Ministry of Finance

Stability Programme 2017-2020

April 2017

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 2017-2020 as approved by the Council of Ministers on 26th April 2017. The SP has been prepared in line with the updated Code of Conduct, which sets out the "Guidelines on the format and content of the Stability and Convergence Programmes". The SP has also been prepared in the context of the European Semester, which gives a clear ex ante dimension to economic policy coordination at EU level and it takes into account the key policy orientations provided in the Annual Growth Survey.

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

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

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The Government of Cyprus implemented an EU-IMF macroeconomic adjustment programme during the period 2013-16, undertaking major reforms in the areas of public finance, the banking sector, the labour market and other structural reforms in key sectors of the economy, which resulted in stabilizing and successfully turning the economy into positive growth territory from 2015 onwards. According to the latest estimates published on 16th March 2017, the economy expanded at an accelerated rate of 2.8% in real terms in 2016, following a positive growth rate of 1.7% in 2015. Due to an environment of improving confidence and credit conditions, as a result of an enhanced and strengthened banking system and the anticipated gradual reduction in non-performing loans, as well as the gradual normalization in the labour market, growth in the forecast horizon of this Programme is expected to remain robust at the levels of 2016.

The fiscal strategy of the Government during the macroeconomic adjustment programme period focused on front-loading the fiscal consolidation effort, exceeding targets by considerable margins and achieving high primary surpluses of the order of 3.0% of GDP by 2016, while at the same time overhauling the institutional framework of public financial governance with the introduction of the Fiscal Responsibility and Budget Systems Law. The results of the reforms in all areas are evident and most importantly reflected in a series of upgrades of the sovereign by the rating agencies, while it must be noted that only around 70% of the bail out money were used at the time of exit from the macroeconomic adjustment programme, which was achieved without a backstop successor arrangement.

The Government regained market access with three successive bond issuances between 2015-2016. As the growth outlook of the economy is forecast to remain strong and the outlook assigned to the Cyprus economy by Rating Agencies is positive, it is expected that further upgrades will be achieved over the course of the coming year.

This Stability Programme outlines the fiscal policy strategy for the period 2017-2020 under the central macroeconomic scenario adopted by the government and sets out the main objectives which are enshrined on the support and enhancement of sustainable growth, leading to job creation and prosperity of the population. In order to achieve these objectives, the strategy targets, a policy orientation revolving around: (a) sound public finances focused on growth and sustainability, (b) gradual and sustained reduction of public-debt to GDP ratio, (c) implementation of the structural reform agenda, (d) decrease in the ratio of non-performing loans and (e) enhancing the competitiveness of the economy in order to support investment. The achievement of an overall environment of sustained macroeconomic stability will boost confidence in the Cyprus economy further, contributing to attracting investment, achieving an attractive investment grade and safeguard sustained market access at affordable rates.

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

Fiscal Policy Objectives

The overall fiscal policy objective consists of maintaining a prudent fiscal stance with primary balances maintained at a surplus of around 3.0% of GDP over the programming period. The medium-term objective remains unchanged and targets a balanced structural position.

Cyclical developments having an impact on revenue and expenditure of the general government will contribute to the maintenance of a robust fiscal position. Windfall revenues due to a better than anticipated performance of the economy will be used for reducing public debt. On the expenditure side, measures containing public expenditure have been introduced and include the collective agreement reached between the Government and public sector Unions, which introduces a control mechanism limiting the overall growth in the wage bill in the public and broader public sector below the growth of nominal GDP, and a Government bill already submitted to Parliament which provides for the indefinite suspension of recruitment of new personnel in the public sector and the introduction for a mechanism regulating exceptions. On the revenue side, the sustained fiscal over-performance of the past few years is forecast to absorb the impact from the termination of the temporary tax measure on private and public sector emoluments amounting to 0.4 percentage points of GDP, which was introduced for the period 2011-2016, and the 2017 residual abolition of the immovable property tax amounting to about 0.1 percentage points of GDP.

According to the latest projections, the nominal budget balance in 2017 is projected at a surplus of 0.2% of GDP, compared to a surplus of 0.4% of GDP in 2016 and is anticipated to improve over the period 2018-2020, reaching a surplus of 0.4% of GDP in 2020. In structural terms, the balance in 2016 is estimated to have registered a surplus of 1.1% of GDP, overachieving the medium-term budgetary objective by the same magnitude in percentage points of GDP. In 2017, as the output gap turns marginally positive based on the commonly agreed methodology, the structural balance is projected to decline and meet the medium-term objective of a balanced structural position. In 2018, the structural balance is projected to deteriorate by 0.4 percentage points. The latter developments ensure the respect of the rules of the Stability and Growth Pact and more precisely the respect of the medium-term objective for Cyprus both in 2016, as well as 2017, while the deterioration in 2018 is contained to marginally below 0.5 percentage points.

The general government debt is forecast to decrease from 107.8% of GDP in 2016 to 104% in 2017 and continue on the declining path down to 88.8% by 2020.

The Government of Cyprus is fully committed to European budgetary agreements and will adhere to its national budgetary framework, which is aimed at maintaining revenue and expenditure ceilings. In this way, Cyprus will remain within the acceptable margins of European budgetary rules under the preventive arm of the SGP, based on the Ministry of Finance projections. The authorities will continue to monitor fiscal developments and in case of deviation stand ready to adopt the necessary corrective measures.

Structural Reform Agenda

In order to support sustainable growth, and building on the ambitious structural reforms which were introduced during the Economic Adjustment Programme, an ongoing reform agenda includes key areas such as:

- *Public Financial Management*

  A Bill establishing a Sovereign Wealth Fund, on the basis of international best practices which will manage future natural gas revenues and the Relevant Regulations governing the Inflows and Outflows Rules of the Fund, are expected to be ratified into law by July 2017.

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

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

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

It is noted that a third round of licensing for offshore Natural Gas Exploitation has been completed in March 2017, with global energy majors.

- *Insurance and Pension Funds*

Aiming towards the strengthening of supervisory capacities for insurance companies and occupational pension funds, a study was conducted for the setting up of a new supervisory authority which will be responsible for the supervision of the two sectors. The study which was prepared by experts in cooperation with the European Insurance and Occupational Pensions Authority (EIOPA), analyses the needs and sets up the necessary steps for creating this new supervisory authority based on international best practices. The Council of Ministers has approved the principle of unified supervision on the 13/9/2016, under an independent supervisory body. The action plan for the implementation of this decision, which also includes the enhancement of the regulatory framework for Pension Funds, has been put into action and it is envisaged that the necessary legal and regulatory framework will be in place by year end. It is envisaged that the unified and strengthened supervision and the reformed regulatory framework will help the industry and provide increased transparency and stability in the two sectors and will also facilitate the sustainability of the pensions system.

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

Even though the Bill pegging the payroll growth below nominal GDP growth failed to be enacted by Parliament, collective agreements have been signed between the Government and Unions of the public and broader public sector, establishing a mechanism that will ensure the application of an effective framework that monitors and regulates payroll growth below nominal GDP growth for 2017-2018, as was originally stipulated in the abovementioned bill.

In addition, the collective agreement signed with the public servant's union, PASYDY, stipulates that no general salary increases will be offered to civil servants for the period 2017-18. The Government has also submitted a Bill to Parliament which provides for the indefinite suspension of recruitment of new personnel in the public sector and the introduction for a mechanism regulating exceptions.

- *Wage Indexation System (COLA) Reform*

To ensure that wage growth better reflects developments in labour productivity and competitiveness in both expansions and recessions, the wage-setting framework for the public and broader public sector has been reformed with a change in the frequency of indexation from twice a year to once a year and a change from full indexation to partial indexation capped at 50% of the increase in the CPI. A mechanism for automatic suspension of application and derogation procedures during adverse economic conditions has been embedded, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation will be effected for a given year. This measure comes in addition to the collective agreement reached between the Government and public sector's unions introducing a control mechanism limiting the overall growth in the wage bill in the public and broader public sector below the growth of nominal GDP accounting inter alia for COLA, annual increments and employment developments.

The aforementioned reform is in effect from 2017 onwards, according to the provisions of the macroeconomic adjustment programme.

COLA reform in the private sector is currently under negotiation under the auspices of the Minister of Labour, Welfare and Social Insurance.

- *Public administration reform*

After failing to secure parliamentary support for the reform package in 2016, the government is preparing to re-introduce Bills which aim at introducing a more transparent and effective Human Resource Management Framework. This will include a revised appointment, appraisal and promotion system, and enhanced labour mobility, both within the Central Government and across the broader public sector.

In parallel, in order to achieve efficiencies in the administration and to streamline decision making, a legislative proposal has been presented to the House of Representatives for the establishment of three new government Departments, responsible for Tourism, Shipping and Growth/Competitiveness, which will be headed by sub-cabinet Ministers. The objective is for the new Departments to be operational by March 2018 and staffing needs will be met by existing personnel only.

- *Local authorities reform*

Another integral reform with a systemic effect on the economy is the local government reform. It essentially influences the delivery of qualitative local public services and enhances the processes of issuing title deeds. The reform particularly aims at making the issuing of building permits and certificates more efficient. It also addresses the current gaps in local government financial reporting, by establishing a common accounting and reporting framework. The authorities have submitted to the Parliament a set of bills for the gradual decrease on the number of Municipalities, within the next three (3) years of the implementation of the reform. A Roadmap for the implementation of the Reform has been prepared, including the framework which encompasses the criteria used for the proposed reduction in the number of Municipalities.

