acknowledged that, the achievement of the fiscal targets set by the Government over the medium term, necessitate the specification of additional measures of permanent nature, especially on the expenditure side. To this end the Government will prepare a draft Budget Bill for 2013 incorporating the measures required to safeguard the achievement of a close to balance budgetary position in nominal terms. The measures under consideration evolve around the following topics:

- Systematic attempt to further curtail current expenditure through the Budget of 2013;
- Dialogue with social partners for the reform of the indexation system of wages, salaries and other benefits to be completed by the end of the first semester;
- Public sector reforms that will address the growing size of civil service. A modernization of the public sector is key and can result in leaner and more productive public services.

Taking into consideration the social dimension of some of the envisaged fiscal measures, consensus building among stakeholders and the timely implementation of the fiscal consolidation measures constitutes a challenge.

In parallel, a number of institutional fiscal governance reforms are underway, aiming at controlling spending, improving planning of expenditures and bringing about a reallocation of resources, in favour of policy priorities of the government. These reforms are:

- The gradual implementation of a binding Medium-Term Budgetary Framework (MTBF)[2], which will institutionalize expenditure rules, give more independence to spending ministries and, at the same time, increase their accountability;
- The introduction of binding fiscal rules through primary legislation;
- Enhancement of public debt and cash management systems;
- Further improvement of tax collection by addressing tax evasion and avoidance and strengthening tax administration.

[2] A more detailed analysis is made in Chapter 7.

Medium-Term Objective

In spite of the slowdown of economic activity and the unfavourable composition of growth and conscious of the need to improve fiscal sustainability, this Stability Programme reaffirms its ambitious Medium-Term Objective of a balanced budget.

The achievement of the MTO will imply the provision of a sufficient safety margin against the reference value and allow scope for the automatic stabilizers to operate freely, thus helping to dampen cyclical fluctuations. Prudent fiscal policies will be framed within a binding Medium Term Budgetary Framework that is currently in the process of legal vetting and will be enshrined into primary law by the end of the semester. This will institute a policy response during "good times", when cyclical conditions are favourable and unemployment low, thus providing the fiscal room necessary for manoeuvre in difficult times.

The country-specific MTO of a balanced budget in structural terms, that is the cyclically-adjusted balance net of one-off and other temporary measures is calculated using the potential output (estimated using the commonly agreed methodology) of the Cyprus economy.

The structural deficit in 2011 is estimated to have exhibited a marginal improvement, falling to 5½% of GDP from 5¾% of GDP the year before. According to the central reform scenario of this Programme, the structural budgetary position is projected to improve further from a planned deficit of 2% of GDP in 2012 to a close to balance position in 2013. This would correspond to a structural improvement of about 2 percentage points of GDP. Thereafter, the structural position would turn marginally positive over the remainder of the programming period, as the output gap closes. The total structural adjustment over the period 2012-2015 is estimated at around 5¾ percentage points of GDP. This corresponds to an average annual adjustment of about 1½ percentage points of GDP, which is in line with the requirements prescribed by the Stability and Growth Pact.

Over the programming period 2012-2015, expenditure is forecast to decrease by some 4¾ percentage points of GDP. This is due to a contained rate of growth of compensation of employees below nominal GDP growth, as a result of the decision of the government to freeze wages and salaries for a period of two years in conjunction with, the decision for reducing the number of government employees by 1.000 annually over the programming period of. Additionally, the anticipated contained rate of growth of other current transfers, mainly associated with the targeting of social benefits, the imposed restrictions on grants to local authorities and semi-governmental organisations and the dissipating effects of one-off measures of 2011 will contribute further to the reduction of expenditure, as a percentage to GDP, over the programming period.

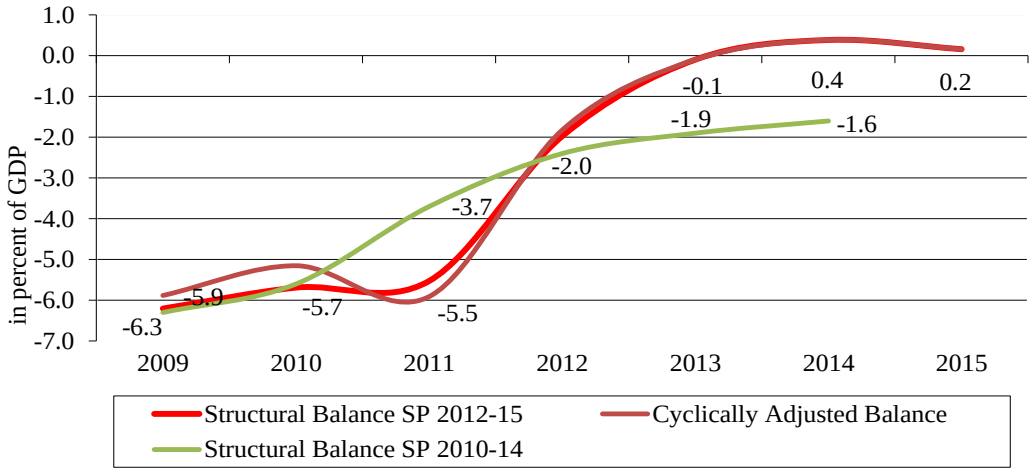
Table V: Components of Fiscal Adjustment and the Medium-term Objective

Δ between Y_T and Y_{T-1} percent of GDP	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**Total Adjustment 2012-2015**
Expenditure developments	*4.1*	*0.2*	*0.9*	*-2.2*	*-2.1*	*-0.9*	*0.5*	*-4.7*
Revenue developments	*-3.0*	*1.0*	*-0.1*	*1.5*	*-0.1*	*-0.3*	*0.5*	*1.6*
General Government Balance	**-6.0**	**-5.3**	**-6.3**	**-2.6**	**-0.6**	**0.0**	**0.0**	**-6.4**
Cyclical Component	*-0.1*	*-0.2*	*-0.4*	*-0.8*	*-0.5*	*-0.4*	*-0.2*	
Cyclically Adjusted Balance	**-5.9**	**-5.2**	**-5.9**	**-1.8**	**-0.1**	**0.4**	**0.2**	**-6.1**
One-off measures	*0.3*	*0.5*	*-0.4*	*0.1*	*0.0*	*0.0*	*0.0*	
Cyclically Adjusted Structural Balance	**-6.2**	**-5.7**	**-5.5**	**-2.0**	**-0.1**	**0.4**	**0.2**	**-5.7**

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

Following an estimated cumulative decline of revenues by around 3 percentage points of GDP in 2009-10, mainly owing to a decline in current taxes on income and wealth (related to the downturn of the real estate and construction sector), as well as in taxes on production and imports, associated with subdued consumption growth, revenue is estimated to have stagnated in 2011 at the level of 2010. It is now forecast to rise by approximately 1½ percentage points of GDP in 2012, due to discretionary revenue measures introduced, as part of the consolidation packages. It is then projected to stabilise in 2013 and then exhibit a decline by approximately ⅓ of a percentage point of GDP in 2014 due to the termination of the application of the bank levy. At the end of the programming period revenue is projected to show an increase of ½ of a percentage point of GDP, due to the closing of the output gap and a more favourable, in terms of tax revenue, composition of growth.

Figure 1: Cyclically Adjusted and Structural Balance



Note: The structural balance and cyclically adjusted balance lines coincide over the period 2012-2015.

General Government Budget Balance in 2011

Public finances deteriorated further in 2011. The budget deficit increased to 6.3% of GDP compared to 5.3% in 2010. The fiscal deterioration took place on the backdrop of weak economic activity and, tax-poor growth composition.

Table VI: General Government Consolidated Accounts

in per cent of GDP	**2010**	**2011**	**2012 est.**	**2013 proj.**	**2014 proj.**	**2015 proj.**
Current Revenue	41.1	41.0	42.5	42.4	42.1	42.6
Current Expenditure	42.6	43.9	42.0	40.3	39.4	39.9
Interest Payments	*2.3*	*2.5*	*3.0*	*3.2*	*3.1*	*3.0*
Current Balance (1)	-1.5	-2.9	0.5	2.1	2.7	2.7
Capital Expenditure (2)	3.8	3.4	3.1	2.7	2.7	2.7
General Government Balance (1-2)	**-5.3**	**-6.3**	**-2.6**	**-0.6**	**0.0**	**0.0**
Primary Balance	-3.1	-3.8	0.4	2.6	3.1	3.0
Government Gross Debt	**61.5**	**71.6**	**72.1**	**70.2**	**67.8**	**65.4**

Revenue

Revenue has stagnated at 41% of GDP. In more detail, in 2011 total revenue is estimated to have exhibited an increase by about 2.4%, stabilising at last year's level at around 41% of GDP.

Tax revenues are estimated to have remained roughly stable at 26.6% of GDP in 2011. The sustained correction of the construction and real estate sectors coupled with the significant deceleration in the growth of corporate profits of the financial sector continued to weigh heavily on government revenues. In particular, depressed activity in the construction and manufacturing sectors led to significantly lower receipts from VAT, which amounted to just 2.0% of GDP in 2011 compared with 2.5% the year before; capital gains taxes and land and survey fees exhibited a similar pattern and continued to contract falling by approximately 0.2 percentage points of GDP in 2011 compared with 2010, respectively.

Despite the hike of excise duty rates on petroleum and tobacco products in 2011, overall, taxes on production and imports exhibited a contraction. This was, largely due to the contraction in manufacturing, retail trade and construction.

Taxes on production and imports are estimated to have decreased substantially by 0.7 percentage points of GDP falling to 14.8%. This is mainly due to a fall in imports especially from third countries, as well as, to the impact associated with the contraction in the manufacturing and construction sectors. This was amplified further by a sharp decline in the demand for intermediate inputs for the construction sector.

In contrast, excise duty receipts exhibited an accelerated rate of growth, brought by the higher rates on petroleum and tobacco products, introduced in mid-June and late 2010, respectively. More specifically, the excise duty rate for petrol was increased from 30 cent per litre to 36 cent per litre, while the excise duty for gas oil was increased from 25 cent per litre to 33 cent per litre. The minimum excise duty on tobacco products was also increased from €1.70 per packet of 20 cigarettes to €2.20.

However, this was partly offset by the negative growth of excise duty receipts on motor vehicles, whose demand continued to contract for the third consecutive year. More specifically, registration of motor vehicles fell by 17.6% during 2011 following a decrease of 12.5% in 2010. This led to an annual fall in excise duty receipts by some 27% in 2011, equivalent to 0.1% of GDP.

Land and survey fees are estimated to have fallen significantly in 2011, by around 17% or 0.2 percentage points of GDP due to subdued Real estate sector activity. Low foreign demand for holiday homes remained at low levels, leading to downward price adjustments, which were more pronounced in the coastal areas. Total transactions in

immovable property decreased at a rate of 10.4% in 2011 compared with the year before, while sale agreements submitted at the Land and Survey Department decreased at a rate of 18.4% in 2011.

Taxes on income and wealth rose by some 9% for the year, reaching, as a percentage to GDP, 11.9 compared with 11.1 per cent in 2010. The rise by 0.8 percentage points of GDP is mainly attributed to the introduction of discretionary fiscal consolidation measures such as the:

- Increase of personal income tax rate on emoluments exceeding €60.000 per annum from 30% to 35% (annual impact <0.1% of GDP);
- increase of the rate for withholding tax on interest from 10% to 15% (annual impact 0.1% of GDP);
- increase of the rate for deemed dividend distribution from 15% to 17% (annual impact 0.1% of GDP);
- increase of the rate for contribution to the widows and orphans fund by 1.25 p.p. to 2% on gross earnings of employees in the central government (annual impact 0.1% of GDP);
- introduction of a bank levy on deposits of the order of 0.0095% (annual impact 0.3% of GDP);
- introduction of a contribution on gross pensionable earnings of employees in the broader public sector against their pension entitlements (annual impact 0.3% of GDP); and
- introduction of a temporary contribution on gross earnings of employees and pensioners in the broader public sector for a period of two years (annual impact 0.1% of GDP).

Receipts derived from corporate taxation exhibited an increase by some 10%, owing largely to the application of the bank levy, rising to 4.6% of GDP in 2011 compared with 4.3% the year before.

In contrast, capital gain taxes on the sale of immovable property decreased at a rate of 21%, as the number of properties sold declined by about 10% in 2010. More specifically, capital gains tax receipts in 2011 are estimated to have declined, as a percentage to GDP, to 0.4% compared with 0.5% in 2010.

Furthermore, income tax receipts from physical persons in 2011 are estimated to have increased marginally, as a percentage to GDP, to 3.6% in 2011 compared with 3.5% the year before largely owing to the increase of personal income tax rate on emoluments exceeding €60.000 per annum from 30% to 35%, as well as, to the introduction of a temporary contribution on gross earnings.

Deemed dividend distribution[3], exhibited a robust growth rate of 14.4% in 2011, rising as a percentage to GDP by 0.3 percentage points to 2.6%. This was due to the hike of the rate from 15% to 17%. Withholding tax on interest increased at a rate of 4.7% in 2011 rising, as a percentage of GDP, to 1%. This was due to the increase of the imposed rate from 10% to 15% at the end of August 2011.

Social contributions increased by 8.7% in 2011 rising, as a percentage of GDP, by ½ a percentage point to 9.5% in 2011. This is largely attributed to the introduction of a permanent contribution on gross pensionable earnings in the broader public sector as well as, the increase in the contribution rate to the widows and orphans fund at the end of August 2011.

On the other hand, property income showed a substantial drop of 40% in 2011, thus declining to 0.9% of GDP from around 1.5% in 2010. This is attributed to the normalisation of dividend income from the Central Bank of Cyprus, which in 2010 was exceptionally high due to the termination of the period of changeover of pound coins to euro coins, leading to the realisation of considerable profits, as well as the allocation of higher profits associated with the extensive operations of the European Central Bank in money markets.

Expenditure

In parallel, expenditure increased by about 1 percentage point of GDP, largely due to a set of one-off expenditure measures associated with the abrogation of the decision of the Competition Protection Authority to impose a fine of 0.3% of GDP on petroleum companies by the Supreme Court, as well as compensating expenditure measures targeting vulnerable groups in light of the application of the reduced VAT rate on foodstuffs and pharmaceuticals and the support provided to Cyprus Airways and laid off personnel of Eurocypria.

Total public expenditure is estimated to have exhibited an increase of approximately 4.5% in 2011 reaching 47.3% of GDP compared with 46.4% the year before. The increase in total expenditure in 2011 can be attributed, mainly, to higher than targeted social payments partly associated with one-off expenditure measures, as well as, interest payments.

More specifically, social transfers have risen by about 1 percentage point of GDP, owing to increased welfare benefits associated with higher number of recipients, as well as, from increased pensions, unemployment and redundancy payments. Social payments are estimated to have risen, to 15.3% of GDP from 14.4% a year earlier,

[3] Deemed dividend distribution is the taxation of seventy per cent of undistributed profits of year t-2 taxed at a rate of 15%, which was then increase to 17% at the end of 2011 and then to 20% temporarily for a period of two years.

due to an increased emphasis on social cohesion, in line with the objectives of the National Reform Programme. Specifically, social security payments are estimated to have exhibited an increase by some 8%, or about 0.4 percentage points of GDP, due to an increase in the level of pensions, as well as an increase in unemployment and redundancy benefits. Also a scheme targeting long term unemployed individuals was introduced. Furthermore, schemes aimed at households living close to relative poverty were reinforced. The fiscal impact of these measures is estimated to have been of the order of 0.2 percentage points of GDP.

On the other hand, the rate of growth of compensation of employees was contained below the growth rate of nominal GDP in 2011. It increased at a rate of 1.7%, thus decreasing marginally by 0.1 percentage points of GDP to 15.8% in 2011 due to a deceleration in the rate of growth of employment in the central government. This was partly offset by the increasing trend of early retirements during the second half of the year due to the introduction and/or discussion of fiscal consolidation measures having an impact on the level of pensions and gratuities.

Owing to a rising stock and cost of debt, interest expenditure increased by 0.2 percentage points of GDP to 2.5% in 2011.

The Government continued for the second year in a row to gradually withdraw part of the growth enhancing measures introduced in 2009 that boosted investment expenditure in 2009, thus leading to decreased investment expenditure. This is estimated to have led to a decrease in government gross fixed capital formation, at a rate of 8%, and a fall, as a percentage to GDP to 3.4% in 2011, compared with 3.8% the year before.

The tightening of fiscal policy and lower defence imports led to a decline, as a percentage to GDP, in intermediate consumption, as well as, gross fixed capital formation by about 0.7 and 0.4 per cent of GDP in 2011 respectively.

Other current expenditure accelerated in 2011, rising as a percentage to GDP, by 0.8 percentage points reaching 4.8%. This is attributed to the application of one-off compensating measures aimed at alleviating the impact on low-income households from the introduction of the minimum VAT rate of 5% on foodstuffs and pharmaceuticals, as well as to the cancellation by the Supreme Court of the fine imposed on petroleum companies by the Competition Protection Authority.

Excessive Deficit Procedure

On the 13th of July 2010, the ECOFIN Council decided to initiate the Excessive Deficit Procedure against the Republic of Cyprus, given that the fiscal deficit in 2009 exceeded the threshold of 3% of GDP. The Council established the deadline of 13 January 2011 for the Government of the Republic of Cyprus to take effective action to specify the measures that will be required to progress towards the correction of the excessive deficit.

At the same time, the Council issued a Recommendation, postulating that Cyprus should correct the excessive deficit - reduce deficit below the 3% of GDP threshold - by 2012 at the latest. The Recommendation specifies the need for credibility and sustainability in the deficit-reducing effort, in the context of a medium term budgetary framework, which should concentrate on an expenditure-driven fiscal strategy. In the event of more favourable economic conditions, the deficit reduction effort should be accelerated. The government debt ratio should be brought back to a declining path approaching the reference value. To this end, an average annual fiscal effort of at least 1½% over the period 2011-2012 should be ensured, but, at the same time, opportunities beyond the fiscal effort, as well as, more favourable economic conditions should be seized.

Finally, the Council stressed the need for strengthening the binding nature of the medium-term budgetary framework and improvement in the monitoring of the budget execution throughout the year. Moreover, the Council recommended to improve the long-term sustainability of public finances by implementing reform measures to control pension and health care expenditure, in order to curb the projected increase in age-related expenditure.

On February 15th 2011, the Council took note of a communication from the Commission assessing action taken by the authorities in Cyprus in order to bring their government deficits below 3% of GDP, the reference value set by the EU treaty. It shared the Commission's view that, Cyprus has taken action representing adequate progress towards correcting their deficits within the time limits set in its recommendation, and that no further steps under the EU's excessive deficit procedure was required.

Furthermore, the Commission, on 11th January 2012, in its Analysis of the budgetary situation in Cyprus in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive deficit, concluded that the adopted last-minute budget amendments (fourth consolidation package) confirm Cyprus' efforts to comply with the Council's recommendation to correct the excessive deficit by 2012. The extra fiscal effort amounts to about ½% of GDP in 2012. Taking this into account, the Commission services' deficit projections were revised down to

2.7% of GDP for 2012 and 1.8% of GDP for 2013. It thus concluded the appearance of a safety margin (0.3%) to hedge against the aforementioned implementation risks. In conclusion, the Commission considered that Cyprus has taken effective action to correct the excessive budget deficit in a timely and sustainable manner.

Budget 2012

The Budget for 2012 was prepared based on a three-year forecasting period, taking into consideration the Medium Term Budgetary Framework of 2012-2014. The Budget for 2012 is restrictive and incorporates the fiscal consolidation packages adopted in the second half of last year. Furthermore, the Budget envisages the withdrawal of the temporary support measures introduced during the course of 2011 aimed at addressing the implications of the application of the reduced VAT rate to vulnerable groups. The Budget also places emphasis on the reallocation of government expenditures towards growth-enhancing activities and other policy priorities, established in the National Reform Programme for Cyprus.

More analytically, the main measures introduced in the course of the last trimester of 2011 having a full year impact on the Budget for 2012 are presented in Table VII.

Table VII: Fiscal Consolidation Measures

Measure	Year of adoption	Direct budgetary impact[4]			
		2011	2012	2013	2014
I. Public Sector Personnel Expenditure					
1. Reduction of the number of personnel in the broader public sector by 5,000 over the next five years (a thousand per annum - one recruitment for every four retirements)	2012-15	-	-0.1	-0.1	-0.1
2. Freezing of emoluments including pensions in the broader public sector for a period of two years	2012-13	-	-0.7	-0.8	-
3. Inclusion of newcomers to the social security fund only (abolition of occupational pension)	2012	-	-0.05	-0.05	-0.05
4. Abolition of all vacant posts	2012	-0.05	-0.1	-0.1	
5. Reduction of salary scales for newcomers in the broader public sector by 10%	2012	-	-0.05	-0.05	-0.05

[4] The direct budgetary impact presented is based on the additional impact, in percent of GDP, of each measure compared to the preceding year.

Measure	Year of adoption	Direct budgetary impact[4]			
		2011	2012	2013	2014
Impact of Public Sector Personnel Measures		***-0.05***	***-1.0***	***-1.1***	***-0.2***
II. Targeting of Social Schemes					
1. Income support provided to Cyprus Airways	2011	0.1	-0.1	-	-
2. Compensating scheme for Eurocypria employees	2011	0.05	-0.05	-	-
3. Targeting of all social schemes based mainly on income and economic criteria	2012	-	-1.0	-	-
4. Reduction and abolition of specific categories of welfare allowances	2012	-	-0.05	-	-
Impact of targeting social schemes		***0.15***	***-1.20***	**-**	**-**
III. Other Expenditures					
1. Containment in the rate of growth of current expenditure	2012-15	-0.1	-0.3	-0.2	-0.1
2.Temporary compensating expenditure measures to vulnerable groups adversely affected by the application of the reduced VAT rate on foodstuffs and pharmaceuticals	2011	0.2	-0.2	-	-
Impact of reduction of other expenditures		***0.1***	***-0.5***	***-0.2***	***-0.1***
IV. Revenue Measures					
1. Application of the minimum excise duties prescribed by the acquis on petroleum products	2010	0.1	-	-	-
2. Application of increased excised duty rates on tobacco products	2011	0.1	-	-	-
3. Application of the reduced VAT rate on foodstuffs and pharmaceuticals as prescribed by the acquis	2011	0.3	-	-	-
4. Application of a levy on bank deposits	2011	0.35	-	-	-0.35
5. Dividend Income from various semi-governmental organisations	2011	-0.7	-	-	-
6. Interest rate swap	2011	-0.2	-	-	-
7. Fee on the issuance of a 3-year special government bond	2010	-	-	-0.1	-
8. Contribution of 3% on gross earnings of broader public sector employees against public pension entitlements	2011	0.1	0.2	-	-
9. Temporary contribution on gross earnings of broader public sector employees and pensioners for a period of two years:	2011	0.05	0.05	-0.05	-0.05

Measure	Year of adoption	Direct budgetary impact[4]			
		2011	2012	2013	2014
€0 - €2500 0% €2501 - €3500 2.5% €3501 - €4500 3.0% > €4501 3.5%					
10. Increase of the rate of contribution for the Widows and Orphans Fund by 1.25 p.p. to 2% on gross earnings of broader public sector employees	2011	<0.05	0.05	-	-
11. Increase of the tax rate on deemed dividend distribution from 15% to 17%	2011	-	0.1	-	-
12. Revision of scales used for applying the tax coefficients on immovable property, until the re-evaluation of immovable property prices from 1980's to current prices	2011	-	0.1	-	-
13. Introduction of a levy on all registered companies	2011	0.05	0.05	-	-
14. Increase of withholding tax on interest accrued on deposits of financial institutions from 10% to 15%	2011	0.1	0.2	-	-
15. Increase of the tax rate for personal income of physical persons above €60.000 from 30% to 35%	2011	<0.05	-	-	-
16. Increase of the standard VAT rate from 15% to 17%, as of March 1st	2012	-	0.7	0.1	-
17. Increase of the tax rate on deemed dividend distribution from 17% to 20% for a period of two years	2012	-	0.1	-	-0.1
18. Temporary contribution on gross earnings of private sector employees and pensioners for a period of two years: €0 - €2500 0% €2501 - €3500 2.5% €3501 - €4500 3.0% > €4501 3.5%	2012	-	0.1	-	-0.1
19. Increase of the overall contribution rates to the Social Security Fund	2014	-	-	-	0.5
Total Impact of Revenue Measures		***0.35***	***1.65***	***-0.05***	***-0.10***
Subtotal as a percentage to GDP		***0.15***	***4.35***	***1.25***	***1.40***
Of which: *Revenue Measures* *Expenditure Measures*		*0.35* *0.20*	*1.65* *-2.70*	*-0.05* *-1.30*	*-0.10* *-0.30*
V. Additional Measures					
Additional measures to be agreed with stakeholders[5]		-	-	*1.8*	-
Total Impact as a percentage to GDP		***0.15***	***4.35***	***3.05***	***1.40***

[5] Additional measures to be agreed and incorporated in the compilation of the forthcoming Budget of 2013.

Revenue

In accordance with the benign central reform scenario, growth of total revenue is forecast to accelerate to 6.1%, that is, above nominal GDP growth, and thus rising, as a percentage to GDP, to 42.5% in 2012 compared with 41% in 2011. The accelerated rate of growth is mainly attributed to the application, on a full year basis, of the fiscal consolidation measures on the revenue side introduced in the course of 2011 as well as those introduced through the Budget of 2012 and are analysed in the Excessive Deficit Procedure section (Table VII).

More specifically, taxes on production and imports are forecast to exhibit an increase of 6.3%, thus rising to 15.3% of GDP in 2012 compared with 14.8% the year before. The acceleration in the rate of growth of taxes on production and imports is mainly attributed to the increase of the standard VAT rate from 15% to 17% enacted on March 1st 2012, as well as, to the application of a levy on all registered companies. The fiscal impact of the VAT rate increase is estimated at 0.8 percentage points of GDP on a full year basis.

Similarly, current taxes on income and wealth are forecast to exhibit an increase of 12.4%, thus rising to 13% of GDP in 2012 compared with 11.9% the year before. The accelerated rate of growth of taxes on income and wealth is attributed mainly to the application on a full year basis of permanent and temporary contributions on gross earnings of broader public sector employees, increases in the tax rates for withholding tax on interest and deemed dividend distribution and to a lesser extent from the application of a temporary contribution on gross earnings of public and private sector employees and pensioners.

Taking into consideration the unfavourable macroeconomic and labour market conditions, social security contributions are forecast to grow at a rate of only 2%, in line with nominal earnings and employment growth, thus stabilising at 9.5% of GDP in 2012.

Property income is forecast to contract for a second year in a row at rate of 33%, as in the course of 2012, while dividend income from semi-governmental organisations is anticipated to be zero. Thus, property income is forecast to fall to 0.6% of GDP in 2012 compared with 0.9% the year before.

Expenditure

Total government expenditure is projected to decline by 2.3% and fall to 45.2% of GDP in 2012 from 47.4% in 2011.

In particular, compensation of employees is projected to decline marginally at rate of 0.5% and fall, as a percentage to GDP, to 15.3% in 2012 compared with 15.8% the year before. This is mainly due to the reduction of public sector employment figures by 1.000 bodies per annum (by implementing a policy of recruiting one person for every four retirements) coupled with public sector wages, salaries and pensions freeze for a period of two years (2012-13). In contrast, public pensions are estimated to exhibit a growth rate of almost 6% in 2012 compared with the year before, as voluntary early retirements are expected to continue to be on the rise.

Concurrently, social payments are projected to decelerate at a rate of 1.4%, falling marginally to 15.2% of GDP in 2012 compared with 15.3% the year before. This is mainly due to the targeting of specific social schemes via the introduction of income and other criteria of households, estimated to lead to savings of the order of 1 percentage point of GDP. However, this is anticipated to be partly offset from the expected growth of Social Security Fund pensions, as well as, redundancy entitlements and unemployment benefits which are estimated to expand at a rate of about 20%.

Subsidies are projected to decelerate in 2012, as a result of the phasing out of agricultural subsidies, financed by national funds, over a period of two years, since these should be eliminated by the end of 2013. Subsidies are forecast to decrease by 0.1 percentage points of GDP to 0.4% in 2012.

The rising trend in interest payments is projected to continue in 2012, as interest rates follow an upward trend and debt stock accumulation is significant. As a result, interest payments, as a percentage to GDP, are forecast to rise to 3% of GDP compared with 2.5% the year before.

Gross fixed capital formation is forecast to decrease at a rate of 8%, following the completion of major infrastructural projects, thus falling at prior to crisis levels of some 3.1% of GDP in 2012.

The budget balance is forecast to be contained at around 2⅔% of GDP in 2012 compared with 6.3% the year before.

It has been noted that during the first three months[6] a divergence in the budget implementation has been observed. The divergence is associated with a poor performance on the revenue side while, expenditure is in line with forecast.

[6] According to data on cash basis for the first three months of 2012, there is a divergence in the monthly general government balance from what was originally forecast amounting to 0.2 per cent of GDP. The divergence is mainly attributed to a negative performance of revenue, which is more pronounced in the category of VAT receipts.

Despite this, it is anticipated that VAT receipts should rebound as of the second quarter of 2012 due to the normalisation[7] of submitted VAT returns, as well as to the increased standard VAT rate from 15% to 17% as at 1st March 2012. Additionally, in accordance with the provisions of Law No. 30(I)/2011 as amended, in case of a settlement of tax obligations up until 2008, the taxable person or legal entity benefits from the cancellation of any interest or penalties thereon. This one-off revenue measure is estimated to increase revenue in 2012 by about 0.7 per cent of GDP.

The Minister of Finance is monitoring the situation closely and stands ready to adopt further measures, if deemed necessary to achieve the fiscal target set. The Minister of Finance publicly announced his intention of introducing additional measures in the course of 2012 of the order of about 1 percentage point of GDP thus safeguarding the achievement of the set target.