The said bills are under consideration by the Interior Parliamentary Committee of the House of Representatives (HoR). A prerequisite set by the competent Parliamentary Committee for adopting the bills was to prepare and submit relevant Regulations that will accompany the three pieces of legislation, along with the Report that elucidates the argumentation for the streamlining of the Municipalities. The relevant Regulations have been drafted and are expected to be submitted together with the Report to the relevant Committee by end of May, 2017.

- *Judicial Reform*

Acknowledging the importance of having an efficient judicial system with strong contract enforcement, especially for the banking and business services sectors, the authorities are promoting a broad structural reform. More specifically, the Supreme Court of Cyprus together with the Ministry of Justice and Public Order (MJPO) and the Ministry of Finance, are promoting a series of measures aimed at reengineering the overall framework inter alia through improving its administration and expediting the delivery of justice. The envisioned reform is based on 4 pillars: (1) court reform, (2) improvement of civil procedures rules, (3) introduction of an e-justice system and (4) training of Judges.

To this end an Administrative Court has been established and is operational since 1.1.2016 taking on board all first instance administrative resources, thus discharging the Supreme Court of this task and enabling it to carry out more expeditiously its second instance jurisdiction (appeals). In addition, in order to increase courts' specialisation, the MJPO and the Supreme Court have conducted a feasibility study on establishing a commercial court. The Commercial Court will be established by the end of 2017 and the necessary appropriations are envisaged to be included within the Budget of 2018.

Draft bills have been prepared and submitted for legal vetting aiming at improving civil procedures and to strengthen the enforcement of judgments. In particular, the MJPO has submitted to the House of Representatives an amendment to the Courts of Justice Law by filtering the right of filing an appeal in civil cases as regards interlocutory decisions during the proceedings, which is currently being debated in the Parliamentary Committee on Legal Affairs. A complementary Bill prepared by the MJPO amends the Civil Procedure Law, so as to strengthen the legal framework for the enforcement of judgments. The Bill includes provisions reinforcing the execution of writs, seizure of movable property and the expediency and effectiveness of garnishee proceedings. This Bill is currently being vetted by the Attorney General's Office.

Complementary to the above, the setting up of a court administration/management information system for the courts (e-justice) has been initiated. The said system will essentially result in the computerization of all administrative processes between legal and physical persons and the court's administration as well as all internal processes of the court. This is anticipated to result in a smoother, swifter and effective functioning of the courts. The procurement of the system has been initiated and it is anticipated that the system will become operational by Q3 2018.

To improve judicial training, the Supreme Court is proceeding with the creation of a special section in charge of the lifelong training of judges, which is envisaged to be in place by mid-2018.

➢ *Title deeds*

- *Issuance of title deeds*: Acknowledging that reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights are key for addressing challenges faced in the economy, including the property market, as well as the financial sector, the authorities are in the process of improving the effectiveness of the overall framework. Steps have been undertaken regarding the issuance of title deeds through inter alia the streamlining of the overall legal framework that relate to the processes for the application and the issuance of planning and building permits.
- *Transfer of immovable property rights*: In order to ensure effective transfer of property titles at all times, the Cypriot authorities have enacted the Transfer and Mortgage Law 9/65 as amended by L139(I)/2015 (Trapped Buyers Law), which is designed to protect the "Trapped Buyers", namely those who have submitted their sale contracts at the Lands Registry Department prior to December 31st, 2014 (legacy cases), by releasing the property from any encumbrances thus allowing for the transfer to take place. Furthermore, the Cypriot authorities are in the process of resolving non-legacy and new property transactions. Currently consultation is taking place with the stakeholders in order to promote amendments to the relevant Laws (the Sale of Immovable Property (Specific Performance) Law L. 81 (i)/2011 and the Law for trapped buyers Law 139(I)/2015) in order to tackle the issue.

➢ *Health reform*

Health reform is based on two interrelated targets. The first relates to the financial and administrative autonomy of public hospitals. This procedure is based upon internationally approved medical and financial best practices and medical protocols. Its aim is to render public hospitals more competitive under a National Health Insurance System (NHIS) environment where public hospitals should freely compete with the corresponding private hospitals. The date of the implementation of this reform should be prior to the NHIS kick off date due to the fact that public hospitals autonomy should be ready beforehand for this transformation. To this end, the Ministry of Health has prepared two relevant bills to promote the implementation of public hospitals autonomy and NHIS. The relevant bill is concerned with the "Establishment of the Organization of public health services of 2016". This bill is expected to be brought before the House of Representatives' plenary by July 2017.

The second target is the implementation of the NHIS. The aim is to lead to a more efficient coverage of the population to quality health care and to foster current health care provision towards better implementation of international medical protocols. In parallel, NHIS implementation can lead to a more efficient allocation of health economic resources, the improvement of the human resources management in the health sector as well as to a more effective utilization of health care apparatus. Moreover, it is expected that through NHIS health expenditure can be contained more efficiently through the family doctor concept, global budgeting, better utilization of health resources and the reduction of drugs abuse. The aforementioned shall be facilitated by the IT system for the NHIS. The relevant bill, "The NHIS Law of 2001-2005", is expected to be brought before the plenary of the House of Representatives by July 2017. In addition, the Ministry of Finance is currently in the process of commissioning a study which will assess the economic impact of the above mentioned Health reform measures focusing on the impact on potential growth and the public finances. The study includes an innovative analysis such as the impact on labour cost, labour demand, employment, GDP growth and the potential growth rate.

- *Energy Sector*

The Cyprus Energy Regulatory Authority, with its Regulatory Decision 01/2017, has set an obligatory timeline for the operation of the competitive electricity market by July 2019. The operation of the competitive electricity market implies the legal and functional separation of the Market Operator (who is also the Transmission System Operator, TSO) from the vertically integrated Electricity Authority of Cyprus. To this end, a relevant proposal is to be submitted to the Council of Ministers for discussion and approval.

- *Better Utilization of State Assets*

Telecommunications

Although no consensus has been reached at the level of the House of Representatives for the privatization of CYTA, the state-owned telecoms utility, a new proposal has been drafted in the form of a Bill and relevant regulations, with the aim to implement the corporatization of CYTA, as a necessary first step towards a partial privatization.

The draft Bill and regulations, currently under consultation with stakeholders, provide for majority ownership of CYTA by the State and respect of the employment status and rights of the current employees while, in parallel, creating the conditions for the attraction of a strategic investor through equity participation and the assumption of management control of the company, something which is considered necessary in order to maintain the value and business prospects of CYTA.

Ports

The privatization of the Port of Limassol, the largest on the island, has been successfully completed in January 2017, with the assumption of operations by consortiums lead by Eurogate, a German operator, and Dubai Ports. The process for the privatization and re-development of the Port of Larnaca, the second largest on the island, is proceeding according to schedule and is expected to be completed by end-2017.

Marinas

A design-build-operate-transfer agreement for the Ayia Napa Resort Marina has been signed in 2016. A similar agreement for the Paphos Resort Marina is expect to be signed in the course of 2018. These investments, along with other private investments, including the casino resort, that are already underway, are expected to provide a significant boost to the economy and increase potential and actual GDP.

Integrated Casino Resort

The signing of a Public-Private Partnership (PPP) agreement with the selected bidder for the construction and operation of an Integrated Casino Resort, is expected to be completed by June 2017.

2. ECONOMIC OUTLOOK

2.1 MACROECONOMIC DEVELOPMENTS 2016

2.1.1 GLOBAL ECONOMY

According to the European Commission Winter Forecast 2017, world economic growth exhibited marginal deceleration in 2016 contained at 3.0% compared with 3.2% in 2015, with growth expected to regain momentum and moderately accelerate to 3.4% in 2017 and 3.7% in 2018. The EU continued to grow in 2016 although at a lower rate compared with 2015, with the real growth rate falling to 1.9% (from 2.2% in 2015). Similarly, the euro area economy grew at a rate of 1.7%, which is lower compared with a 2.0% growth of 2015. However, although all Member States recorded positive economic growth, economic performance is still uneven across EU Member States, with Ireland, Malta and Spain recording growth rates of 4.3%, 4.0% and 3.2% respectively, much higher than EU averages.

For two of the most significant trade partners of Cyprus, UK and Russia, the outlook is mixed. The economy of the UK grew by 2.0% in 2016 in contrast with 2.2% the year before, while Russia contracted by 0.6% in 2016, compared with a contraction of 3.7% in 2015. For 2017 and 2018, economic growth in Russia is projected to be positive of the magnitude of 0.8% and 1.1% respectively, exhibiting moderate economic recovery. Economic growth in the UK is expected to decelerate in 2017 and 2018, hovering around 1.5% and 1.2% respectively, amid expectations of a negative impact from the decision to exit the EU.

Table I: External Assumptions, 2016-2020

	2016	2017	2018	2019	2020
Growth assumptions					
World growth excluding EU, GDP growth	3.2	3.7	3.9	3.9	3.9
EU GDP growth	1.9	1.8	1.8	1.8	1.8
US	1.6	2.2	2.3	2.3	2.3
Short-term interest rate (annual average, euro area)	-0.26	-0.30	-0.14	-	-
Long-term interest rate (annual average, euro area, 10-year government bonds, Germany)	0.09	0.38	0.59	0.59	0.59
USD/€ exchange rate (level)	1.11	1.07	1.08	1.08	1.08
Nominal effective exchange rate of the EU (% change)	0.29	-0.18	0.02	-	-
World import volumes, excluding EU	0.9	3.0	3.8	3.8	3.8
Oil prices (Brent. USD/barrel)	44.8	53.5	53.2	53.2	53.2

Source: Spring 2017 forecast assumptions and European Commission Winter Forecasts for EU GDP growth; for beyond 2018 remain unchanged.