Plans for 2013 Budget and Medium Term

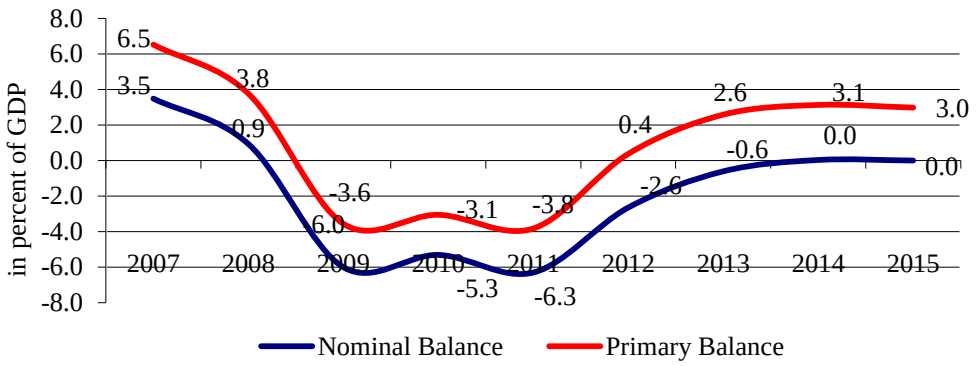
The Government is firmly committed to meet its obligations stemming from the revised Stability and Growth Pact and which essentially require Member States to maintain sound public finances and address the issue of long-term fiscal sustainability.

The fiscal consolidation measures, ted include a systematic attempt to curtail current expenditures, public sector reforms, which will address the growing size of civil service, and a careful reform of the system of social transfers in order to target better benefits and help more those in greater need thus contributing to an improved social cohesion.

More analytically, the fiscal consolidation measures implemented with an estimated fiscal impact are presented in the table above (Table VII). The said table includes, also the additional amounts that are required to be agreed in the on-going dialogue process in the course of the compilation of the forthcoming Budget bill for 2013 –with political parties and social partners in order to reach the fiscal targets set by the Government.

[7] As of October 2011, the period of submission of VAT returns by entreprises with a output VAT paid of €1 million annually has been set from a monthly basis to a quarterly basis.

Figure 2: Overall Nominal and Primary Balance



There are downside risks to this central reform scenario. These stem from the anticipated growth scenario where the balance of risks to GDP growth remains tilted to the downside, amid still-high uncertainty. Risks also stem from the envisaged impact of the consolidation measures associated with the containment in the rate of growth of the public wage bill particularly with regard to the reduction in employment.

An additional risk factor to the achievement of deficit and debt targets is the practice of adopting supplementary budgets, especially in light of the fact that Cyprus has entered an electoral.

Medium Term Budgetary Framework

With a view to ensuring fiscal sustainability, a modern framework for fiscal management is being promoted, with the introduction of a draft Bill on Budgetary Stability establishing principles of transparency and reliability and incorporating a set of fiscal rules and an automatic correction mechanism in the primary legislation. The draft Bill, which is expected to be adopted by the Parliament by the end of the current semester and apply in the compilation of the 2013 Budget Bill provides for the achievement of the Medium-Term Budgetary Objective over the medium term, through the introduction of expenditure and debt brake rules. The draft Bill also provides for the introduction of a binding Medium-Term Budgetary Framework into primary law, which intends to lead to a containment of expenditures by line ministries and, at the same time, promote the reallocation of expenditure in favour of growth - enhancing activities, consistent with the priorities set by the National Reform Programme. This framework is already reflected in the 2012 Budget, in which ceilings on expenditure per line ministries are provided for the years 2012-2014.

Overall, the MTBF budgeting should enable managers to plan activities more effectively, by incorporating the amount of financing required to sustain a particular government policy, budget activity or expenditure project over several years.

Furthermore, budgetary reform process also requires that line ministries and other government spending agencies will enter into a process of progressively redesigning their annual budgets, reflecting a new approach based on Programme and Performance Budgeting (PPB).

The first steps for introducing the new PPB framework were taken in 2007, with the implementation of pilot projects, covering three ministries. In 2008, the number of ministries and spending agencies, adopting this approach, increased and it is expected that all agencies will prepare their financial year (FY) 2015 budgets according to both the traditional (input-based) budget method and the new PPB format. This will enable all spending agencies to have at least two "trial" years, in which the new methods can be developed, tested and refined.

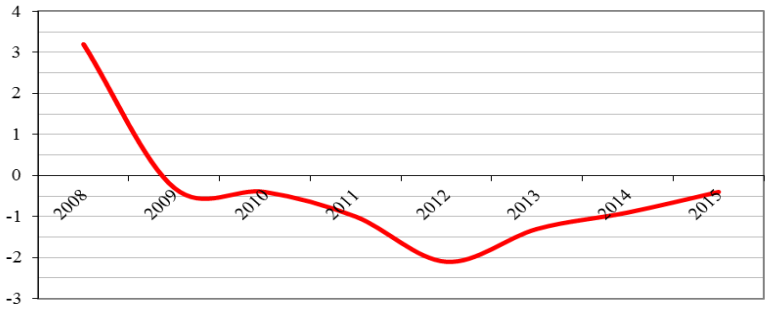
During this trial period, the Treasury Department has been upgrading the accounting software Financial Management Accounting System (FIMAS) to a newer version that is capable of supporting the new budgetary methods and classifications. The new PPB approach will become the official (and only) budget method from FY 2015 onwards.

A detailed presentation on legislation, discussing its binding nature and the fiscal rules is provided in Chapter 7 – Institutional Features of Public Finances.

Structural Balance and Fiscal Stance

Following a period of weak economic activity, output gap turned negative reaching in 2009 to about -⅓% of potential GDP. The downturn led to a considerable fall in the capacity utilisation rate of the economy and to a widening in the output gap, which is estimated to have continued to be negative also during late 2011. Specifically, output gap is estimated to have turned negative reaching 1% of potential GDP in 2011 from a marginally negative position in 2010 and is expected to widen further in 2012 peaking at about 2% of potential GDP. In 2013-15, the output gap is forecast to remain in the red but gradually improve as economic activity intensifies, closing at 0.4% of potential GDP by the end of the programming period.

Figure 3: Output Gap



Based on this analysis of the cyclical position of the economy, and to provide a clear picture of the underlying fiscal position, the following analysis disentangles trend, cyclical, and one-off fiscal effects.

One-off and temporary measures

During 2009-11 following a period of exceptional high revenues, brought by the boom in the real estate sector during the period 2006-2008, construction and real estate activities contracted and VAT receipts associated with the construction sector, capital gains tax receipts and land and survey fees exhibited sharp declines. The direct loss of revenue attributed to the slowdown in the real estate sector is estimated to amount to about 4 per cent of GDP in 2011 vis-à-vis 2008 levels.

In addition to this, one-off revenue measures in 2009 associated with the imposition of a fine to petroleum companies by the Competition Protection Authority amounted to 0.3% of GDP. In 2010 one-off measures associated with exceptional higher dividend by the Central Bank of Cyprus and a semi-governmental organisation, a profit realised from an interest rate swap, a fee on the sale of a 3-year special government bond, as well as to a capital injection to a state owned airline company, amounted to about 0.5% of GDP.

During the course of 2011, one-off measures were deficit increasing and amounted to 0.4 per cent of GDP. These one-off measures included the cancellation by the Supreme Court of the fine imposed on petroleum companies by the Competition Protection Authority, the implementation of compensating temporary measures addressed to low income families in view of the application of the reduced VAT rate on foodstuffs and pharmaceuticals (0.2% of GDP), as well as, the provision of compensation to a state owned airline company in line with the European Commission's authorisation including income support provided to redundant employees of Eurocypria (0.15% of GDP), which was wound down.

The Stability Programme relies, to a great extent, on the implementation of measures of permanent nature over the programming period. Owing to the implementation of the fiscal consolidation measures, the tax buoyancy ratio (that is the ratio of the percentage change in revenue resulting from a one percentage change in the GDP) is forecast to rise to 2.9 in 2012 from 1.7 the year before and subsequently stabilising at about 1 over the remainder of the programming period, below historical levels.

Table VIII: Cyclical Developments and one-off measures

as a percentage of GDP	2010	2011	2012 est.	2013 proj.	2014 proj.	2015 proj.
GDP growth at constant prices	1.1	0.5	-0.5	0.5	1.0	1.5
General Government Balance	**-5.3**	**-6.3**	**-2.6**	**-0.6**	**0.0**	**0.0**
Net Interest payments	2.3	2.5	3.0	3.2	3.1	3.0
Potential GDP growth (% change)	1.3	0.9	1.1	1.1	1.1	1.2
GDP output gap[1]	-0.4	-1.0	-2.1	-1.3	-0.9	-0.4
Cyclical budgetary component	-0.2	-0.4	-0.8	-0.5	-0.4	-0.2
Cyclically-adjusted balance	**-5.2**	**-5.9**	**-1.8**	**-0.1**	**0.4**	**0.2**
Cyclically-adjusted primary balance	-2.9	-3.4	1.2	3.1	3.5	3.1
One-off measures	*0.5*	*-0.4*	*0.1*	*0.0*	*0.0*	*0.0*
Cyclically-adjusted balance net of one-off and other temporary measures	**-5.7**	**-5.5**	**-2.0**	**-0.1**	**0.4**	**0.2**
Structural Change	0.5	0.2	3.5	1.9	0.3	-0.2
Cyclically-adjusted primary balance net of one-off and other temporary measures	-3.4	-3.0	1.0	3.1	3.5	3.2

[1] In percent of potential GDP.

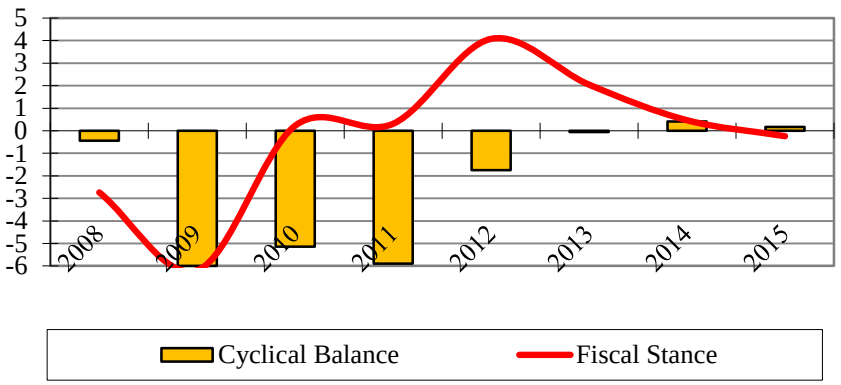
The cyclically-adjusted balance and structural balance

Similarly to last year's Stability Programme, indicators of cyclically-adjusted budget balances have been incorporated in the compilation of the updated Stability Programme 2012-2015, in order to take into account cyclical variations. The cyclically adjusted budget balance is estimated to have increased from a deficit of 5.2% of GDP in 2010 to a deficit of 5.9% in 2011, and is projected to exhibit a declining trend at the beginning of the programming period falling to a deficit of 1.8 per cent of GDP in 2012. This trend is projected to continue over the remainder of the programming period reaching a close to balance position in 2013 and improving

further in the outer years of the programming period reaching a marginally positive cyclically adjusted budgetary position.

Reflecting the expansionary fiscal policies followed during the 2008-10 period, fiscal stance turned negative in 2008 reaching 2.7% of GDP and peaking in 2009 reaching 6.2% of GDP. In 2010 and 2011, fiscal stance is estimated to turn positive again reaching on approximately 0.2 and 0.3 per cent of GDP, respectively. Subsequently, it is forecast to increase further in 2012 peaking at 4.1 per cent of GDP and fall to 2 per cent in 2013. Over the course of 2014, fiscal stance is forecast to be close to ½ per cent of GDP and at the end of the programming period to turn marginally negative.

Figure 4: Cyclical Balance and Fiscal Stance
(in per cent of GDP)



A similar picture is also presented for the cyclically-adjusted balance, net of one-off measures (Table VIII). The cyclically-adjusted balance net of one-off measures, as a percentage to GDP, improved in 2010 falling to a deficit of 5.7% compared with a deficit of 6.2% the year before, due to the containment in the rate of growth of expenditure, leading to an improvement in the structural position by ½ a percentage point of GDP. The structural balance in 2011 exhibited a marginal improvement of about 0.2 percentage points of GDP, thus falling to a structural position of a deficit of 5.5% of GDP. The structural adjustment effort is positive over the programming period, as the cyclically adjusted balance, net of one-off measures, is forecast to continue improving thus, reaching a structural budgetary position of a deficit of 2 per cent of GDP in 2012. Towards the outer years of the programming period, where output gap nears to a close, the medium-term budgetary objective, in cyclically adjusted terms net of one-off and other temporary measures, is achieved. The implied annual fiscal effort is negative averaging at about 1⅓ per cent of GDP over the programming period 2012-2015.

Debt Management

Debt Levels and Developments

The revised Stability and Growth Pact (SGP) specifies that, in light of the increased economic and budgetary diversity in the EU, *"the medium-term budgetary objectives (MTOs) should be differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as the diversity of risks to the sustainability of public finances".*

The European Council on the 20th of March, 2005 indicated that "*the long-term sustainability of public finances would be supported by the convergence of debt ratios towards prudent values*". The 'Code of Conduct' also stresses that *"member states that have not yet reached their MTO and are faced with a debt level exceeding 60% of GDP or with pronounced risks in terms of overall debt sustainability, a faster adjustment path towards the medium-term budgetary objectives should be expected, i.e. above 0.5 of a percentage point of GDP as a benchmark in cyclically adjusted terms, net of one-off and other temporary measures".*

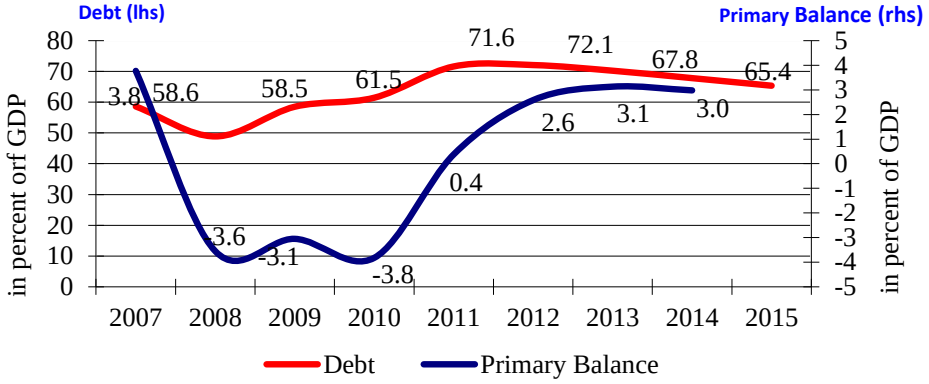
Furthermore, the Excessive Deficit Procedure may be initiated in the cases where the reported government debt ratio is above the reference value of 60% of GDP and its differential with respect to the reference value has not decreased over the past three years at an average rate of one-twentieth as a benchmark.

In light of the above, the evolution of public debt has been brought to the forefront of fiscal surveillance. Countries with higher-than-average debt levels are subject to stricter consolidation requirements, while low public debt countries are allowed to sustain small scale budget deficits and adopt accordingly their MTOs.

Following a period of debt consolidation the on-going economic downturn and the worsening fiscal position will inevitably reverse this positive development, at least until the fiscal situation stabilises by the end of the programming period. The debt-to-GDP ratio is estimated to have risen to 71.6% of GDP in 2011 compared to 61.5% the year before, or by some 10 percentage points of GDP. The increase of the debt-to-GDP ratio is largely attributed to the large primary deficit and the accumulation of financial assets in the form of deposits, following a bilateral loan procured by the Russian Federation, towards the end of the year. The debt-to-GDP ratio is projected to continue its upward path and peak to around 72.1% of GDP in 2012 exhibiting a further increase of approximately ½ percentage point of GDP. It is then forecast that, the debt-to-GDP ratio upward trend will be reversed and exhibit a decline falling to about 65½% of GDP by the end of the programming period. Excluding the effect of the first tranche of the bilateral loan, which will be used to finance government

operations in the course of 2012, the net government debt is estimated at 67.6% of GDP.

Figure 5: Government Gross Debt and Primary Balance



Stock-Flow Adjustment

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 marginally negative stock flow adjustment in 2010, equivalent to 0.1% of GDP, reflect primarily the positive "snow ball" effect brought by a modest growth of nominal GDP and secondarily the deccumulation of financial assets in the form of currency and deposits, as well as, the loans provided to third parties. In 2011, the stock flow adjustment turned positive rising to about 6.3% of GDP owing primarily to the accumulation of financial assets towards the end of the year. More specifically, at the end of the financial year the financial assets accumulated in the form of currency and deposits amounted to 4.1% of GDP of which, part of it correspond to the first tranche of a bilateral loan received as at 31st December, 2011.

The contribution of SFA is projected to remain positive during the programming period at relatively low levels falling in 2012 at about 0.8% of GDP, and subsequently falling only marginally to 0.7% of GDP in 2013-14. Due to the fact that contributions to the ESM paid-in capital will be completed by 2015, it is projected that, the stock flow adjustment will fall to ½% of GDP in that year.

Table IX below presents the gross debt level, according to the central reform scenario, and the contribution to change in gross debt for the period of 2010-2011, and projections covering the period 2012-2015.

Table IX: General Government – Debt Developments

as a percentage to GDP	2010	2011	2012 est.	2013 proj.	2014 proj.	2015 proj.
Gross Debt Level	61.5	71.6	72.1	70.2	67.8	65.4
Change in Gross Debt	2.9	10.2	0.5	-1.8	-2.4	-2.5
Contributions to Change in Gross Debt						
Primary Balance	-3.1	-3.8	0.4	2.6	3.1	3.0
Interest Payments	2.3	2.5	3.0	3.2	3.1	3.0
Nominal GDP Growth	2.9	2.5	2.5	2.5	3.1	3.5
Stock-flow adjustment[1]	-0.1	6.3	0.8	0.7	0.7	0.5
Net Financial debt	56.8	67.6	69.5	69.3	66.9	65.0
Implicit interest rate	4.0	4.1	4.3	4.5	4.5	4.5

[1] Including "snow-ball" effect.

Financing actions in 2011

The Public Debt Management Office of the Ministry of Finance had set the following targets for its public debt management strategy at the beginning of 2011.

- Short-term public debt will comprise only 5-10% of the total public debt;
- Weighted-average remaining maturity of public debt to remain at an estimated of 5-6 years;
- Amount denominated in euro constitutes almost 100% of public debt;
- Public debt with fixed interest rates to remain at about 90% of total public debt.

The significant worsening of market conditions and the eventual exclusion of the Republic of Cyprus from the European capital markets in the second half of 2011 lead to the inability of the Republic of Cyprus to meet most of the above targets. In particular by the end of 2011:

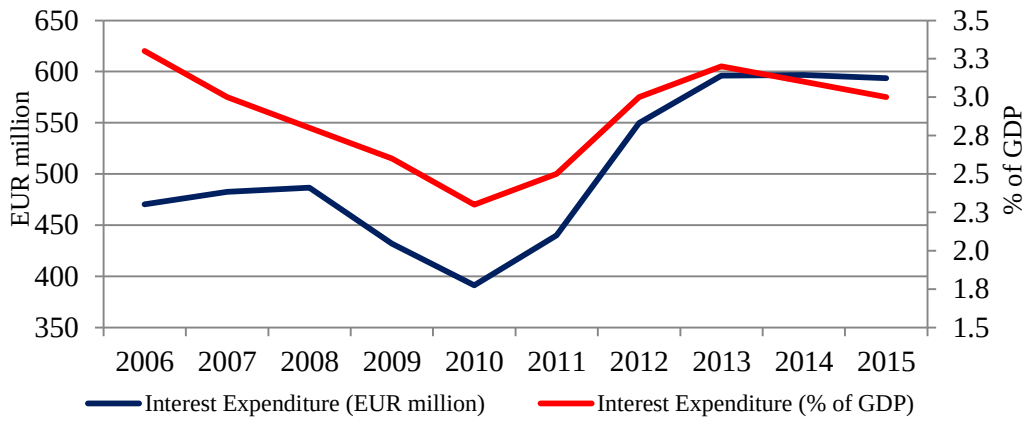
- Short-term public debt comprised 12% of the total public debt;
- Weighted-average remaining maturity of public debt is estimated at 4.6 years;
- Amount denominated in euro constitutes almost 100% of public debt;
- Public debt with fixed interest rates to remain at about 86% of total public debt.

The increased risk aversion exhibited by investors led to a large difficulty in attaining long term financing, resulting in a relatively large increase in the issuance of short term debt. The total debt with original maturity less than one year outstanding at the end of 2011 was €1.5 billion euros. The rest of the financing needs of 2011 were covered by the issuance of €975 million medium term (2 to 10 years) debt in the domestic market and €200 million of long term debt from the EIB and CEB.

Overall yields followed an increasing trend throughout 2011, spiking sharply at the end of May 2011 with the serious deterioration of the Greek situation. Although yields have dropped from those levels they still remain at exceedingly high levels, mainly due to the exposure of the banking sector to Greece and the serious lack of liquidity in the secondary markets. The end result was a loss of access to the European capital markets, which was offset by the domestic capital market and a bilateral €2.5 billion loan agreement with the Russian Federation, which was used to finance the bulk of the 2012 financing requirements.

As indicated in the relevant chart below, the interest rate burden has increased during 2011 due to the increasing trend in public debt and the increasing yields in government bonds in 2010 and 2011.

Figure 6: Cost of Servicing the Public Debt



The Cyprus debt portfolio carries low market risk. Only around 14% of debt is indexed to floating interest rates and that is connected to loans from the EIB and CEB which have very favourable terms whereas securities and loans denominated in currencies other than the euro make up less than 1% of outstanding debt.

Financing 2012

Gross financing needs for 2012 are projected to be close to €3.2 bn. The following financing operations have already taken place:

- A bilateral loan from the Russian Federation of €2.5 billion;
- Domestic bond issue of €82 million with a 3-year maturity.

For covering the rest of the financing needs the following options are available:

- Domestic Government Bonds of maturity of 2 to 5 years of around €100-200 million through auction in the domestic market;
- Short-term TBs of maturity of 3 to 12 months through auction in the domestic market;
- Institutional loans for project financing of around €100 million from the EIB and CEB.

Financing 2012 – 2014

The following are projections of the annual refinancing needs for the period 2012 – 2014, as at 31 Dec. 2011:

Table X: Refinancing needs for the period 2012–2014

Year	2012	2013	2014
EUR mn	2700	2350	880

The Government will pursuit the same borrowing policy and low-risk public debt management strategy in the near future, placing also emphasis on reducing borrowing costs, through the further development and more efficient functioning of the secondary market.

For 2013 and 2014, we expect a return to the markets and thus a return to the previous financing strategy of issuing at least 1 billion of medium to long term Eurobonds to European investors and the remaining to be covered through the issuance of domestic instruments, both sort term and long term. An additional objective for the coming years will be the development of alternative markets (Asia, Eastern Europe) in order to increase the investor base and reduce reliance to any single market segment.

Balance by Sub-Sector of General Government

The General Government sector in Cyprus comprises of the central government, the local authorities and the social security funds. The central government accounts for the bulk of the general government deficit, with the local authorities responsible for a small share of some 0.1% of GDP, as a substantial part of their operations and investment programmes are financed by transfers from the central government (Table XI).

The Central Government deficit is estimated to have deteriorated from a deficit of the order of 7.8% of GDP in 2010 into a deficit amounting to 8.4% in 2011. While, Social Security Funds balance, which is based on a pay-as-you-go system, exhibited a smaller surplus, from 2.5% of GDP in 2010 to 2.1% in 2011, mainly due to a deceleration in the rate of growth of contributions associated with a subdued growth of nominal earnings and employment growth, thus impacting on the overall budget balance[8].

During 2012, it is projected that the Central Government budget balance will begin to exhibit a downward trend and as a percentage to GDP fall to 4.3%. The surplus of the Social Security Fund is projected in 2012 to decline further, due to adverse conditions in the labour market, and fall to a surplus of 1.7% of GDP, bringing the overall balance of the General Government to a deficit of around 2⅔% of GDP.

The sizeable surplus of the Social Security Funds is linked to the still-favourable demographics, but also is due to the fact that the Social Security System will continue its maturing phase for another few years, after which people who are entitled to full benefits will start to retire.

The projected fall in the surplus of the Social Security Fund is mainly due to benign rate of growth of contributions in conjunction with increases in pension entitlements, as well as, the number of beneficiaries, and an accelerated rate of growth of unemployment and redundancy payments due to adverse conditions prevailing in the labour market. Specifically, the surplus of the social security funds is projected to decline from a forecast of 2.1% of GDP in 2011 gradually to 1.3% by 2013 attributed to a subdued rate of growth of contributions as employment and nominal earnings will show moderate signs of recovery. Over the period 2014-15, the surplus of Social Security Funds is projected to rise to about 1½% of GDP, mainly due to increases in social security contribution rates as agreed in the 2009 parametric reform of the system.

[8] The Government as an employer and as a contributory party to the whole scheme contributes annually approximately 3 per cent of GDP.

Table XI: General Government Budgetary Developments by Sub-Sector

in per cent of GDP	2010	2011	2012 est.	2013 proj.	2014 proj.	2015 proj.
			Net lending by sub-sectors			
General Government	**-5.3**	**-6.3**	**-2.6**	**-0.6**	**0.0**	**0.0**
Central Government	-7.8	-8.4	-4.3	-1.9	-1.5	-1.5
Local Government	0.0	0.0	0.0	0.0	0.0	0.0
Social Security Funds	2.5	2.1	1.7	1.3	1.6	1.5

Euro Plus Pact

In the framework of the Euro Plus Pact, the Government of the Republic of Cyprus committed in engaging in dialogue with all relevant stakeholders, addressing competitiveness issues and implement specific measures concerning competitiveness, sustainability of public finances and financial stability, as presented below.

Fostering competitiveness

Admittedly, there is strong correlation between public sector and private sector developments. Therefore, developments in public sector wages is considered to be catalytic in determination process of private sector wage bargaining negotiations. In view of the above, following discussions with stakeholders with a view to address among other competitiveness challenges, progress has been made in the area of containing public wage growth. More specifically, the freezing of wages and salaries in the broader public sector for a period of two years has been legislated. This has a permanent effect on the level of wages and salaries in the broader public sector.

The above decision affected the wage bargaining negotiations in other sectors of the economy. Examples to that respect are the similar agreement reached in the banking sector, as well as the provision of zero contractual increase in other sectors, albeit with some exceptions.

Furthermore, a public dialogue with trade unions for a containment of public sector payroll in the medium term and the re-designing of the system of Cost of Living Allowance (COLA) in order to limit increases in higher income groups, thus making it more equitable has been initiated. The Government's intension is to reach an agreement by the end of the first half of the year.

Meanwhile, concerning corporate taxation, Cyprus intends to maintain its current system which is characterized by low tax rates and a broad tax base, in line with broadly accepted principles of effective and fair taxation systems.

Contributing further to the sustainability of public finances

The Government has proceeded with the restructuring of the public pension system. To that end, contributions of 3% of gross pensionable earnings of broader public sector employees towards their pension entitlements has been introduced, as well as an increase in the contribution rate to the widows and orphans fund. Furthermore, the public pension scheme for new entrants in the broader public sector has been abolished leading to considerable improvement in the long-term sustainability of public finances.

Additionally, a Budgetary Framework (BF) is being gradually established. Towards this end a Bill has been drafted. The BF, among others, includes the introduction of national fiscal rules and the application of a binding MTBF as described above. The national fiscal rules include an expenditure and debt rule, as well as a budget balance rule and an automatic correction mechanism in line with the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. A more detailed description of the BF, as this is defined in the drafted Bill, is given in Chapter 7.

Reinforcing Financial Stability

The Cyprus financial sector is currently confronted with serious challenges, emanating from its exposure to the Greek banking sector and the Greek sovereign debt. Therefore, there is a continuous and close monitoring of the liquidity and capital adequacy position of financial institutions by the supervisory authorities and several options are being examined for the required recapitalization of banks.

Moreover, an ad hoc committee has been set up, with the participation of the Central Bank, in its capacity as supervisor of banks and responsible for the overall financial stability, as well as with the other supervisors, which monitors closely the developments of the financial sector.

In this context, a framework draft law for dealing with financial crisis has been prepared, to enable the Council of Ministers, following a proposal of the Minister of Finance and taking into account the opinion of the Governor of the Central Bank of Cyprus (CBC) and after approval of these measures by the House of Representatives, to take, ‘in a period of a financial crisis’, measures intended to address liquidity or

insolvency problems affecting financial institutions, in full compliance with the relevant acquis framework.

In relation to banks and cooperative credit institutions, the establishment of a fully independent Financial Stability Fund has been initiated, which will be financed through the imposition of a special tax, yielding around €60m per annum The Independent Financial Stability Fund will be set up, with a view to supporting and facilitating the resolution of distressed credit institutions.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

The overall picture of the global economy has been mixed in 2011 and economic growth has been uneven across regions. The fragile recovery from the global crisis that had started in 2009 has been negatively affected by sharp commodity price increases, natural disasters in Asia, and increased uncertainties about the resolution of the sovereign debt crisis in the euro area. Differences exist not only across continents but also within, especially the euro area. The sovereign debt crisis in the euro area, is casting a shadow over the subdued economic environment and uncertainties remain elevated. The return to potential growth is therefore characterized by uncertainty, which can also affect Cyprus, given its small and open nature.

The economy of Cyprus decelerated in 2011 exhibiting a modest positive growth. As in the previous SP 2010-2014, the current SP, following the anticipated dip in 2012, envisages a gradual recovery towards a considerably lower, compared to pre-financial crisis period, potential GDP growth. In the short term, the scenario takes a conservative stance with regards to the growth prospects of 2013, envisaging moderate growth, stemming particularly from exports of services. Construction and financial intermediation activities are forecast to remain subdued, whereas tourist activities are expected to follow a moderate growth path over the programming period.

Risks to the projections are associated with the uncertainties in relation to the external environment of Cyprus and more specifically, on the assumption that adequate policy measures are decided and implemented at the EU and Member-State level to overcome the sovereign debt crisis. This assumption underpins the forecast of a gradual return of confidence and a recovery in investment and consumption in the second half of 2012, which is however set to occur later and be more modest than assumed last autumn. Moreover, the financial market situation remains fragile. If the sovereign-debt crisis were to rebound massively, with a broad surge in risk premia and spill overs across countries, severe credit rationing and a collapse of domestic demand could ensue. Such an outcome would most likely trigger a deep and prolonged recession, not sparing even those countries which have shown more resilience so far.