The unemployment rate in the EU remained at relatively high levels, on average, in 2016, albeit it declined to 8.5% from 9.4% in 2015, indicating that the efforts for a return to growth and job creation have to some extent bared fruits.

Inflation rate in the EU accelerated slightly in 2016 at 0.3%, compared to 0.0% in 2015. The developments in the international price of oil are still one of the reasons behind the relatively low inflation rates, with deflation still observed in a number of Member States in 2016. Amid improving labour demand conditions, inflation is expected to pick up pace in 2017 and 2018 at 1.8% and 1.7% respectively.

Recent developments in the exchange rates of major currencies reflect primarily the uneven pace of the economic recovery and related divergences in monetary and financial stances. Global exchange rate developments were marked by a broad-based strengthening of the US dollar, mainly driven by markets' expectations of the tightening of monetary policy in the US.

In this context, the euro lost ground against the US dollar amid increasing divergence between monetary policy in the US and the euro area.

The exchange rate of the euro against the pound recorded significant movements in recent months, reflecting fluctuations in investors' assessment of the political and economic consequences of UK’s withdrawal from the E.U. It is noted that the UK economy has showed resilience after the referendum to leave the EU, with growth rates in the second half of 2016 in line with those of the preceding two years.

In contrast with euro appreciation against the Russian ruble observed in 2015 due to political developments, a depreciation of the euro has been observed recently. Indicatively, from October 2016 to March 2017, the euro depreciated by 10.5% against the ruble.

2.1.2 DOMESTIC ECONOMY

According to latest estimates published on 16th March 2017, the economy expanded at an accelerated rate of 2.8% in real terms in 2016, following a positive growth rate of 1.7% in 2015.

Growth in 2016 was driven by domestic demand. Domestic demand grew by 3.9%, mainly driven by private consumption and gross fixed capital formation, which grew in real terms by 2.9% and 25.9%, respectively. Gross fixed capital formation, which had the biggest contribution to growth, was influenced by significant increases in investment of transport equipment. Imports, in real terms, grew by 5.3% mirroring the trend of domestic demand, while exports, in real terms, also grew at a rate of 3.6%.

From a sectoral perspective, the economy grew mainly due to the strong performance of tourism and business services. In more detail, economic growth is mainly attributed to the sectors of "Accommodation and Food Service Activities", "Professional, Scientific and Technical Activities", "Construction", "Retail and Wholesale Trade" and "Manufacturing". Negative growth was recorded in the “Financial and Insurance Activities”.

The accelerated rate of growth of the economy, in 2016, was reflected in a higher rate of growth of employment, reaching about 2.7%. Employment growth was stronger in the sectors of accommodation and food service activities, wholesale and retail trade, professional, scientific and technical activities and manufacturing. Unemployment declined and averaged around 13% of the labour force in 2016, after peaking at 16.1% in 2014 and subsequently falling to 14.9% in 2015.

Compensation of employees increased in 2016 by 2.2%, following a moderate increase of 0.8% in 2015 in contrast to a marked contraction of 11.2% and 5.9% in 2013 and 2014, respectively. As a consequence, nominal unit labour costs continued to contract also in 2016 by 0.7%, in addition to declines of 0.9% and 4% in 2015 and 2014, respectively.

Table II: Selected economic indicators, 2014-2016, y-o-y %

	2014	2015*	2016*
GDP (constant prices)	-1.5	1.7	2.8
Public consumption	*-7.9*	*-0.6*	*-1.4*
Private consumption	*0.7*	*1.9*	*2.9*
Gross Fixed Capital Formation	*-17.5*	*12.0*	*25.9*
Exports	*4.2*	*0.0*	*3.6*
Imports	*4.6*	*2.1*	*5.3*
Tourist arrivals (000's)	2.441	2.659	3.187
Tourist arrivals growth	1.5	8.9	19.8
HICP	-0.3	-1.5	-1.2
Labour productivity growth (persons)	0.2	-0.2	0.1
Employment growth	-1.8	1.9	2.7
Compensation per employee	-3.8	-1.1	-0.6
Unemployment rate (Labour Force Survey)	16.1	14.9	13.0

**Provisional Data*

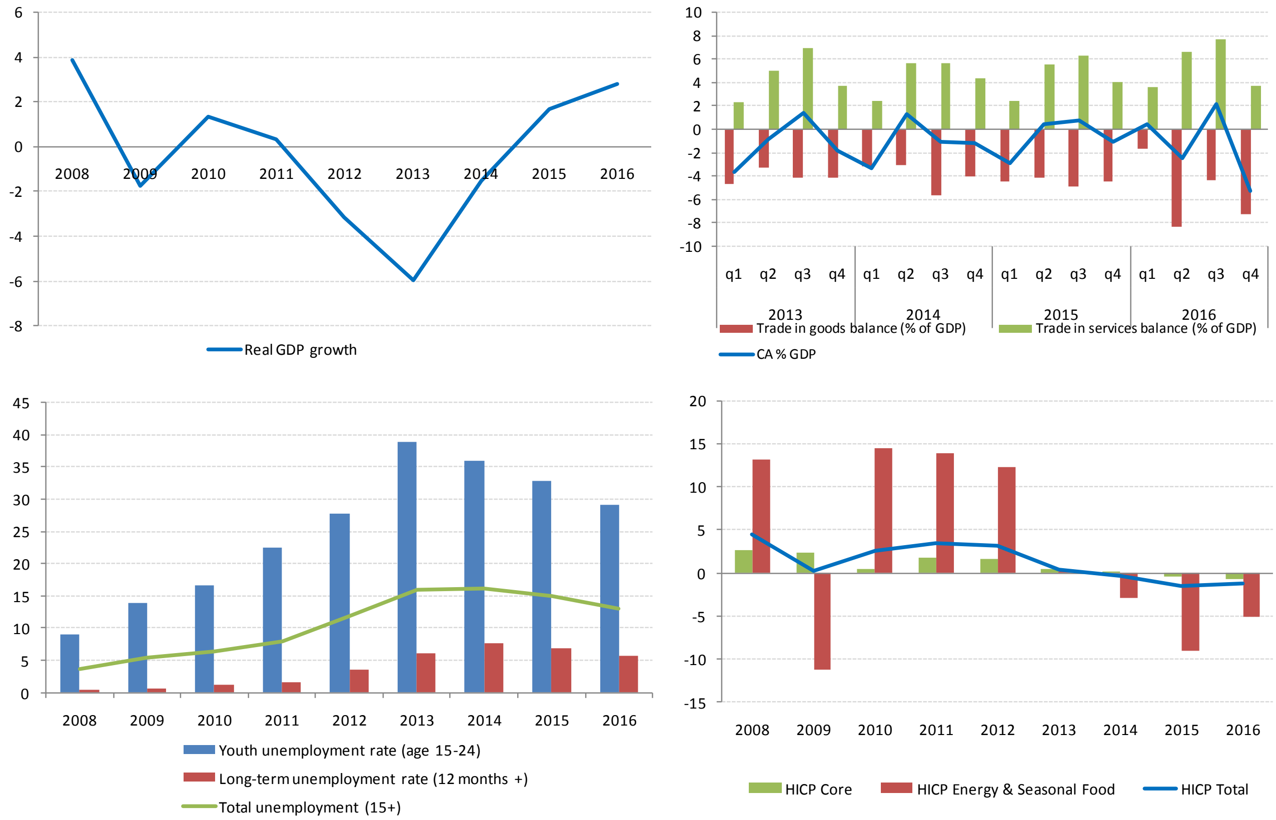
Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), continued to be negative also in 2016 by 1.2% compared to a deflation of 1.5% in 2015. Deflation is driven by developments in international oil prices, with a significant impact on domestic prices of energy products in Cyprus. The HICP, excluding seasonal food and energy, decreased by 0.7% in 2016, compared to a decrease 0.4% in 2015 and an increase of 0.1% in 2014.

According to the latest Balance of Payments data for 2016, the current account recorded a deficit of €941.8 million, or 5.3% of GDP, compared with a deficit of €514.0 million in 2015, or 2.9% of GDP, due to a significant deterioration in the income account. The current account balance is also significantly influenced by exports and imports of mobile transport equipment. More specifically, excluding these one-off type of transactions the deficit in the current account balance is contained to about 2.1% of GDP in 2016. The trade balance was close to balance in 2016 (0% of GDP) compared to a surplus of €59.1 million (0.3% of GDP) in 2015. Excluding the abovementioned one-off transactions, the trade balance is transposed into a surplus reaching around €564 million, or about 3.1% of GDP. The primary income account recorded a deficit of €482.6 million in 2016, compared to a deficit of €62.5 million in 2015. The deficit in the primary income account is mostly attributed to other investment income associated with transactions of Multinational Entities (MNEs). The secondary income account continued to record a deficit in 2016 of €459.6 million, compared to a deficit of €510.6 million in 2015.

The international investment position (IIP) of Cyprus in 2016 improved, reaching a net liability position of €22,452.7 million in 2016 compared with a liability position of €22,985.2 million in 2015, due to developments in "other" investment. The negative position in the IIP is mainly driven by the net position in "other" investment which, is disconnected with the domestic economy. Other investment is driven by the inclusion of liabilities of Special Purpose Entities (SPEs) operating primarily in the shipping sector. SPEs do not have a direct link to the domestic economy as their operations are financed externally. Excluding the liabilities of SPEs, the IIP falls to about -44.1% of GDP.