Tensions in euro area sovereign debt markets are key. Future developments in the euro area will be critical for the economy as a whole as they influence the economy of

Cyprus both directly and indirectly, especially through confidence effects and volatility of spreads.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

To address the sensitivity of the projected general government balance and debt ratios, alternative assumptions for real GDP growth rates and interest rates have been incorporated in two distinct scenarios. All simulations assume unchanged policies but free operation of automatic stabilizers.

Assumption 1: *Heavier toll in domestic demand and more pronounced losses in financial services sector that could lead to lower annual growth by 1 percentage point of GDP over the programming period of the central reform scenario.*

Other things being equal, the budget balance is projected to deteriorate by some 0.4 per cent of GDP at the beginning of the programming period to a deficit of 3 per cent of GDP in 2012. The deficit in 2013 falls to about 1½ per cent of GDP compared to a close to balance position under the central reform scenario and then the resulting deficit path follows an upward trend reaching 1.4 per cent of GDP, at the end of the programming period, about 1½ percentage points higher than the central reform scenario. The public debt-to-GDP ratio is projected to follow a less pronounced declining path falling to 70.8 per cent to GDP in 2015, 5.8 percentage points of GDP higher than the central reform scenario.

Table XII: Scenarios for Public Finances

in per cent of GDP	**2012**	**2013**	**2014**	**2015**	**2012-2015 4-year average**
Central Reform Scenario					
GDP	-0.5	0.5	1.0	1.5	0.6
General Government Balance	-2.6	-0.6	0.0	0.0	
General Government Debt	72.1	70.2	67.8	65.4	
Sluggish external recovery					
GDP	-1.5	-0.5	0.0	0.5	-0.4
General Government Balance	-3.0	-1.4	-1.6	-1.4	
General Government Debt	73.4	71.8	70.8	70.8	

Assumption 2: *Interest rates remain 100 basis points above baseline each year during 2012-2015.*

Under this scenario, the government deficit would be 0.7 per cent of GDP higher at the end of the programming period, and the government debt-to-GDP ratio would be higher by about 2 percentage points of GDP at the end of the programming period.

Table XIII: Scenarios for Higher Interest Rates Cumulative Differential

in per cent of GDP	2012	2013	2014	2015
Central Reform Scenario				
GDP	-0.5	0.5	1.0	1.5
General Government Balance	-2.6	-0.6	0.0	0.0
General Government Debt	72.1	70.2	67.8	65.4
Higher interest rates				
GDP	-0.5	0.5	1.0	1.5
General Government Balance	-2.8	-1.0	-0.6	-0.7
General Government Debt	72.3	70.9	69.0	67.3

The analysis presented here underlines the sensitivity of deficit and debt dynamics on alternative growth paths, and underscores the crucial role of reforms in maintaining strong potential growth in the medium term. Additionally, borrowing costs are also key, especially during periods of moderate growth of the economy.

Comparison with Previous Update

Compared with the forecast presented in the Stability Programme 2010-2014, GDP growth forecasts for 2012, as well as for the outer years of the programming period have been substantially revised downwards, taking upon a more conservative stance, amid unfavourable conditions in the external environment, the difficulties faced by the domestic financial sector, the fiscal consolidation efforts and the negative confidence climate. The general government balance and debt, as a percentage of GDP, are projected to exhibit an improvement, in accordance to the Councils' recommendations issued under the Excessive Deficit Procedure initiated for Cyprus, whereby the correction of the excessive deficit should be reached by 2012 the latest.

The general government balance, as a percentage of GDP, is estimated to have reached a deficit of 6.3% in 2011, some 2.3 percentage points higher than what was anticipated in the last update. The difference is mainly attributed to the lower growth and non-tax rich composition of growth witnessed in 2011. The general government balance is projected to fall to a deficit of about 2½% in 2012 and a deficit of 0.6% in 2013 in accordance to the Councils' recommendations. The forecast for the general government budget balance for 2012 is the same as the one projected in the last update. At the end of the programming period, the general government position is projected to be in balance compared to a deficit projection of 1.6% of GDP of the last update.

The general government debt-to-GDP ratio is estimated to rise to 71.6% in 2011 and subsequently increase further, peaking at about 72% in 2012. At the end of the programming period, debt-to-GDP ratio falls to 65.4%. These projections are higher in comparison to the previous update, despite the fact that, primary balances are projected to exhibit an improvement compared to the last update. This is mainly attributed, to the revised forecast of nominal GDP levels.

Table XIV: Divergence from previous update

in per cent of GDP	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
			GDP Growth			
Previous Update	0.9	1.5	2.5	2.7	3.0	n/a
Latest Update	1.0	0.5	-0.5	0.5	1.0	1.5
Difference	0.1	-1.0	-2.0	-2.2	-2.0	
			General Government Balance			
Previous Update	-5.3	-4.0	-2.6	-2.0	-1.6	n/a
Latest Update	-5.3	-6.3	-2.6	-0.6	0.0	0.0
Difference	0.0	-2.3	0.0	1.4	1.0	
			Debt-to-GDP Ratio			
Previous Update	56.2	61.0	63.2	63.1	62.3	n/a
Latest Update	61.5	71.6	72.1	70.2	67.8	65.4
Difference	5.3	9.4	8.9	7.1	5.5	

5. SUSTAINABILITY OF PUBLIC FINANCES

This chapter illustrates the overall situation concerning the sustainability of public finances, looking in more depth at the projected development of the General Social Insurance Scheme (GSIS) and other public age-related expenditures, as well as the future evolution of the general government expenditures and revenues. For the purposes of this analysis, it is assumed that the budgetary situation evolves in line with the Stability Programme targets for 2012-2015. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2015 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government deficit.

The projection results included in this report, as it was the case with last year's Stability Programme, incorporate the reform of the GSIS, which took place in 2009 and aimed at addressing the long-term sustainability of the GSIS. The new law, which came to effect on April 1st, 2009, includes a set of parametric reforms that are to be phased in gradually, but also a set of principles to be followed by the Government concerning the investment policy of the GSIS. These reforms include a progressive increase of social security contributions – seven increases by 1.3 percentage points every five years, first increase in April 2009 and last increase in January 2039 – and other reforms on the expenditure side that aim at tightening eligibility criteria. More details about the above reforms and their impact were given in previous Stability Programme reports.

In addition, the projection results included in this report, but not in last year's Stability Programme, incorporate the recent reform of the Government Employee Pension Scheme (GEPS), which took place in August 2011. The new law stipulates that, effective October 1, 2011: (i) GEPS becomes closed to new members and any newcomers will join the GSIS under the same terms and conditions as those of salaried employees in the private sector and (ii) existing members of the GEPS increase their contribution rate from approximately 1 per cent to 5 per cent of pensionable emoluments. Furthermore, it was agreed that future increases of GEPS pensions in payment will be awarded only in accordance with consumer price index, as it is currently stipulated by the legislation. Previously, pension increases were awarded not only in line with the legislated consumer price indexation, but also in line with general salary increases on a discretionary basis.

All of the above reforms over compensate the effects of additional reforms, including increasing statutory retirement age in alignment to life expectancy.

It is noted that public pension projections included in this Stability Programme cover the pension expenditure of the GSIS, GEPS and Social Pension Scheme (SPS), which

in total, represent almost 100% of 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 2010-2060. The main elements of the analysis are the long-term projections for public pensions, health and education expenditures. The base year for the projections is 2010 and therefore, the figures for the subsequent years are projections. In addition, the projections undertaken for the purposes of the present Stability Programme exercise are based on the latest available commonly agreed assumptions of the EPC-AWG (adopted in July 2011).

Table XV shows the key demographic and labour market assumptions used for the purposes of this year's Stability Programme exercise as compared with those of last year's exercise.

Table XV: Basic Demographic and Labour Market assumptions 2010-2060

SP 2012-15						
	2010	**2020**	**2030**	**2040**	**2050**	**2060**
Total Fertility Rate	1.50	1.52	1.55	1.57	1.60	1.62
Life Expectancy at birth						
- Males	78.3	79.9	81.3	82.7	83.9	85.1
- Females	82.8	84.2	85.4	86.7	87.9	89.0
Participation Rates	73.9	77.9	78.4	78.0	78.1	78.0
- Males	79.8	81.8	80.7	80.0	80.3	80.1
- Females	65.6	74.1	76.1	76.0	75.7	75.9
Migration	2.220	5.955	5.497	5.039	4.705	4.127
SP 2010-14						
	2010	**2020**	**2030**	**2040**	**2050**	**2060**
Total Fertility Rate	1.50	1.54	1.58	1.60	1.60	1.60
Life Expectancy at birth						
- Males	78.3	79.9	81.3	82.7	83.9	85.1
- Females	82.8	84.2	85.4	86.7	87.9	89.0
Participation Rates	73.9	78.1	79.4	79.2	80.9	81.4
- Males	79.8	82.1	82.4	81.8	82.0	81.8
- Females	65.6	70.2	71.9	72.1	74.1	75.6
Migration	2.220	5.955	5.497	5.039	4.705	4.127

It follows from the above table that the key demographic and labour market assumptions under both this year's and last year's Stability Programme exercises are broadly the same.

Table XVI shows the aggregate results of the projections for public pension expenditure and contributions over the period 2010-2060.

Table XVI: Projected public pension expenditure and contributions - baseline scenario, % GDP

in per cent of GDP	2010	2020	2030	2040	2050	2060
Total Expenditure[1]	7.6	9.5	11.1	12.1	14.4	16.4
Total Amount of Contributions[2]	7.3	8.4	9.5	10.5	10.3	10.4
Reserves of the GSIS	40.9	55.9	64.2	66.6	56.0	14.7

[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.

The results indicate a significant increase in public pension spending over the next 50 years, with the most dramatic deterioration occurring from 2040 onwards. Up to 2040 contributions and expenditure increase in a similar pace with the excess of expenditure over contributions staying at relatively low level, whereas over the period 2040-60 the excess of expenditure over contributions increases considerably. In particular, total public pension expenditures are projected to increase from 7.6% of GDP in 2010 to around 11.1% of GDP in 2030 and 16.4% of GDP in 2060. At the same time contributions increase from 7.3% of GDP to 9.5% of GDP in 2030 and 10.4% GDP in 2060. The reserve of the GSIS which is in surplus equivalent to some 41% of GDP is projected to reach 66.6% of GDP in 2041, year in which it reaches its maximum level. From 2041 onwards, the GSIS reserves are expected to decrease significantly to 14.7% of GDP by year 2060.

The aforementioned significant increase in public pension expenditures over the period 2010-60 is explained at a great extent by the deterioration of the demographic dependency ratio (population aged 65+ over population aged 20-64), and to a much lesser extent by the increased coverage ratio (number of pensioners over population 65+). The latter is due to the expected increase in the percentage of female insured persons who meet the qualifying conditions for receiving an old-age pension before the age of 65, while they might also be entitled to a survivor's pension (receiving double pensions). This is as a result of the expected increase in the female labour force participation rates and longer contribution periods.

Table XVII shows the reduction in the total public pension expenditure of this year's Stability Progarmme over the projection period 2010-60 as compared to the projected figures of last year´s Stability Programme.

Table XVII: Difference between SP 10-14 and SP 12-15 pension projection exercise (% of GDP)

in per cent of GDP	2010	2020	2030	2040	2050	2060
Stability Programme 2010-2014 **(1)**	8.3	9.7	11.3	12.9	15.2	16.8
Stability Programme 2012-2015 **(2)**	7.6	9.5	11.1	12.1	14.4	16.4
Reduction in expenditure **(1) – (2)**	0.7	0.2	0.2	0.8	0.8	0.4

The pension expenditure projection results of this Stability Programme, as presented in Table XVII above, differ from those of last year mainly because of the following two factors:

- The GEPS' legislative amendments, following the 2011 pension reform, had a significant downward effect on the public pension expenditures, especially in the longer term – in particular, in 2060 it is projected that the GEPS' legislative amendments would reduce expenditure by 1.6 percentage points.
- Finally, the overall impact of changes in macroeconomic assumptions onto the public pension expenditures is negative, largely driven by lower GDP growth rates, resulting in a considerable increase of the public pension expenditures in the longer term – in particular, in 2060 it is projected that the changes in macroeconomic assumptions would increase expenditure by 1.2 percentage points.

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 July 2011 for the purposes of the forthcoming 2012 Ageing Report – are projected to rise from around 20.1% of GDP in 2010 to around 28.1% in 2060.

As a result total general government expenditure is set to increase from 46.4% of GDP in 2010 to around 50.1% in 2060. General government revenue, which is estimated to have declined significantly between 2007-2010, is forecast to increase from 41.1% of GDP in 2010 to around 45.1 % in 2060.

The results of this analysis clearly reveal that, while the problem is contained broadly through 2040-45, when the adverse demographics kick in the deterioration in the financial position of the GSIS and, in turn, that of the general government worsens markedly.

6. QUALITY OF PUBLIC FINANCES

Policy Strategy

Improving the quality of public finances has become a key policy challenge for policy makers. Rising pressures from contagion of the financial crisis, ageing populations, and long-term sustainability of public finances are limiting the manoeuvrability of fiscal policy, while sound fiscal positions remain a top priority for the European Union's framework. Policy makers are becoming more restricted as far as fiscal policy is concerned, and have moved towards improving the qualitative aspects of fiscal policy with a view to supporting economic growth and realizing the growth potential.

The general framework for improving the quality of public finances in Cyprus, targets public resources, by raising the efficiency of public spending, modernising public finance institutions and budget administration, establishing efficient and growth-enhancing revenue systems and creating supportive fiscal frameworks. Considerable attention is paid to the quality aspects of public expenditure to ensure that growth enhancing budgetary items are not squeezed out by uncontrolled expenditure costs or by growth in inefficient expenditure categories.

The spending priorities include the education and health sector, infrastructural investment, IT-development, and research. On the revenue side, Government policies aim at preserving the current system, characterized by low marginal tax rates and a wide tax base. These are important elements of the EU 2020 for promoting growth and jobs, while simultaneously meeting the objectives of the Stability and Growth Pact.

Reallocation of Expenditures

For the second year, the budgetary process (for 2012), required line ministries to provide forecasts of their expenditure needs over a three year horizon. Forecasts were split between current obligations and future needs and any additional available resources were allocated to high priority areas, such as health, education, research and technology, all in line with the objective of redirecting public expenditure to growth-enhancing categories.

The policy for reallocation of government expenditure evidently leads to the reduction in absolute terms of expenditure functions such as Defence, Public Order and Safety and Economic Affairs, while high priority functions such as Education, Housing and Community Amenities, Health and Social Protection exhibit an increase in the expenditure functions.

Table XVIII: Functional Classification of Expenditure

in per cent of GDP	2006	2007	2008	2009	2010	2011 est.
1. General public services	10.3	11.1	10.9	12.0	10.7	10.7
2. Defence	2.0	1.8	1.7	1.9	2.4	2.1
3. Public order and safety	2.1	2.1	2.1	2.3	2.4	2.1
4. Economic affairs	4.2	3.6	3.5	3.7	3.9	3.7
5. Environmental protection	0.3	0.3	0.3	0.3	0.3	0.3
6. Housing and community amenities	2.5	2.5	2.7	3.2	2.8	3.3
7. Health	3.1	2.9	3.0	3.3	3.3	3.5
8. Recreation, culture and religion	1.3	1.3	1.3	1.4	1.3	1.3
9. Education	6.4	6.3	6.8	7.2	7.5	7.5
10. Social protection	10.3	9.5	9.8	11.0	11.7	12.7
11. Total expenditure	**42.6**	**41.3**	**42.1**	**46.2**	**46.4**	**47.3**

High priority areas

Total expenditure for *infrastructure*, in the Budget for 2012 and in projects financed through Private Public Partnership agreements, exceed 4% of GDP. Considerable progress has been achieved in the expanding and upgrading of basic infrastructure including the completion of important projects in the area of health, education and transport.