The difference between gross external debt and total liabilities in IIP is the absence of all equity and investment fund shares components and financial derivatives. Therefore, total liabilities in IIP in 2016 amounted to €261,565.2, from which €106,912 million correspond to the gross external debt compared with €97,082 million in 2015. The increase in general government debt contributed to the increase in gross external debt by €930.7 million, along with an increase in debt held by other sectors, i.e. except the Central Bank of Cyprus and deposit-taking corporations by €11,294.9 million.

Figure 1: Economic trends

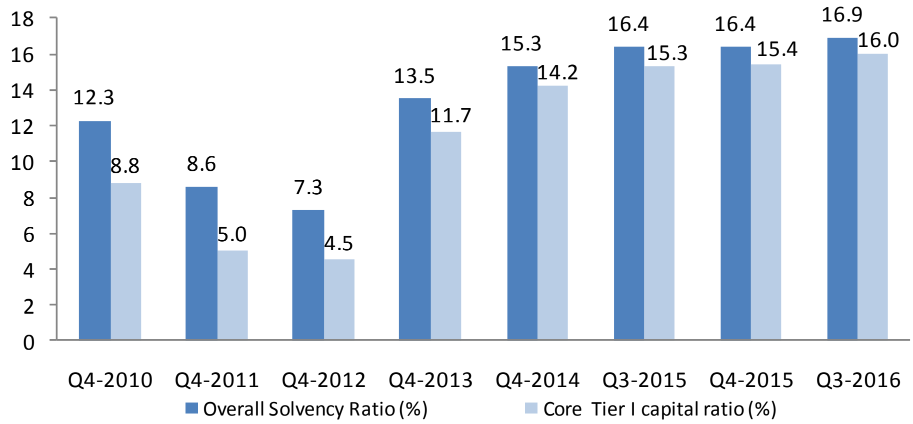


2.1.3 FINANCIAL SECTOR DEVELOPMENTS

Banking sector developments

The Cyprus banking sector is dominated by three large domestic banks (Bank of Cyprus, Co-Operative Central Bank and Hellenic Bank) which collectively represent a share of 69% in total deposits while, the remaining market consists of the three Greek subsidiaries with a market share of 14% in total deposits and other smaller credit institutions.

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



The three large domestic banks have been recapitalised in the past years on the basis of (i) an independent due diligence exercise conducted by an international firm under the direction and review of the Commission, the ECB and IMF, (ii) the comprehensive assessment conducted in 2014 by the European Central Bank which included Asset Quality Reviews and Stress Tests as a precondition for the undertaking of the direct supervision of the systemically significant Eurozone banks and more recently (iii) the SREP exercise performed by the SSM. As part of the restructuring process, the infusion of equity capital and retained profits boosted overall solvency ratio across the Cyprus banking system by nearly 10 percentage points (Dec 12: 7.3% to Sep 16: 16.9%).

The overall performance of the Cyprus economy which, resulted in the successful completion of the macroeconomic adjustment programme in March 2016, has strengthened confidence in the Cyprus economy, both domestically and abroad.

A significant downsizing of the Cypriot banking sector took place in the past four years. Total assets decreased from 631% of GDP end of 2012 to 373% in September 2016, as a result of the shredding of operations of domestic banks through the sale of their subsidiaries in Greece, as well as subsidiaries in other jurisdictions, the decrease in domestic bank lending due to the deleveraging process and the substantial increase in the provisions for bad debts.

Prior to March 2013, the loan/deposit ratio was consistently lower than 100% indicating that the Cyprus banking system's loans were mainly funded by deposits. Following the "bail-in" of creditors including uninsured depositors in March 2013, where a substantial share of deposits was converted into equity as part of the recapitalisation of the two major banks and the withdrawal of deposits from the system, the loans/deposits ratio increased rising above 1, but it has recently declined significantly to 112% in February 2017.

The main indicators of the financial sector have shown substantial improvements and are now based on sounder fundamentals in terms of capitalization and liquidity. Banks' strategies are based on deleveraging through the disposal of non-core operations, focus on domestic operations (core businesses) and at the same time strengthening of their capital and liquidity positions. The profitability of credit institutions though, continues to be adversely affected by the prolonged environment of low interest rates, as well as the burden of increasing provisions for bad debts.

The deposit base has increased and is experiencing positive growth rates. Closely connected to the increase of deposits, is the full repayment of Emergency Liquidity Assistance in January 2017, with €3.8 billion of ELA being repaid during 2016 and early 2017. The outstanding amount of deposits reached €49.3 billion in February 2017 compared to €46.2 billion a year before. Total loans exhibit negative growth rates since May 2013. In February 2017 the annual growth rate of total loans stood at -6.3% compared to an average drop of 10% in 2016. New lending, therefore, remains at low levels.

Figure 3: Deposits

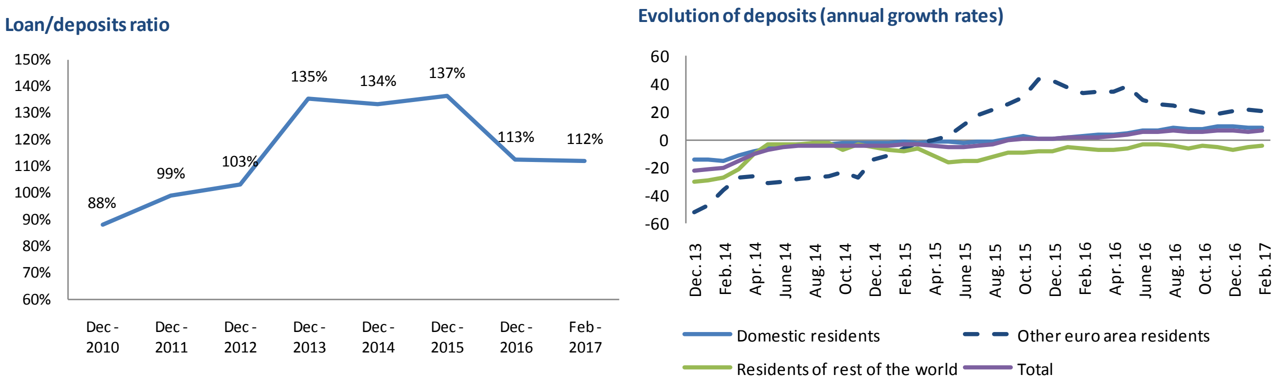
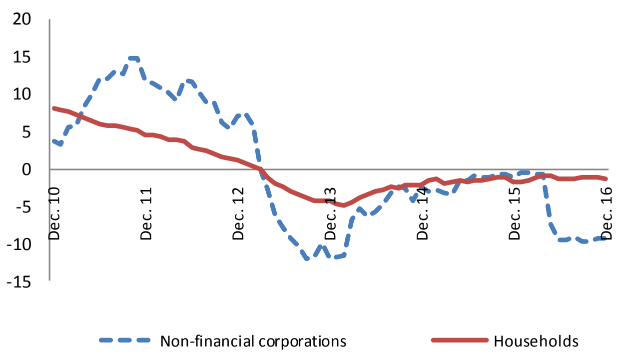


Figure 4: Loans to domestic non-financial corporations and households (annual growth rates %)



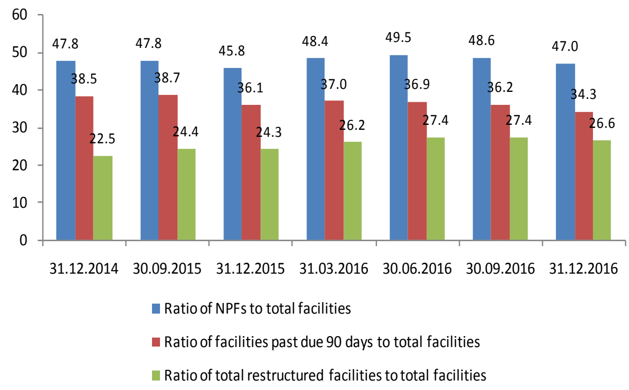
Non-performing facilities (NPFs)

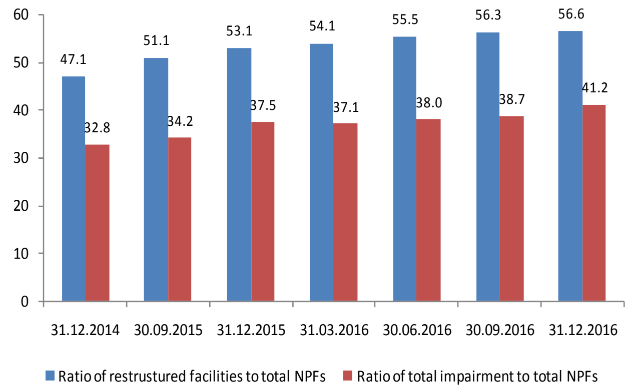
The amount of non performing facilities (NPFs), excluding the overseas operations of Cyprus credit institutions1, remains high, but efforts at restructuring have intensified since the end of 2015, as indicated by available data from the Central Bank of Cyprus (CBC). In particular, NPFs at the end of 2016 stand at €23.6 billion, compared to €27.3 billion at the end of 2014. This corresponds to an overall decrease of NPFs by €3.7 billion or 13.4%. During the fourth quarter of 2016 alone, total NPFs decreased by €452 million, while total facilities increased by €768 million, which resulted in a drop in the ratio of NPFs to total facilities from 48.7%

[1] Non performing facilities include (i) loans, (ii) overdraft accounts with a debit balance, and debit balances in accounts without an approved limit, (iii) revolving credit facilities, financial leasing, hire purchase financing and credit cards, (iv) discounting of promissory notes or bills of exchange, payments under documentary letters of credit, payment under letters of guarantee, advances against goods in bonded warehouses, trust receipt advances, and (v) any other type of funded facility granted to customers of credit institutions.

at the end of September 2016 to 47% end of 2016. Isolating lending which presents over 90 days past due (+90 dpd) the ratio drops from 36.2% at the end of September 2016 to 34.3% end of 2016. The downward trend in NPFs can be attributed to increased repayments, restructurings successfully completed by the end of the observance period and reclassified as performing facilities, write-offs, as well as settlement of debt through swaps with immovable property which, ultimately aim at its disposal and consequently a faster cash collection.

Figure 5: NPFs

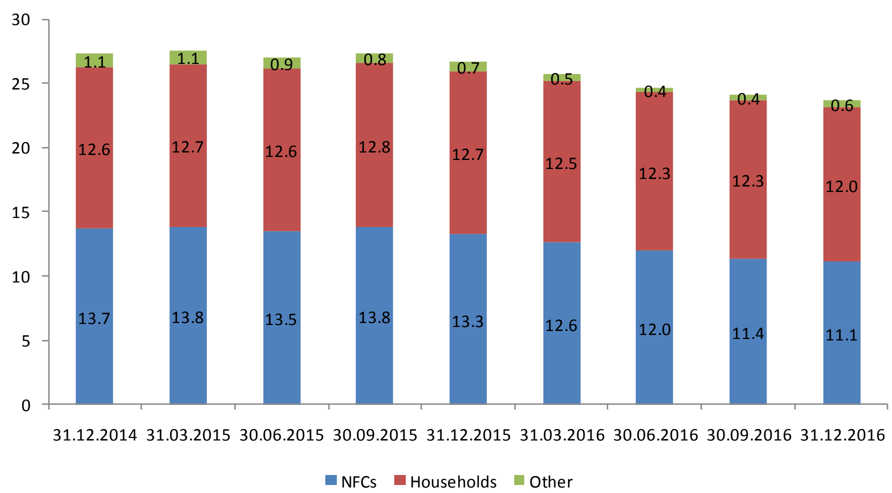




The ratio of restructured facilities to total facilities stood at 26.6% at end of 2016, compared to 27.4% end of September 2016. The ratio of restructured facilities to total NPFs stood at 56.6% at end of 2016 as opposed to 56.3% at end September 2016. Meanwhile, risk provisioning has been gradually increasing, with the coverage ratio (ratio of total impairment to total NPFs) having risen to 41.1% at the end of 2016 compared to 38.8% at the end of September 2016. Therefore, at the end of 2016, 97.7% of NPFs are either restructured facilities or correspond to total impairment provisions.

The reduction in NPFs was more due to non-financial corporations, where a drop of €2.6 billion in NPFs of non-financial corporations accounted for 70.3% of the total drop in NPFs (€3.7 billion from end of 2014 to end of 2016). The drop in household NPFs accounted for €0.7 billion and the rest of €0.5 billion was due to drop in NPFs of government and financial companies.

Figure 6: Non-Performing Facilities by economic category (billion euro)



It should be noted that credit institutions apply the definition of NPFs adopted by the European Banking Authority. Based on this definition, when an NPF is restructured it remains under observation within the NPF category for a further period of at least 12 months, even if the customer follows the new repayment schedule without arrears. Facilities with forbearance status at the end of December 2016 amounted to €13,139 million, of which €9,701 million are still classified as NPFs party due to the definition of NPFs. It is also noted that, according to the data collected by the CBC, the percentage of restructurings since January 2014 which exhibited arrears of less than 8 days at the end of the reporting quarter stood at 72% end December 2016.

Regulation/Supervision

Several regulatory and supervisory reforms have been implemented, aiming mainly at the reduction of the high level of NPLs in the banking system through, inter alia the enactment of legislation enabling to accelerated transfer of title deeds, as well as legislation on foreclosures and insolvency. In addition, the enactment of the Sale of Credit Facilities and Other Related Matters Law in 2015, along with the amendment of the Business of Credit Institutions Law, allows credit institutions to manage properties that have recently been added onto their balance sheets, more effectively. In December 2015, the House of Representatives enacted a series of laws providing tax breaks to delinquent borrowers engaging in loan restructurings or loan write-offs through asset swaps.

The Financial Leasing Law of 2016 recently enacted aims at the development of financial leasing services with adequate supervision and strict criteria, which will provide businesses and citizens with alternative tools of financing. The envisaged benefits of the said law are the following:

(a) Alternative means of financing where the legal owner is the leasing company or the bank, which consequently generates lower credit risks.

(b) Reduction of non-performing loans by converting such loans to leasing contracts.

(c) More flexibility provided to the lessee as he/she is not the owner of the lease hold (therefore has possibility to terminate the lease) through lower payments (installments) either due to lower credit risk of the leasing company or due to an increased acquisition price at the end of the lease period.

The draft law regulating the framework on credit agreements for consumers relating to residential immovable property is expected to be enacted by end April 2017. The bill gives a high level of protection to consumers who acquire residence and requires diligence obligations to banks, with licensing and supervisory powers of the competent authorities.

Box 1: Macroeconomic Imbalances – Private Indebtedness

Data published in the Quarterly Financial Accounts (QFA), published by the Central Bank of Cyprus, with latest available data for September 2016 (published February 2017), show that consolidated indebtedness levels of the Private Non-Financial Sector (PNFS), despite having decreased by about 14 percentage points of GDP between September 2015 and September 2016, remains high compared to the indicative threshold (133%) set by the European Commission in the scoreboard of macroeconomic imbalances (MIP Scoreboard).

In more detail, the indebtedness of the PNFS sector debt stood at a rate of 348% of GDP in Q3 2016, as the deleveraging process both for non-financial corporations (NFCs) and households (HHs) was outweighed by the rate of contraction of nominal GDP. The high ratio of non-performing loans in the banking system is a factor that contributes to sustaining private indebtedness at high levels, but it should also be acknowledged that Cyprus is an international business centre, resulting in substantially inflated ratios and figures by Multinational Entities' (MNEs) operations based in Cyprus.

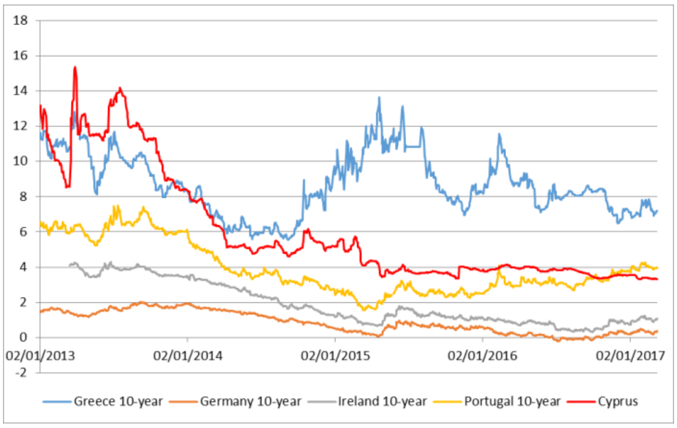
In particular, the private debt indicator of the MIP Scoreboard includes the liabilities of MNEs that are not interlinked to the domestic economy of Cyprus or its financial sector per se. Excluding this debt, private debt to GDP ratio decreases by 75 percentage points of GDP, to around 280% of GDP. Concerning households' debt, this stands at 124% of GDP as at September 2016. However, excluding the asset side (mainly liquid deposits), households net debt is negative, implying that household deposits more than outweigh household loans. Furthermore, from surveys conducted by the CBC (the Household Finance and Consumption Survey, HFCS) it appears that about 67% of households that do have loans also have deposits. At the same time households in Cyprus own a very significant value of real assets often used as collateral for their loans.

Moreover, in the case of Cyprus, NFCs debt to GDP has always been relatively higher than the EU average. This is the result of three factors very specific to Cyprus. First, NFCs are almost in their entirety SMEs privately owned. Second, the capital market is practically non-existent as corporates opt for debt financing rather than equity financing and third, debt financing is preferred due to a biased treatment against equity financing for taxation purposes. To this end, the Cyprus Authorities have proceeded with the introduction of allowances on equity financing for taxation purposes in order to address the negative bias against equity financing. In view of the removal of the tax bias between equity and debt financing, we are anticipating a gradual normalisation of this indicator over the medium term.

Spreads

Government bond yield spreads for Cyprus have dropped significantly in the period from June 2013 to March 2017 as the economy underwent a remarkable transformation through a series of major reforms addressing imbalances in key sectors complemented by structural reforms which resulted in successfully navigating the exit from the macroeconomic adjustment programme.

Figure 7: Spreads



Government bond yields for Cyprus continued trending downwards in 2016 and 2017 despite the fact that the Republic is excluded from the ECB's QE program and have outperformed most peer countries during this period. In spite of the loss of access to the QE Program in 2016 yields continue to drop as more positive developments into the economy materialized and a number of Rating Agencies upgraded the Republic in autumn 2016. Long term spreads to Germany have seen significant narrowing since the exit from the programme as they dropped from 402 basis points in 1st of March 2016 to 318 basis points on the 8th of March 2017. As the economy continues on a growth path we expect spreads to continue to narrow albeit on a slower pace.