The general trend for the budgeted amounts of all functional classification of expenditure is downwards, given the current fiscal consolidation process. High priority areas, such as health, education, research and technology, social protection, depicted a decrease in absolute terms; however the decrease was lower than other areas, given their concurrent obligations. Total expenditure on ***education*** is budgeted to decrease by approximately 2% in 2012 compared to 2011, reaching approximately 7.2% of GDP. Expenditure on education is focused mainly on the reconfiguration of the analytical programmes in primary and secondary education, the continuation of computerisation of all primary and secondary schools and funding of higher education by upgrading of new research and academic institutions (University of Cyprus, Cyprus University of Technology, Open University).

Total expenditure on ***health*** is budgeted to decrease by approximately 5% in 2012, compared to 2011, reaching 3.2% of GDP. The Budget for 2012, allocates considerable funds for the extension and renewal of one of the general hospitals, for the promotion of private health care services. The improvement of the quality of the

health care system and the effective tackling of the anticipated increases in public health expenditure constitutes a significant challenge.

The annual Budget for 2012 shows large decreases in the areas of agriculture, security and defence, of public administration with the largest decreases in the areas of transport and agriculture reaching 15% and 19% respectively.

Revenue Side

Improving the quality of public finances from the revenue side has represented an important challenge to the Cyprus authorities covering different aspects. As levels of government revenue and tax structures have macroeconomic and microeconomic consequences, their impact will shape many aspects of the Cyprus economy.

Firstly, the macroeconomic consequences of taxation are materialized by its stabilization, redistribution and (dis)incentive effects. Tax systems must contribute to ensuring budgetary discipline. With the adoption of a fiscal consolidation plan the authorities have identified the less distortionary categories of taxes with respect to growth and employment and have introduced them to address the fiscal imbalances that have emerged. A better functioning product, labour and capital markets, as well as, the enhanced automatic stabilization potential of fiscal policy have been required. Moreover, with tax policy impacting on both, the authorities are closely monitoring the macroeconomic effects of the tax system.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

Budgetary Procedures, including public finance statistical governance

By law, the fiscal year in Cyprus corresponds to the calendar year, while Article 167 of the Constitution places the responsibility for the preparation of the comprehensive budget on the Minister of Finance. Under Article 81 of the Constitution, the budget then has to be brought before in the House of Representatives at least three months before the commencement of the financial year, i.e., by September 30 of each year, and it is to be voted upon by the House not later than December 31 of each year (Box 3). Accordingly, the Ministry of Finance issues the budget circular by the end of March. The budget circular outlines the various parameters for budget preparation for the guidance of the line ministries. A separate, parallel circular is issued by the Planning Bureau for the development expenditure component of the budget, within the ambit of a five year strategic development plan drawn up by the Planning Bureau (Box 4). The budget is presented on a line item basis. The budget and accounts classification are consistent and mainly based on an administrative classification, whereas a classification a classification by economic category of expenditures is also presented.

Box 3. The Budget Preparation Calendar

Due dates	Activities	Legal basis
The fiscal year is set on a calendar-year basis by the Constitution. The main steps in the process are as follows:		
End-March	Budget circular issued to ministries detailing the basic parameters	Administrative instructions of the Ministry of Finance
20 May	Line ministries submit budget proposals to Ministry of Finance	Administrative instructions of the Ministry of Finance
June to late September	Budget discussion between line ministries and Ministry of Finance	Administrative instructions of the Ministry of Finance
Early September	Submission to the Council of Ministers for discussion and approval	

Box 3. The Budget Preparation Calendar		
Due dates	Activities	Legal basis
30 September	Ministry of Finance submits budget proposals approved by the Council of Ministers to the House of Representatives	Art. 81 of the Constitution
October to December	Discussion of the proposed budget in the Parliamentary Committee of Finance and Budgets and in plenary session; budget approval	
1 January (next year)	Commencement of budget approved by the House of Representatives	Art. 81 of the Constitution

Box 4. Budget Preparation Process

Until 1998, the government used to present four separate budgets—the Ordinary Budget, the Development Budget, the Special Relief Fund for the Displaced and Affected persons and the Defence Fund. By order No. 48.868 of December 16, 1998, the Council of Ministers approved the consolidation of all four budgets, although the presentation is still in two separate categories of expenditure namely for the ordinary and the development expenditures.

The budget circulars of the Ministry of Finance specify the date for submission by the line ministries of their proposals to the Ministry of Finance, and the date when the Ministry of Finance, in turn, has to submit the combined budget documents to the House of Representatives. The budget circulars also detail the parameters for the preparation of budget estimates as based on the Stability Programme. It also details various budgetary ceilings or cuts to be made. However, no reference to estimated revenue inflows is made at this stage.

All investment programmes and projects are described in the explanatory memorandum accompanying the development expenditures part of the budget. A limited number of expenditure subheads in the budget's development part are marked with a dagger (+), indicating that expenditure cannot be incurred until full details of the project have been provided to the Minister of Finance and an "Authority to incur Expenditure" has been issued by the Minister of Finance. The final approval for de-daggering rests with the Minister of Finance upon advice by the Director of Budgets and Fiscal Control.

Daggering is applied when implementing line ministries have not provided adequate project information by the time the budget is submitted to the House of Representatives or when more time is needed to analyze and evaluate the project (in case of new project proposals). Daggering is also used as a mechanism to monitor monthly cash flows of large projects, in which case cash releases are made after periodic implementation reviews in the course of the year.

Implementation of National Budgetary Rules

The net lending/borrowing targets of the general government are set in accordance with the provisions of the revised Stability and Growth Pact, as well as any recommendations issued by the ECOFIN Council. The government monitors the general government balance consistently (on a quarterly basis), and also tracks such indicators as the general government primary and structural balances (in the context of the semi-annual fiscal notifications to the European Commission) and the balance of the consolidated central government and social security funds (monthly). The deficits of municipalities and communities are not systematically monitored.

Through budget circulars, the Ministry of Finance indicates to the line ministries the broad policy guidelines for the budget formulation for the coming year with regard to the recurrent and the development items in the budget. While a general review of macroeconomic policies is available in the Finance Minister's budget speech and the accompanying report on economic developments, and a broad consensus exists on the macroeconomic goals, the budget remains essentially based on an incremental budgeting mechanism for expenditure items and only a consolidated revenue forecast based on existing tax policies is prepared. A short document summarizing the economic developments in the previous year and the prospects for the coming year is prepared by the Ministry of Finance each year. This document discusses broadly the international and domestic economic developments including details of the inflation rate and the budget balance and also presents a brief sectoral analysis.

The government has set up a financial and management accounting system (FIMAS) in the treasury. The system has the capacity to monitor expenditures on a monthly basis and on a programme basis. The system also has the capacity to check payments against budget allocations and record commitments (Box 5). In combination with strict payment authorization procedures, this ensures strong ex-ante control. The system is also used for preparing the budget documents. The government operates a single account called the government general account and all revenues deposited in private banks are deposited into it within two days of collection. Transfer delays are watched by the Treasury and a system exists to collect interest on delayed payments into the government general account. The Central Bank of Cyprus provides the Treasury daily balances on the government general account.

Box 5. The FIMAS System

The FIMAS system is based on a 10 digit code supported by a further 10 digit analysis and a 10 digit transaction code, which allows generation of about 250 standard reports and a further number of customized reports at any hierarchical level, including on payments and commitments. FIMAS has a general ledger; includes expenditure control, budget preparation, costing and reporting modules; and maintains a database of outstanding government liabilities.

FIMAS could be used to strengthen commitment control. Clauses 11 & 12 of the Law for the Management of Revenues, Expenditures and of Accounting Systems of the Republic and Other Related Matters makes the controlling officers personally liable for ensuring that expenditures do not exceed allocations. In addition, Law No. 112 (1)/2002 makes the incurrence of any expenditure in excess of approvals a criminal offence. The government has also issued instructions (Order No. 1568 of December 23, 2003, Para 3.1.5 and Arts. 73 and 74 of the Finance and Accounting Instructions issued by the accountant general) to ensure recording of commitments.

The system covers all national and EU funds except those directly paid to citizens in the area of agriculture (channeled through the Cyprus Agricultural Payments Organization) but not local authorities or semi-government organizations. The consolidated central government budget and accounts classifications are uniform.

Other Institutional Developments in relation to Public Finances

In early 2005 the IMF was invited to undertake a report on the Observance of Standard and Codes (ROSC) for Cyprus and assess compliance with the IMF's "Code on Good Practices on Fiscal Transparency". The report concluded that "Cyprus has been making major progress in improving fiscal transparency, helped by the Government's efforts to strengthen budget management system and comply with the acquis communautaire. As a result, the country now fully meets or even exceeds the Code´s standards in many areas".

The IMF fiscal ROSC pointed out, however, that more progress was warranted in the areas of the public expenditure and financial management. To bring the management of public finances in line with best practices a number of initiatives have been taken, including the introduction of a comprehensive financial information and management system (FIMAS) from January 2004.

It was further noted that increasing amounts of resources were being used in public private partnership (PPP) projects. However, the risks for the public sector arising from PPP projects needed to be better assessed and identified. Reacting to this concern, the Cyprus authorities decided to develop adequate risk analysis systems and

reporting, and monitoring mechanisms so as to better reflect risks and potential budgetary costs.

Furthermore, the Ministry initiated the preparation of a medium-term budgetary framework (MTBF), which takes into consideration the medium-term targets and polices incorporated in the Stability and the National Reform Programmes of Cyprus. Such a medium-term budgetary framework will improve the ability of the Government to prioritize programmes based on the needs of the economy, tighten further public expenditure limits and minimize the scope for a mid-year reopening of the budget. The Authorities introduced the multi-year budgetary framework with the preparation of the 2012 budget.

Further "fiscal structural reforms" will lay down the key principles for the formulation of fiscal policy, integrate a multi-year budgetary process and set strict procedures on spending both for broad spending categories as well as for Ministries. The new policy framework will limit significantly the practice of mid-year, supplementary, budgets and will boost significantly the credibility of fiscal policy.

Policy Framework and Structural Reforms

Taking into account, the adoption of the Council Directive *On the Requirements for Budgetary Frameworks of the Member States*, the signing of the *Treaty on stability, coordination and governance in the economic and monetary union*, as well as, the anticipated introduction of the Regulations on strengthening the surveillance of member states under the excessive deficit procedure or member states faced with difficulties in their financial sector (*«two pack»)*, the Ministry of Finance is introducing an enhanced budgetary policy framework that will assist in the development of strong and flexible public finances, in order to resist any external shocks. To this end, a draft bill has been compiled incorporating all the relevant provisions in order to strengthen economic governance and improving quality of public finances.

More specifically, the Ministry of Finance envisages the *adoption of the «Bill on Regulating Medium Term Budgetary Frameworks and Fiscal Rules»* and simultaneously promoting the establishment of an Independent Fiscal Council by the end of the first half of 2012. The main provisions of the draft Bill are:

1. Numerical Fiscal Rules

- Should promote compliance with the reference values on deficit (3%) and on public debt (60%) in accordance with the Treaty.
- The government's nominal budgetary position should be either balanced or in surplus.
- In case of non-compliance with the predetermined path towards the MTO, correction measures of a structural nature apply, related mostly to the

expenditure side, taking into account the time horizon recommended by the Council of Economic and Financial Affairs. The Minister of Finance prepares, within a month, and submits an amending Budget, to the Council of Ministers, describing in detail the necessary measures needed for achieving the correction of any divergence from fiscal targets within the prescribed time horizon.

- When the ratio of general government gross debt to gross domestic product (GDP) exceeds the reference value, measures are undertaken so that the differential with respect to the reference value has decreased over the previous three years at an average rate of one-twentieth per year as a benchmark.
- When MTO is not achieved annual expenditure growth does not exceed a rate below a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.
- Exceptional revenues should be used for the reduction of public debt.

2. Medium – term budgetary frameworks

- Multiannual fiscal planning horizon (3 years).
- Multiannual transparent budgetary objectives in terms of general government deficit and debt.
- Description of medium term policies showing how the MTO is to be achieved or maintained.

3. Accounting and Statistics

- Should cover all sectors of general government.
- Timely and regular availability of public data (monthly for central government, quarterly for local government).

4. Forecasts

- Based on most likely macro scenario or more prudent scenario.
- Significant differences between our forecasts and commissions forecasts shall be explained.
- All budgetary forecasts including methodologies, assumptions shall be made public.

The new draft Bill will be submitted to the Council of Ministers for approval by the end of May 2012 and following its approval it will then be tabled before the House of Representatives for discussion and final adoption.

In addition to the draft Bill, *the establishment of an Independent Fiscal Council* is promoted to foster unbiased and realistic macroeconomic and budgetary forecasts, which can considerably hamper the effectiveness of budgetary planning and consequently impair commitment to budgetary discipline and the quality of public finances, if are biased and unrealistic.

APPENDIX

The Banking System in Cyprus

During the past 25 years Cyprus has developed considerably in the area of services, beyond the traditional tourism-related activities. Indicatively, the share of services other than tourism in total GDP rose from around 61½% in 1995 to around 74% in 2011. More specifically, the share of financial intermediation as a whole has risen from around 5% in 1995 to around 9% in 2011.

The structure of the Banking System

A few large players dominate the Cypriot banking sector. The domestic banking market is dominated by Bank of Cyprus, Marfin Popular Bank, Hellenic Bank and the greek subsidiary Alpha Bank. Together they hold about 53% market share of total lending, whereas the Cooperative Sector holds another 20%.

In total, there are forty-one (41) banks subject to authorisation and supervision by the CBC operating through branches and offices all over Cyprus.

- Six (6) of them are locally based banks, of which the largest 3 are listed on the Cyprus Stock Exchange and are also internationally active with presence mainly in Greece but also the UK, Russia and other Eastern European Countries. The remaining locally based banks are small locally activated banks among which is a small state owned institution specialising in house mortgage lending and the Central Cooperative Bank (CCB) which acts as the central banker of credit co-op institutions (managing their liquidity). CCB also acts as the central body for the affiliated cooperatives (all cooperatives except one) guaranteeing all their liabilities.
- Eight (8) are subsidiaries of foreign banking groups (of which 5 are subsidiaries of banks from EU countries mainly from Greece and 3 are subsidiaries from other non-EU countries).
- Twenty five (27) are branches of foreign banks (of which 11 are branches of banks from EU countries and 16 are branches of banks from countries other than EU).
- All, but one, foreign branches described above and one foreign subsidiary, transact almost exclusively with non residents. This group holds about 15% of the market share in terms of total domestic deposits and lending. The presence of these banks in Cyprus relates to the strategic planning of their parent banks and their domestic operations are minimal.