Insurance and Pension Funds

Based on the government's policy of strengthening and consolidating the supervision of insurance companies and occupational pension retirement funds, a study was conducted for the setting up of a new supervisory authority which will be responsible for the supervision of the two sectors. The study which was prepared by experts in cooperation with the European Insurance and Occupational Pensions Authority (EIOPA), analyses the needs and sets up the necessary steps for creating this new supervisory authority based on international best practices. The Council of Ministers has approved the unified supervision on the 13/9/2016, under an independent supervisory body outside state control. The action plan for the implementation of this decision, has been put into action and it is envisaged that the necessary legal and supervisory framework will be in place by year end. It is envisaged that the unified and strengthened supervision, will help the industry and provide increased transparency and stability in the two sectors.

2.2 MACROECONOMIC OUTLOOK 2017-2020

2.2.1 GROWTH PROSPECTS 2017-2020

Medium-term Scenario 2017-2020

In the medium-term, the outlook of the economy is expected to continue to improve even further. Due to an environment of improved confidence and credit conditions, created by continuing with the restructuring of the banking system and the anticipated gradual reduction in non-performing loans, as well as the gradual normalization in the labour market, growth is expected to remain robust in the forecast horizon of this Programme. The improved macroeconomic environment is expected to improve the attractiveness of the Cyprus economy and is expected to boost investment and external demand for services contributing positively to growth. In addition, fiscal policy is expected also to contribute positively to growth through increased investment expenditures.

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

For 2017, the economy is estimated to expand further, in real terms, at around 2.9%. This is primarily supported by a continued positive contribution of private consumption to growth, driven by an improvement in disposable incomes, as well as net exports. In particular, for employment, the positive trend of 2015-2016 is expected to continue in line with growth expectations.

Growth is forecast to remain at 2.9% in 2018 and then marginally decline to about 2.7% in 2019 and 2020. Inflation, measured by HICP, is forecast to turn positive in 2017 rising to 1.1% and then projected to marginally decline to 1.0% in 2018 and then climb to 1.5% and 2.0% in 2019 and 2020, respectively.

Growth is estimated to remain relatively strong over the projected horizon, mostly due to internal drivers and to a lesser extend external drivers. Consumption will continue to provide a positive contribution to growth, mainly due to labour market developments, as well as the secondary effects from export oriented services sectors. Investment growth is estimated to continue contributing positively to growth, albeit at more moderate levels compared to 2016, due to a significant number of new projects that are being implemented in the areas of tourism, transport and education and include inter alia the construction of Marinas, a casino resort and an infrastructure development of the University of Cyprus.

Table III: Medium Term Framework, 2017-2020

Annual rate of change	2016	2017	2018	2019	2020
Real GDP	**2.8**	**2.9**	**2.9**	**2.7**	**2.7**
Government Consumption	*-1.4*	*0.8*	*0.3*	*0.0*	*0.0*
Private Consumption	*2.9*	*2.3*	*2.3*	*2.3*	*2.3*
GFCF	*25.9*	*0.2*	*6.5*	*5.2*	*5.2*
Exports	*3.6*	*3.0*	*3.5*	*3.5*	*3.5*
Imports	*5.3*	*1.0*	*3.2*	*3.2*	*3.2*
Deflator	-1.3	1.3	1.0	1.5	2.0
Nominal GDP	1.5	4.2	4.0	4.2	4.7
HICP	-1.2	1.1	1.0	1.5	2.0
CPI	-1.4	1.3	1.0	1.5	2.0
Employment (persons)	2.7	2.2	2.0	1.7	1.7
Unemployment (LFS)	13.0	11.5	10.0	8.5	7.0
Compensation of employees	2.2	3.5	3.7	3.8	4.1
Compensation per employee	-0.6	1.3	1.7	2.1	2.4

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

From a sectoral perspective, growth is expected to be mainly export-led, due to the performance in sectors such as professional and shipping services, which are expected to continue on a positive trend. Furthermore, the prospects in the tourism sector are positive also for 2017, as arrivals are anticipated to grow at a rate 5% over the record performance of 2016 fueled particularly by strong demand from the UK, German and Russian markets and to a lesser extent by increasing demand from markets of continental Europe attributed to increasing awareness of the attractiveness of the Cyprus tourist product.

The current account deficit improved significantly in recent years, mostly due to a cyclical correction of the goods balance. In general, however, on average an annual deficit of around 4.7% of GDP was recorded for the period 2012-2016 by the primary and secondary income account balances reflecting net outflows by MNEs with foreign shareholding in the form of dividends, as well as net outflows by non-resident employees.

Table IV: External balances

% of GDP	Year 2015	Year 2016	Year 2017	Year 2018	Year 2019	Year 2020
Current account	**-2.9**	**-5.3**	**-4.5**	**-4.3**	**-4.1**	**-3.7**
- Balance on goods and services	*0.3*	*0.0*	*0.6*	*0.6*	*0.6*	*0.7*
- Balance of primary incomes and transfers	*-3.2*	*-5.3*	-5.0	-4.9	-4.7	-4.5

At the same time, on average the goods and services balance is forecast to be in surplus reaching about 0.6% of GDP. As the economy continues to recover the deficit of the goods balance is expected to widen to some extent, fully compensated by a substantial surplus in the balance of services, resulting in an overall surplus in the balance of goods and services of about 0.6% of GDP. The current account deficit is thus anticipated to improve over the medium-term, declining to around 4% of GDP during 2018-2020. This estimation relies on the expectation that the balance of primary incomes and transfers will hover around the 2016 levels, in absolute terms, for the period covered in this Stability Programme.

BOX 2: Macroeconomic Imbalances and External Competitiveness

Current Account Balance

The current account of the Balance of Payments is a measure of Cyprus's financial flows with the rest of the world. The deficit in the current account balance improved significantly in recent years with the most significant correction registering in the goods balance. Considering the medium-term developments, the cyclical correction of the current account due to the correction in the goods balance is not expected to continue as the economy enters a recovery phase where the deficit in the goods balance is expected to widen to some extent reflecting the peak up of domestic demand. However, the reporting of external trade statistics has been substantially altered in light of the new methodological and statistical changes, i.e. the European System of Accounts, 2010 (ESA 2010) and the Balance of Payments and International Investment Position Manual of the IMF, sixth edition (BPM6). With the introduction of the ESA 2010 and BMP 6 statistical methods, total imports and exports of Cyprus include, among other things, the economic transfer of mobile transport equipment and activities of ship owning SPEs. Due to the characteristics of the Cyprus economy, this methodological change result in a disproportionate alteration of the statistics in the current account balance. These statistics, especially in the case for exports and imports of goods, do not reflect the economic fundamentals of the domestic economy as a result of the inclusion of the economic transfer of mobile transport equipment by the ship owning SPEs registered in Cyprus. These transactions do not affect nor are affected by domestic developments.

The above is evident in the 2016 current account results, where the current account recorded a deficit of €941.8 million, or 5.3% of GDP, compared to 2.9% of GDP in 2015. Excluding the one-off transactions in imports and exports of goods and services of mobile transport equipment, and more specifically the import of a yacht valued at €563.4 million in May 2016, the deficit of the current account balance is limited to 2.1% of GDP in 2016, exhibiting an improvement vis-à-vis the year before of about 1 percentage point of GDP.

Table VI: Balance of Payments, 2009-2016

in per cent of GDP	2009	2010	2011	2012	2013	2014	2015	2016
Exports of Goods	13.1	13.9	15.3	15.6	15.0	16.0	14.1	13.6
Imports of Goods	34.7	36.8	35.5	33.7	31.2	32.0	32.0	35.1
Goods Balance	-21.6	-22.9	-20.2	-18.0	-16.2	-16.0	-18.0	-21.5
Services Balance	16.3	15.6	17.2	16.6	18.0	18.1	18.3	21.5
Primary Income Balance	-1.3	-3.0	0.0	-3.0	-4.7	-3.6	-0.4	-2.7
Secondary Income Balance	-1.1	-1.0	-1.1	-1.4	-2.1	-2.8	-2.9	-2.6
Goods & Services Balance	**-5.3**	**-7.3**	**-2.9**	**-1.5**	**1.8**	**2.1**	**0.3**	**0.0**
Current Account Balance	**-7.7**	**-11.3**	**-4.1**	**-6.0**	**-4.9**	**-4.3**	**-2.9**	**-5.3**

Box 2 continued next page

Box 2 continued

Net International Investment Position (NIIP)

The sizeable negative International Investment Position of Cyprus, reflects the characteristics of a small open economy with a relatively large international business and shipping sector, as a result the implementation of the new methodological standards have a significant negative impact on the NIIP of Cyprus. Special Purpose Entities (SPEs) affect the imports and exports of goods as the change of ownership of ships is reflected as imports/exports of goods. Ship owning SPEs, as well as MNEs have also a negative impact on the primary balance as profits from their operations are recorded as outflows through the primary income account. The persistent negative current account deficits create a persistent negative exposure in the NIIP position, however, this may not be considered to be problematic especially the deficits attributed to the aforesaid operations. Furthermore, sustainability of current account deficits is safeguarded by financing through non-debt creating FDI flows. During the past few years, the Cyprus current account deficits were mostly financed by “other investment” (foreign deposits) which is, however, considered to be very liquid, while Foreign Direct Investment (FDI) only partially financed current account deficits. It should be noted that during 2013-2014, following the correction of imbalances in the economy, the current account deficits were fully financed by FDI flows (excluding SPEs), a trend that may continue in the coming years given the expected flows in foreign investment.

In 2016, the deterioration in the NIIP was triggered by the adoption of the methodological changes and the implementation of the new statistical standards, as well as the inclusion of the economic transfer of mobile transport equipment of ship owning companies. The latter have significant financial liabilities used for financing their operations including the acquisition of the companies’ assets. While these loans impact directly on the IIP, the respective real assets (ships) do not, thus creating an imbalance in the figures reported. Most importantly, SPEs do not have a link domestic economy as these operations are financed from abroad. Excluding the transactions of ship owning SPEs, the net IIP in 2015 improves by 75 percentage points and is limited to -€9.7 billion or -55.2% of GDP. In September 2016, the net IIP excluding the transactions of ship-owning SPEs amounted to -€7.4 billion or -44.1% of GDP, which is close to the threshold established in the context of the macroeconomic scoreboard.

2.2.2 LABOUR MARKET

Labour Market

The expectations in the labour market are encouraging. In 2016, employment growth is estimated to have risen by 2.7% and is expected to continue expanding also in 2017 albeit at a slower pace of 2.2%. In 2018 employment is projected to grow at a rate of 2% while in 2019 and 2020 is envisaged to maintain a more moderate increase of 1.7% per annum.

At the same time, the unemployment rate is envisaged to maintain a downward path commenced in 2015, declining from 13.0% of the labour force in 2016 to 11.5% in 2017 and gradually falling to 8.5% in 2019 and subsequently to 7.0% in 2020. The reduction in the unemployment rate is triggered by positive economic growth fostered by capital investment and higher private consumption spending leading to a sustained job creation.

Table V: Labour market developments

	2013	2014	2015	2016	2017	2018	2019	2020
Employment (persons) growth	-5.9	-1.8	1.9	2.7	2.2	2.0	1.7	1.7
Unemployment rate	15.9	16.1	14.9	13.0	11.5	10.0	8.5	7.0
Compensation per employee, growth	-5.4	-3.8	-1.1	-0.6	1.3	1.7	2.1	2.4
Nominal unit labour cost, growth	-5.4	-4.0	-0.9	-0.7	0.6	0.8	1.1	1.4
Productivity (persons)	0.0	0.2	-0.2	0.1	0.7	0.9	1.0	1.0

The composition of unemployment shows that youth and long-term unemployed remain the major challenges in the labour market, but with encouraging signs of de-escalation. Youth unemployment since Q2 2013 where it peaked reaching a rate of 40.3% followed a downward path declining to 29.8% by Q4 2016. Similarly, long-term unemployment decreased to 5.7% in 2016, down from a peak of 7.8% in Q3 2014.

Wages

Wage growth as reflected in compensation per employee in 2016 is estimated to have exhibited a marginal decline of 0.6% and it is forecast to turn positive thereafter increasing by 1.3%, in 2017 and 1.7% in 2018. It is then projected to accelerate to 2.1% in 2019 and 2.4% in 2020.

Wage developments follow the steady recovery of the economy denoting an improving labour market and rising labour demand faster than supply.

Productivity and ULC

Based on the indicative forecasts in the labour market, productivity is estimated to have been positive in 2016 reaching 0.1%. Productivity in 2017 is projected to rise to 0.6% and then accelerate to 0.9% in 2018 and 1% in 2019 and in 2020.

Unit labour costs (ULC) are forecast to follow a similar path to the compensation per employee. In 2016, unit labour costs are estimated to have declined by 0.7% following a decline of 0.9% in 2015. The trend is forecast to turn positive as from 2017 onwards reflecting the anticipated positive economic developments. ULC are forecast to exhibit an increase of 0.6% in 2017, 0.8% in 2018, and then accelerate to 1.1% and 1.4% in 2019 and 2020, respectively. The projections in nominal unit labour costs underpin that cost competitiveness shall be sustained at relatively satisfactory levels maintaining the overall competitiveness of the Cyprus economy at a good pace.

Real unit labour costs in 2016 were positive by 0.7% following the 1.2% increase in 2015, due to the more negative inflation developments, while in 2017 it turns back negative reaching 0.7%. The above picture continues for the period 2018-2020 where RULC are estimated at -0.2%, -0.4% and -0.6% respectively, reflecting cost competiveness gains.

2.2.3 PRICE DEVELOPMENTS

Harmonised Consumer Price Index (HICP)

Inflation, as measured by HICP, turned positive in December-2016 after its prolonged continuous negative trend since late-2014. During 2016, harmonized inflation averaged at -1.2%. Harmonized energy inflation was negative at -9.5% and total harmonized inflation excluding energy prices was negative at -0.5%. During the first two months of 2017 inflation was positive of about 1.0% mainly due to the consequential effects of internationally higher oil energy prices. Taking into account the projected trends in international oil prices, HICP is estimated to average to around 1.1% in 2017, compared to -1.2% the year before. Based on the basic external assumptions on oil prices ($53.5 per barrel in 2017 and $53.2 per barrel in 2018) and the dollar/euro exchange rate (1.1$/€ in 2017 and 2018), inflation in the medium-term horizon is forecasted to pick up at 1%, 1.5% and 2.0% in 2018, 2019 and 2020, respectively, which is in line with the trend in economic activity.

Consumer Price Index (CPI) - Price developments in 2017

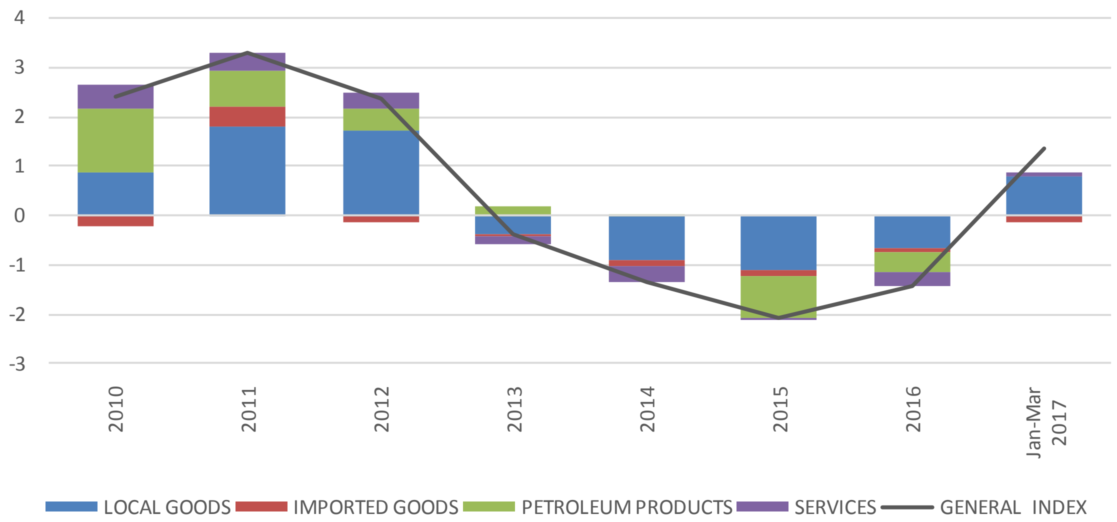
In 2016 the Consumer Price Index (CPI) recorded a decrease of the order of -1.4% compared to the year before. Analysis of CPI by economic activity indicates that this decrease was mainly attributed to electricity and water prices as well as petroleum products, which recorded an annual rate of growth of -13.8% and -7.6% respectively (total contribution to 2016 inflation of about -0.8 percentage points).

During the first three months of 2017, inflation was positive of the order of 1.4% attributed mainly to electricity and water prices as well as petroleum products, which recorded an annual rate of growth of 12.8% and 14.2% respectively (total contribution to 2016 inflation of about 0.9 percentage points), following the 59.3% increase recorded in international oil prices during the period January-March 2017 compared to the same period of the year before ($53.7 per barrel compared to $33.7 per barrel, respectively). Taking into account the projected trends in international oil prices, inflation as measured by CPI is estimated to average to around 1.1% in 2017.

Table VI: CPI by Economic Activity

(annual % change)	2010	2011	2012	2013	2014	2015	2016	Jan-Mar 2017
GENERAL INDEX	**2.4**	**3.3**	**2.4**	**-0.4**	**-1.4**	**-2.1**	**-1.4**	**1.4**
LOCAL GOODS	3.0	11.0	6.7	-1.6	-3.4	-3.9	-2.7	4.1
Local Agricultural	0.0	-1.6	-1.3	-1.0	-3.7	1.0	0.4	7.2
Local Industrial	0.7	11.8	2.0	0.9	-0.2	-0.5	-0.6	-0.3
Electricity and Water	22.2	13.5	26.9	-6.4	-9.2	-16.3	-13.8	12.8
IMPORTED GOODS	-0.9	2.8	-0.6	-0.2	-0.6	-0.6	-0.4	-0.8
Imported Agricultural	1.6	13.8	2.6	-0.9	-2.0	0.7	-0.6	7.2
Imported Industrial (Excl. petr.)	-1.0	2.7	-0.7	-0.1	-0.5	-0.6	-0.4	-1.0
PETROLEUM PRODUCTS	19.4	19.3	7.9	3.3	0.3	-13.3	-7.6	14.2
SERVICES	1.2	1.6	1.0	-0.5	-0.9	0.0	-0.8	0.2
Rents	1.3	0.7	0.2	-6.7	-5.9	-1.2	-0.5	0.3
Repairs & maint. of dwellings	0.7	0.1	-0.6	-0.5	-1.5	-2.0	1.1	1.3
Transport	-9.5	-0.5	0.5	1.9	3.4	2.1	-14.1	-2.8
Communication	0.0	0.0	1.4	1.3	2.0	1.0	-0.3	-1.4
Insurance	0.7	-1.4	-0.1	3.0	-0.8	0.1	0.2	-1.8
Government services	1.2	4.8	1.8	2.7	9.1	0.7	-2.4	1.2
Education	4.7	3.2	2.4	-0.7	-3.5	-1.1	0.4	0.5
Medical care	3.9	1.3	0.6	-2.9	-1.7	1.0	1.6	1.0
Restaurants & Coffee shops	2.1	1.2	1.0	0.4	-1.4	0.2	0.3	0.4
Personal & Household services	1.9	1.1	1.2	-0.3	-1.1	-0.6	-0.1	1.2

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



2.2.4 RISKS TO MACROECONOMIC OUTLOOK

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

- Weaker than expected growth in the euro area.
- Deeper recession in Russia in conditions of protracted decline in oil prices but also from developments concerning EU-Russia relations.
- Slower than expected growth in the UK and further weakening of the pound against the euro as a result of higher uncertainty, given the beginning of the negotiations for the withdrawal of UK from the E.U.
- Possible negative developments in connection with Greece, even though potential negative spillovers to the domestic economy have not been confirmed.