Total banking system assets, as at 31 Dec 2011, were in the region of €146bn, of which about €34bn relates to the overseas operations of the three domestic banking groups mentioned above. Foreign owned branches account for about €8bn or 6% of

total banking system assets. Foreign owned subsidiaries hold assets of about €38bn representing 26% of the total banking system assets. However, substantial amounts of their assets relate to booking transactions funded by their parents which in most cases retain the credit risk. This practice is part of the respective banking groups' tax planning activities and aim at taking advantage of the low tax rate in Cyprus. It is evident from the above, that a significant part of the Cyprus Banking Sector's assets does not relate to and is not directly affected by the local economy. The following table provides further details of the breakdown of the banking system assets.

Bank Asset Structure (including overseas operations of locally based banking groups)

As at 31 Dec 2011 €million	Total Assets	Lending (Net of provisions)		Securities and other investments held[*2]	Exposures[*3] for which the credit risk is born by the parent bank	Bank placements
		Residents[*1]	Non Residents including Brass Plates[*1]			
EU branches	**1.912**	287	234	10	-	1.345[*4]
Non EU branches	**6.351**	175	1.541	897	-	3.565[*4]
EU subsidiaries	**26.511**	4.921	4.037	13.840	10.479	3.321[*4]
Non EU subsidiaries	**11.973**	1.226	7.823	639	146	1.654[*4]
Locally based banks	**82.392**	24.562	34.263	10.415	-	7.981[*5]
Coop Sector	**17.066**	12.892	36	2.257	-	968
Total Banking System	**146.205**	44.063	47.934	28.058	10.625	18.834

[*1]In relation to the resident/non resident distinction it is important to note that as per the EU statistical definition, all companies registered in Cyprus are classified as residents. In the case of Cyprus, where several foreign owned and foreign activated companies are registered in Cyprus due to the tax incentives present, this definition does not convey a fair picture of the domestically activated companies. In the above table this distortion is partly overcome by reclassifying a specific subcategory of residents, that of "Brass Plate" companies (companies registered in Cyprus but with no physical presence in Cyprus) into the non – residents category. Still, some element of foreign owned foreign activated companies, those with physical presence in Cyprus, remains under residents and cannot be distinguished.

[*2]Mostly sovereign and bank bonds.

[*3] Exposures relate both to loans granted and securities held. The credit risk is effectively transferred to the parent bank by a legally binding agreement with a right of set-off of the exposures against the amounts due to the parent bank (i.e. the funding provided by the parent bank).

[*4]Mostly placements with their head office/ parent.

[*5]Mostly placements with highly rated overseas banks.

It is important to note that the above table includes the activities of the three locally based banking groups with operations abroad. Accordingly, lending to non residents by locally based banks includes loans granted to customers in Greece amounting to €21.8bn, in other South East European countries, Russia and Ukraine €3.7bn and in

other countries, mainly in the UK €2.3bn. Furthermore, other exposures to the Greek economy (Placements with Greek Banks and Greek bank and sovereign bonds held) are in the region of €1.7bn for the locally based banking groups of which €1.4bn relate to Greek Government bonds. For the foreign owned subsidiaries with Greek exposures (in this case being the subsidiaries of Greek banks) Greek exposures are backed by funding from the parent bank and, for most of the amounts involved, with a legal right of set-off. Thus the credit risk associated with these exposures is considered very low.

Nonetheless, business conducted with non residents is an important element of all banks business (excluding the Cooperative sector and the small state controlled bank). Non-resident and brass plate deposits have been growing steadily and consistently over the years, with the exception of the year 2011 during which a small reduction was observed, currently comprising about 45% of total customer deposits in Cyprus of which about 55% are in foreign currency. Given the short term nature and the volatility of these deposits, the Central Bank of Cyprus has imposed high liquidity requirements in order to ensure that banks can withstand severe withdrawals. For example, there is a 70% stock liquidity requirement imposed on banks in relation to their foreign currency customer deposits whereas for the local currency deposits there are, in addition to a minimum stock liquidity ratio of 20%, maximum mismatch ratios for the short term maturity time bands up to a month. Liquid assets are defined as short term bank placements with highly rated banks and high quality tradable securities. The following table provides the recent growth history of the deposits of banks, in Cyprus (i.e. excluding deposits of Cypriot banks through their overseas operations).

Total Deposits held by banks in Cyprus

€million	31.12.2011	31.12.2010	31.12.2009	31.12.2008	31.12.2007
Total Deposits	**69.302**	**69.940**	**58.155**	**56.005**	**52.514**
Euro / +CYP in 2007	48.596	47.260	41.942	38.110	34.029
Other Currencies	20.706	22.680	16.213	17.895	18.485
Analysed by residence*:					
Residents	37.921	37.256	34.933	33.752	32.033
Non Residents	31.381	32.684	23.222	22.253	20.481

*Brass Plate Companies (i.e. companies registered in Cyprus but with no physical presence in Cyprus) are classified under non residents in this table.

The Cooperative Credit Institutions (CCIs) continue to play an important role in the Cypriot banking system. Cooperatives' overall market share has been broadly stable, at around 12% in terms of total assets of deposit-taking institutions. CCIs are involved only in traditional banking and have no activities in foreign markets.

The cooperative credit sector has been going through a major consolidation in the last 5 years, mostly in response to the new regulatory and competitive environment. The number of cooperative credit institutions, which was around 360 in 2005, has come down to 99 in April 2012. The 99 CCIs operating in Cyprus hold an operating licence either on a stand alone basis (1 CCI) or through their affiliation to the Cooperative Central Bank (CCB) Ltd which acts as the Central Body (CB) based on article 3 of the EU directive 2006/48/EC.

Both banks and cooperatives operate on the "traditional" banking model of raising deposits and granting loans with limited reliance on wholesale funding. Loans to deposits ratio is calculated at 104%. Banks do not have exposure to complex toxic assets, proprietary trading is very limited whereas they are not allowed to own investment property other than that obtained in satisfaction of debts and which must be disposed within three years. Also foreign currency exposure of banks is limited. In conclusion, the banks' risks relate to the risk of default on credit granted to customers for which the banks apply prudent lending criteria at the time of granting and, to a great extent, they also require tangible security as a second way out in case of default of the customer.

The way in which banks fund their operations is demonstrated in the following analysis of their liabilities structure:

Banks' Liabilities structure (including overseas operations of locally based banking groups)

As at 31 Dec 2011 €million	Total Liabilities and shareholders' funds	Deposits		Total funding by parent	Due to Other Banks (incl. European Central Bank)	Capital & Reserves	Loan Capital
		Residents excluding Brass Plates	Non Residents including Brass Plates				
EU branches	**1.912**	759	542	231	331	42	-
Non EU branches	**6.351**	425	4.065	928	641	205	-
EU subsidiaries	**26.511**	3.133	3.889	17.043	620	1.346	100
Non EU subsidiaries	**11.973**	1.129	2.013	6.196	2.060	367	26
Locally based banks	**82.392**	18.418	40.125*	-	14.257	4.285	2.223**
Coop Sector	**17.066**	14.057	247	-	815	1.495	-
Total Banking System	**146.205**	37.921	50.881	24.398	18.724	7.740	2.349

*includes €19.5billion deposits raised and held at the overseas branches and subsidiaries of three locally based banking groups, from residents in the countries of operation.
**of which hybrid capital € 1.9bn.

Deteriorating loan quality which led to increased bad debt provisions as well as the losses from the Greek PSI, have negatively affected banks' profitability and capital. Substantial recurring pre-impairment profitability provides a cushion for further loan losses, especially from their Greek loan books. However, the banks need to raise additional capital to cover the Greek PSI losses they suffered. Table below shows a number of consolidated profitability indicators for the locally active banks[9] which underline the strong financial position of banks in Cyprus. The last table shows some further financial soundness indicators for the whole consolidated banking system[10].

Profitability indicators (locally active banks including the overseas activities of locally based banking groups)

	2011 provisional	2010	2009	2008	2007
Net interest income	2.721m	2.475m	2.057m	2.004m	1.878m
Operating profit	1.712m	1.513m	1.438m	1.416m	1.675m
Provisions charge	2.043m	817m	634m	292m	208m
Impairments/Non oper. losses	(4.425)m				
Net profit after tax	(4.433)m	606m	705m	959m	1.233m
After Tax Return on total assets	(3.74)%	0.44%	0.55%	1.03%	1.72%
After Tax Return on own funds	(61.21)%	7.49%	9.34%	14.0%	21.1%
Cost to Income ratio	48.9%	53.7%	53.6%	51.1%	44.5%
Net interest margin	2.4%	1.9%	1.7%	2.3%	2.7%

Other financial soundness indicators (all banks, at consolidated level)

	Dec 2011 provisional	Year 2010	Year 2009	Year 2008	Year 2007
Solvency Ratio	9.5%[11]	12.2%	11.8%	10.6%	12.5%
NPLs including fully collateralised loans*	15.9%	11.6%	9%	n/a	n/a
Provisioning Coverage	36.4%	36.1%	40.3%	n/a	n/a

*Credit facilities in arrear over 3 months (classified at customer level).

[9] Those branches and subsidiaries of foreign banks that are situated in Cyprus for the strategic [tax] planning reasons of their parent banks and have little or no business interest in the local market, have been excluded.

[10] Consolidated banking system means locally based banking groups at consolidated level, i.e. including their overseas activities through branches and subsidiaries abroad, and all locally established branches and subsidiaries of foreign owned parent banks.

[11] This ratio is estimated to have risen to 9.7% following the rights issue of €160m at Bank of Cyprus in March 2012.

To properly interpret the NPL ratios shown above, one must bear in mind an important peculiarity of the Cyprus legal system, this being the delay in reaching legal settlement and liquidating collateral. This affects the speed of recovery of nonperforming loans and results in the banks accumulating in their books long-due delinquent loans which are either covered by bad debt provisions, or by collateral which will eventually be liquidated in satisfaction of the debts. An important additional ratio to consider is that of NPLs (including fully collateralised loans) after provisions, currently standing at 10.1%.

Bank of Cyprus and Cyprus Popular Bank have participated in the EBA recapitalisation exercise which requires banks to have a Core Tier 1 ratio of 9% plus additional capital buffer to cover the mark to market losses on their EEA sovereign exposures. A total shortfall of €3.5bn was identified for the two Cypriot banks (€1.560mn for Bank of Cyprus and €1.971mn for Cyprus Popular Bank). This shortfall is reduced by €1bn through existing contingent convertibles (€887mn for Bank of Cyprus and €65mn for Cyprus Popular Bank) that are fully loss absorbing on a going concern basis. The banks have until the end of June 2012 to cover the shortfall and have devised their recapitalisation plans which were approved by the Central Bank of Cyprus. These plans entail capital increases through new share issues and conversion of existing hybrids into contingent convertibles but they also include reduction of RWAs through sale of assets. Significant progress was mainly achieved by Bank of Cyprus which by the end of 2011 had managed to reduce its shortfall to €481mn and actions in progress provide a reasonable assurance that the shortfall will be covered. For Cyprus Popular Bank the situation is more challenging and progress so far has been slow. The new share issue under way is very critical to the bank's efforts to cover its shortfall.

The supervisory regime

Banking System Supervision is split between the Central Bank of Cyprus - being the competent authority for the supervision of banks - and the Co-operative Societies Supervision and Development Authority being the competent authority for the supervision of Co-operative Societies. The legal and regulatory framework of the two authorities is aligned with EU requirements but also with the requirements and guidelines of the EBA (formerly CEBS) and the Basel Committee on Banking Supervision. Both Supervisory Authorities conduct their work through a combination of off-site monitoring and on-site examination. Off-site monitoring entails the submission by banks of an extensive range of periodic returns which cover numerous aspects of banking operations. Any areas of concern revealed through the returns are taken up promptly with the bank involved for remedial action.

On-site examinations are carried out with a view to assessing the current financial position and soundness of a bank and its future prospects at a given time. In this respect, the following main areas are covered:

- the quality of the management of the bank, including internal control and risk management aspects;
- the bank's loan portfolio, with emphasis on credit risk management, the quality of the loan portfolio and the adequacy of the provisions for bad and doubtful debts;
- the bank's treasury operations with emphasis on risk management;
- the profitability of the bank including the analysis of its income generation and costs and the assessment of the returns achieved;
- the compliance with the conditions of the bank's licence and with Central Bank directives, regulations and instructions on internal governance, capital adequacy, liquidity, large exposures, etc.;
- adherence to the requirements of the anti-money laundering legislation and guidance notes.

Supervision is exercised on a consolidated basis and covers the bank and its subsidiary companies which carry out banking related activities.

All CCIs are regulated and supervised by the Authority for the Supervision and Development of Cooperative Societies (ASDCS). Additionally and due to the fact that CCB is also a bank, under the provisions of the Banking Law is supervised by the Central Bank of Cyprus, the CCB and affiliated CCIs are also subject to consolidated supervision by the Central Bank of Cyprus. The CCB Ltd engages in accepting deposits mainly from its member societies, financing their requirements and generally managing their liquid assets.

The regulatory regime is very conservative and the EU Capital Requirements Directive was transposed adopting the more conservative option for areas where national discretion was allowed. In addition, strict liquidity requirements are imposed to address non-resident deposits while a maximum loan to value ratio of 70% is imposed for property financing (80% for the primary residence). There are restrictions for banks' investments in companies outside the financial sector whereas overseas expansion requires supervisory approval which is granted only if the business plan is feasible and the bank has sufficient capital and liquidity to support expansion. Banks are not allowed to invest in property other than for property used for their operations and there are limits on foreign currency open positions.

In line with EU requirements, each bank conducts an Internal Capital Adequacy Assessment Process (ICAAP) to determine the amount of capital necessary to cover the nature and level of the risks to which the bank is or might be exposed. The CBC carries out, on an annual basis for each bank, a Supervisory Review and Evaluation

Process (SREP) to assess the adequacy of the bank's capital, imposing additional capital requirements in case where capital is not commensurate with the bank's assessed risk profile, and takes into account the results of stress testing. The SREP includes on-site review of all significant overseas operations. Furthermore, the CBC organises supervisory colleges for the locally based banking groups and participates in those organised by the foreign home supervisors of locally established, foreign owned subsidiaries. Moreover, Cyprus participates in the IMF Financial Sector Assessment Program (FSAP) and undergoes annual Article IV surveillance.

Recent and planned policy initiatives

An ad hoc committee has been set up under the chairmanship of the Central Bank in its capacity as supervisor of banks and responsible for the overall financial stability, with the participation of the MoF and the other supervisors, which monitors closely the developments of the financial sector.

In response to the exceptional turbulence in world financial markets, Cyprus implemented in November 2009 a scheme providing for the issue of special government bonds allocated to credit institutions with a view to enhance liquidity in the economy and exercise a dampening impact on interest rates, the final objective being the real economy. These bonds, of an overall amount of almost €3 billion and with a duration of three years were given to eligible credit institutions to use them as collateral to obtain liquidity from the ECB and interbank markets against a remuneration and appropriate collateral.

Furthermore, it is noted that Cyprus proceeded in July 2009 with the amendment of the two deposit insurance schemes (one for commercial banks and one for cooperative credit institutions). The main amendments include the following: (i) increasing the level of cover from 20,000 euros to 100,000 euros per customer) per bank, (ii) cover the deposits in all currencies (up to then only deposits in European currencies covered), (iii) increasing payout to 100 percent of guaranteed deposits i.e. abolition of the coinsurance component, (iv) shortening the payout time below the statutory minimum of three months by increasing preparedness, and (v) improving financial strength and coverage by increasing member contributions, supplementary contributions, and borrowing arrangements.

In December 2010, Cyprus created the regulatory framework for covered bonds. Covered bonds have provided banks with another financing instrument – medium and long term financing at favourable terms.

As part of the setting up of the recovery and resolution framework, three laws were enacted in 2011. In April 2011, the law on the imposition of bank levy on financial institutions passed through the Parliament, based on which banks are required to pay a

levy, for two years, of 0.095% on their total deposits, excluding interbank deposits. In accordance with the provisions of the said law, 25/60 of the revenue collected should be deposited in a special account with the Central Bank of Cyprus for the benefit of the Independent Financial Stability Fund, the operation and functions of which are governed by a separate Law.

The Independent Financial Stability Fund, set up on the basis of a law enacted in December 2011, will be funded by annual contributions from credit institutions, both banks and cooperatives, at a rate of 0.03% on total liabilities excluding Tier 1 capital. As per the law, the size of the Fund is targeted to reach 5% of the GDP, which is translated to approximately €1billion, by 2025. Its resources are to be used for financing the application of resolution tools.

In addition, a law on the Management of Financial Crisis was enacted in December 2011. The said law empowers the Council of Ministers to provide temporary support in the form of capital, loans or guarantees, upon recommendation of the Central Bank of Cyprus, following consultation with the competent supervisory authority and subject to conditions, to credit and financial institutions incorporated in Cyprus, deposit protection funds and the financial stability fund. The support is provided to address liquidity and/or solvency problems.

Tables

Table 1a. Macroeconomic prospects

	ESA Code	**Year 2011**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	15.153	0.5	-0.5	0.5	1.0	1.5
2. Nominal GDP	B1*g	17.761	2.5	2.5	2.7	3.0	3.5
Components of real GDP							
3. Private consumption expenditure	P.3	10.125	0.2	-1.3	1.0	1.5	1.7
4. Government consumption expenditure	P.3	2.846	-4.7	-3.8	-3.5	-1.1	-0.7
5. Gross fixed capital formation	P.51	2.636	-13.8	5.5	-1.0	-0.2	1.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	18	0.1	0.1	0.1	0.1	0.1
7. Exports of goods and services	P.6	6.839	3.6	2.0	3.0	3.6	4.0
8. Imports of goods and services	P.7	7.311	-5.0	1.5	1.5	2.8	3.3
Contributions to real GDP growth							
9. Final domestic demand		15.607	-3.6	-0.7	-0.2	0.7	1.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	18	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-472	4.1	0.2	0.7	0.3	0.3

Table 1b. Price developments

	ESA Code	**Year 2011**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		117.2	2.0	3.0	2.2	2.0	2.0
2. Private consumption deflator		117.5	3.1	2.8	2.0	1.8	1.8
3. HICP[1]		115.9	3.5	3.0	2.2	2.0	2.0
4. Public consumption deflator		121.3	4.0	3.3	2.4	2.2	2.2
5. Investment deflator		111.7	0.9	1.2	2.2	2.6	2.6
5a. Gross Fixed Capital Formation deflator		*111.6*	*0.9*	*1.2*	*2.2*	*2.6*	*2.6*
6. Export price deflator (goods and services)		112.6	1.7	3.0	2.2	2.0	2.0
7. Import price deflator (goods and services)		112.9	3.5	2.0	2.0	2.0	2.0

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	**Year 2011**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1] (000´s)		386,2	0.6	-0.2	0.2	0.3	0.3
2. Employment, hours worked[2] (thousands)		722,9	0.3	-0.2	0.2	0.3	0.3
3. Unemployment rate (%)[3]		31,5	7.7	9.5	9.5	9.0	8.5
4. Labour productivity, persons[4] (€, 2005 prices)			-0.1	-0.3	0.3	0.7	1.2
5. Labour productivity, hours worked[5](€, 2005 prices)			0.1	-0.3	0.3	0.7	1.2
6. Compensation of employees (€ million)	D.1	8.121	2.5	1.0	1.5	1.5	2.0
7. Compensation per employee (€)		20,564	2.0	1.2	1.3	1.2	1.7

[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	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-10.4	-7.5	-6.5	-5.5	-5.0
of which:						
*- Balance on goods and services**		-3.6	-3.0	-2.2	-1.9	-1.4
*- Balance of primary incomes and transfers**		-6.8	-4.5	-4.3	-3.6	-3.5
2. Net lending/borrowing of the private sector	B.9	-4.1	-4.9	-5.9	-5.5	-5.0
3. Net lending/borrowing of general government	EDP B.9	-6.3	-2.6	-0.6	0.0	0.0
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

* Any differences are due to rounding.

Table 2a. General government budgetary prospects

	ESA Code	Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-1.118,9	-6.3	-2.6	-0.6	0.0	0.0
2. Central government	S.1311	-1.486,1	-8.4	-4.3	-1.9	-1.5	-1.5
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	-8,0	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	375,2	2.1	1.7	1.3	1.6	1.5
General government (S13)							
6. Total revenue	TR	7.282,2	41.0	42.5	42.4	42.1	42.6
7. Total expenditure	TE[1]	8.401,1	47.3	45.1	43.0	42.1	42.6
8. Net lending/borrowing	EDP B.9	-1.118,9	-6.3	-2.6	-0.6	0.0	0.0
9. Interest expenditure	EDP D.41	440,0	2.5	3.0	3.2	3.1	3.0
10. Primary balance[2]		-678,9	-3.8	0.4	2.6	3.1	3.0
11. One-off and other temporary measures[3]		-68,0	-0.4	0.1	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		4.726,6	26.6	28.3	28.4	27.7	28.0
12a. Taxes on production and imports	D.2	2.620,4	14.8	15.3	15.4	15.4	15.3
12b. Current taxes on income, wealth, etc.	D.5	2.105,4	11.9	13.0	13.0	12.3	12.7
12c. Capital taxes	D.91	0,8	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1.686,7	9.5	9.5	9.4	10.1	10.0
14. Property income	D.4	169,5	1.0	0.6	0.6	0.6	0.6
15. Other[4]		699,4	3.9	4.1	4.0	3.7	3.9
16=6. Total revenue	TR	7.282,2	41.0	42.5	42.4	42.1	42.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		6.412,5	36.1	37.8	37.8	37.7	38.0

Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3.684,3	20.7	20.3	19.6	19.2	18.7
17a. Compensation of employees	D.1	2.805,8	15.8	15.3	14.6	14.3	13.9
17b. Intermediate consumption	P.2	878,5	4.9	5.0	4.9	4.9	4.8
18. Social payments (18=18a+18b)		2.725,8	15.3	15.2	15.5	15.7	15.8
of which Unemployment benefits[6]		98,4	0.6	0.7	0.6	0.6	0.5
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	12,2	0.1	0.2	0.2	0.2	0.2
18b. Social transfers other than in kind	D.62	2.713,6	15.3	15.0	15.3	15.5	15.6
19=9. Interest expenditure	EDP D.41	440,0	2.5	3.0	3.2	3.1	3.0
20. Subsidies	D.3	85,2	0.5	0.4	0.3	0.3	0.3
21. Gross fixed capital formation	P.51	606,6	3.4	3.1	2.7	2.7	2.7
22. Other[7]		859,2	4.8	3.1	1.8	1.1	2.1
23=7. Total expenditure	TE1	8.401,1	47.3	45.1	43.0	42.1	42.6
p.m.: Government consumption (nominal)	P.3	3.459,6	19.5	19.1	18.4	18.0	17.6

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

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

[4] P.11+P.12+P.131+D.39+D.7+D.9 (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 cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

[7] D.29+D4 (other than D.41) + D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 2b. Breakdown of revenue

		Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies		7.247,2	41.0	41.0	40.8	40.8	40.8
2. Discretionary revenue measures		35	0.2	1.3	0.1	0.7	-

Table 2c. Expenditure to be excluded from the expenditure benchmark

		Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue		42,6	0.2	0.6	0.6	0.5	0.5
2. Expenditure fully matched by mandated revenue increases		n/a	n/a	n/a	n/a	n/a	n/a
3. Non-discretionary changes in unemployment benefit expenditure		n/a	n/a	n/a	n/a	n/a	n/a

Table 3. General government expenditure by function

% of GDP	COFOG Code	**Year 2009**	**Year 2014**
1. General public services	1	12.0	9.5
2. Defence	2	1.9	1.5
3. Public order and safety	3	2.3	1.8
4. Economic affairs	4	3.7	4.0
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	3.2	2.5
7. Health	7	3.3	3.5
8. Recreation, culture and religion	8	1.4	1.2
9. Education	9	7.2	7.8
10. Social protection	10	11.0	10.0
11. Total expenditure (=item 7=23 in Table 2)	**TE**	**46.2**	**42.1**

Table 4. General government debt developments

% of GDP	ESA Code	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
1. Gross debt[1]		71.6	72.1	70.2	67.8	65.4
2. Change in gross debt ratio		10.2	0.5	-1.8	-2.4	-2.5
Contributions to changes in gross debt						
3. Primary balance[2]		-3.8	0.4	2.6	3.1	3.0
4. Interest expenditure[3]	EDP D.41	2.5	3.0	3.2	3.1	3.0
5. Stock-flow adjustment		6.3	0.8	0.7	0.7	0.5
of which:						
- Differences between cash and accruals[4]		-0.2	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		0.6	0.5	0.5	0.5	0.5
of which:						
- privatisation proceeds		*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
- Valuation effects and other[6]		*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
p.m.: Implicit interest rate on debt[7]		4.1	4.3	4.5	4.5	4.5
Other relevant variables						
6. Liquid financial assets[8]		4.0	2.6	0.9	0.9	0.4
7. Net financial debt (7=1-6)		67.6	69.5	69.3	66.9	65.0
8. Debt amortization (existing bonds) since the end of the previous year		6.5	14.8	15.0	5.3	7.3
9. Percentage of debt denominated in foreign currency		0.2	1.0	1.0	1.0	1.0
10. Average maturity		4.6	5.0	5.0	5.0	5.0

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**	**Year 2015**
1. Real GDP growth (%)		0.5	-0.5	0.5	1.0	1.5
2. Net lending/borrowing of general government	EDP B.9	-6.3	-2.6	-0.6	0.0	0.0
3. Interest expenditure	EDP D.41	2.5	3.0	3.2	3.1	3.0
4. One-off and other temporary measures[1]		-0.4	0.1	0.0	0.0	0.0
5. Potential GDP growth (%)		0.9	1.1	1.1	1.1	1.2
contributions:						
- labour		0.5	0.7	0.6	0.5	0.5
- capital		0.8	0.9	0.9	0.9	0.9
- total factor productivity		-0.5	-0.5	-0.5	-0.3	-0.2
6. Output gap		-1.0	-2.1	-1.3	-0.9	-0.4
7. Cyclical budgetary component		-0.4	-0.8	-0.5	-0.4	-0.2
8. Cyclically-adjusted balance (2 - 7)		-5.9	-1.8	-0.1	0.4	0.2
9. Cyclically-adjusted primary balance (8 + 3)		-3.4	1.2	3.1	3.5	3.1
10. Structural balance (8 - 4)		-5.5	-2.0	-0.1	0.4	0.2

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

Table 6. Divergence from previous update

	ESA Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
Real GDP growth (%)						
Previous update		1.5	2.5	2.7	3.0	n/a
Current update		0.5	-0.5	0.5	1.0	1.5
Difference		-1.0	-3.0	-2.2	-2.0	n/a
General government net lending (% of GDP)						
Previous update		-4.0	-2.6	-2.0	-1.6	n/a
Current update		-6.4	-2.7	-0.7	0.0	0.0
Difference		-2.4	-0.1	1.3	1.6	n/a
General government gross debt (% of GDP)						
Previous update		61.6	62.0	61.3	60.1	n/a
Current update		71.6	72.1	70.2	67.8	65.4
Difference		10.0	10.1	9.1	7.7	n/a

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	**41.3**	**46.4**	**42.7**	**44.6**	**45.4**	**47.7**	**50.1**
Of which: age-related expenditures(1-5)	***16.9***	***20.1***	***20.7***	***22.7***	***23.4***	***25.7***	***28.1***
1.Pension expenditure	6.9	7.6	9.5	11.1	12.1	14.4	16.4
1.1 Social security pension	4.6	5.8	7.8	9.7	11.1	13.7	16.1
Old-age and early pensions (A)	3.3	4.4	6.1	7.8	9.0	11.6	13.8
Other pensions (disability survivors) (B)	1.3	1.4	1.7	1.9	2.1	2.2	2.3
1.2 Occupational pensions (if in general government)[1]	2.3	1.8	1.7	1.4	1.0	0.6	0.3
2. Health care[2]	2.9	3.3	3.4	3.5	3.6	3.6	3.7
3. Long-term care *(this was earlier included in the health care)*[2]	0.01	0.2	0.2	0.2	0.2	0.3	0.3
4. Education expenditure[2]	6.3	7.5	6.6	6.9	6.5	6.4	6.8
5. Other age-related expenditures	0.8	1.5	1.0	1.0	1.0	1.0	1.0
Interest expenditure[3]	…	…	…	…	…	…	…
Total revenue	**44.8**	**41.1**	**43.1**	**44.2**	**45.1**	**45.0**	**45.1**
Of which: property income	*0.7*	*1.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*
Of which: from pensions contributions (or social contributions if appropriate)	*4.5*	*7.3*	*8.4*	*9.5*	*10.5*	*10.3*	*10.4*
Pension reserve fund assets	**36.4**	**40.9**	**55.9**	**64.2**	**66.6**	**56.0**	**14.7**
Of which: consolidated public pension fund assets (assets other than gvt liabilities	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth (hours)	2.3	1.1	0.8	1.7	1.7	1.6	1.5
Real GDP growth	5.1	1.1	1.8	2.4	2.2	1.6	1.5
Participation rate males (aged 15-64)	81.2	79.8	81.8	80.7	80.0	80.3	80.1
Participation rates females (aged 15-64)	64.7	65.6	74.1	76.1	76.0	75.7	75.9
Total participation rates (aged 15-64)	72.9	73.9	77.9	78.4	78.0	78.1	78.0
Unemployment rate (aged 15-64)	4.5	6.2	5.3	4.7	4.6	4.5	4.5
Population aged 65+ over total population	12.5	13.4	16.8	19.9	21.4	24.6	27.7

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

Table 7a. Contingent liabilities

% of GDP	**Year 2011**
Public guarantees	**10.0**
Of which: linked to the financial sector	**-**

Table 8. Basic assumptions

	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
Short-term interest rate (annual average)	1.4	0.8	0.9	-	-
Long-term interest rate (annual average)	2.6	1.9	2.2	-	-
USD/€ exchange rate (annual average)	1.39	1.32	1.32	1.32	1.32
Nominal effective exchange rate[1]	109.57	-	-	-	-
World growth excluding EU	4.2	4.2	4.3	-	-
EU GDP growth	1.5	0.1	1.4	1.9	2.0
Growth of relevant foreign markets [UK]	0.7	0.6	1.5	2.6	2.6
World import volumes, excluding EU	7.5	5.6	6.2	-	-
Oil prices (Brent. USD/barrel)	111.5	119.9	113.5	112.0	112.0

[1]Nominal Effective Exchange Rate - 36 trading partners.