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

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1 POLICY STRATEGY

As already stated, the Government's main policy objective is to safeguard macroeconomic stability in order to facilitate growth and job creation. To this end, fiscal policy will be geared towards maintaining high primary surpluses during the programming period and beyond in order to facilitate the gradual decline of debt-to-GDP ratio at a satisfactory pace. Taking into account the cyclical position of the Cyprus economy and the fiscal over achievements during the macroeconomic adjustment programme, the Government intends to maintain a growth-friendly, prudent fiscal stance, utilizing any fiscal space to raise the potential growth of the economy through increased high value added investments. Windfall revenues due to a better than anticipated performance of the economy, including windfall revenues associated with the energy sector, will be used solely for the reduction of public debt.

3.2 MEDIUM TERM OBJECTIVE

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

Over the medium term, the government's fiscal policy stance is based on a prudent macro-economic scenario, which locks in the fiscal achievements and the respect of the national MTO over the medium-term. The prudent fiscal stance to be followed will safeguard the maintenance of a healthy primary balance position, with the aim to enhance credibility, thus facilitating access to the international markets at favourable rates on a sustainable basis.

The nominal budget balance in 2017 is projected at a surplus of 0.2 percent of GDP, compared to a surplus of 0.4% in 2016. The nominal fiscal projection of 2017 is influenced from cyclical developments as the economy normalises following the emergence from a severe financial crisis. Beyond these developments, the 2017 Budget forecast is also influenced by ad hoc measures both on the revenue as well as the expenditure side. On the expenditure side, measures containing the rate of growth of expenditure have been promoted and include the collective agreement reached between the Government and public sector Unions which introduces a control mechanism limiting the overall growth in the wage bill in the public and broader public sector below the growth of nominal GDP, the provision of the collective agreement with the Union of Civil Servants for zero salary general increases in 2017-2018 as well as, the legislative proposal already submitted to Parliament which, provides for the indefinite suspension of recruitment of new personnel in the public sector and the introduction for a mechanism regulating exceptions. On the revenue side, the sustained fiscal overperformance of the past few years is forecast to absorb the impact from the termination of the temporary tax measure on private and public sector emoluments amounting to 0.4 percentage points of GDP, which was introduced for the period 2011-2016, and the 2017 residual abolition of the immovable property tax amounting to about 0.1 percentage points of GDP.

The cyclically adjusted balance, net of one-off and other temporary measures, is calculated using the commonly agreed methodology, based on the central macroeconomic scenario of the current updated Stability Programme. Any differences, therefore, with Winter Forecasts 2017 published by the European Commission are due to differences in the macroeconomic scenaria, which in the current update envisages gains in factors of production such as labour and capital over the medium term. The output gap is projected to turn marginally positive in 2017 reaching 0.4% of potential output, widening thereafter over the period 2018-2020. Therefore, the structural balance in 2016 is estimated to have registered a surplus of 1.2% of GDP, overachieving the medium-term budgetary objective of 2016 by the same magnitude in percentage points of GDP. In 2017, as the output gap turns marginally positive based on the commonly agreed methodology, the structural balance, is projected to decline and meet the medium-term objective of a balanced budget. The latter development ensures the respect of the rules of the Stability and Growth Pact and more precisely the respect of the medium-term objective for Cyprus both in 2016, as well as 2017.

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

Table VII: Potential GDP and Output Gap estimations

	2015	2016	2017	2018	2019	2020
Real GDP growth	1.7	2.8	2.9	2.9	2.7	2.7
Comparison with Commission Winter Forecast	*1.7*	*2.8*	*2.5*	*2.3*	*2.0*	*2.0*
Potential GDP growth	-0.9	0.5	1.0	1.6	2.0	2.1
Comparison with Commission estimation, based on Winter Forecast	*-0.9*	*-0.1*	*0.4*	*0.7*	*0.8*	*0.8*
Output Gap (% GDP)	-3.7	-1.5	0.4	1.6	2.3	2.9
Comparison with Commission estimation, based on Winter Forecast 2017	*-3.8*	*-1.1*	*1.0*	*2.6*	*3.8*	*5.1*

The developments in the general government balance are primarily influenced by cyclical developments. On the expenditure side, over the programming period 2017-2020, expenditure as a per cent of GDP is forecast to decrease by 1.4 percentage points of GDP, while revenue as a per cent of GDP is forecast to exhibit a decrease by 1.3 percentage points of GDP.

Table VIII: Components of Fiscal Adjustment and Medium-term

Δ between Y_T and Y_{T-1} per cent of GDP	2016	2017	2018	2019	2020	Total Adjustment 2017-2020
Revenue developments	0.0	-0.7	-0.2	0.0	-0.5	-1.3
Expenditure developments	-1.5	-0.5	-0.4	0.0	-0.5	-1.4
General Government Balance	**1.4**	**-0.2**	**0.2**	**0.0**	**0.0**	**0.1**
Cyclical Component	1.2	1.0	0.6	0.4	0.3	2.3
Cyclically-adjusted Balance	0.3	-1.1	-0.4	-0.4	-0.3	-2.2
One-off measures	0.3	0.0	0.0	0.0	0.0	0.0
Structural balance	0.3	-1.1	-0.4	-0.4	-0.3	-2.2

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

In per cent of GDP, total expenditure declines from 38.9% in 2016 down to 38.4% in 2017, 38.0% in 2018 and contained at 37.4% in 2020. This development is attributed to a contained rate of growth in compensation of employees below nominal GDP growth based on the recent collective agreement reached between the Government and public sector unions, as well as an anticipated moderate growth in public sector retirements, resulting in savings of the order of 0.6 percentage points of GDP, complemented by a decline in social payments associated with the cyclical upturn and improvement in the labour market, projected to result in savings of about 1.2 percentage points of GDP.

Revenue, over the period 2017-2020, is projected to decline from 38.6% in 2017 of GDP to 37.9% in 2020. This is mainly attributed to the termination of the temporary tax measure on public and private sector's emoluments as from 2017 amounting to 0.4 percentage points of GDP, the phasing in of the VAT Directive on e-services and the residual abolition of the immovable property tax as of 1st January 2017, resulting in a decline of the order of 0.3 and 0.1 percentage points of GDP, respectively.

3.3 GENERAL GOVERNMENT BALANCE FOR 2016

The government's budget policy in 2016 was reflecting the neutral fiscal stance adopted thus allowing automatic stabilizers to operate freely. The budget balance turned positive reaching a surplus of 0.4% of GDP in 2016, compared to a deficit of the order of 1.1% of GDP the year before, reflecting the improvement of the economic environment and labour market conditions. Primary balance position strengthened further reaching a surplus of 3.0% of GDP compared to a surplus of 1.7% the year before, recording an improvement of about 1.3 percentage points of GDP.

Revenue

In 2016, total revenue as a percentage of GDP amounted to 39.2% remaining at the same levels as in 2015. In value terms, total revenue increased by 1.5% compared to the year before. Tax revenue increased by 2.9% mostly due to an increase in taxes on production and imports. In more detail, taxes on production and imports increased by 5.1% due to the increase in VAT receipts by 5.9% compared to 2015, reflecting the improvement in economic conditions and the increase in private consumption fueled by the performance in the tourist sector. Revenue from taxes on income and wealth decreased marginally by 0.3%, stemming from the reduction in immovable property tax receipts, as a decline by 75% on last year's tax was effected in July 2016. Receipts from the withholding tax on interest, also contributed in the reduction of taxes on income and wealth as they declined significantly attributed to the continued reduction in interest rate levels. These decreases were compensated from an increase in corporate income tax receipts and capital gains taxes exhibiting a robust growth compared to the year before of 11% and 57%, respectively.

Concerning the rest of the revenue components, revenue from social contributions increased by 3.7%, reflecting the improved conditions in the labour market namely employment and wage developments. On the other hand, revenue from property income decreased by 20.2%, primarily due to a lower dividend from the Central Bank of Cyprus (CBC) by about €40 million compared to the dividend received the year before, as well as from a lower dividend from the Cyprus Telecommunications Authority (CYTA). Finally, revenue from other sources, which consists of non-tax revenue, decreased by 3.6%, reflecting, in part, a decrease in the rate of absorption from the EU's Budget associated with the start of the new programming period.

Expenditure

Total expenditure in 2016 exhibited a decline falling to 38.9% of GDP from 40.3% of GDP in 2015, mainly due to the fact that the expenditure of 2015 was increased by €175 million, or by 1.0% as a percent of GDP, relating to the recapitalization of the cooperative sector. In absolute terms, total expenditure decreased by

2.2%, while excluding the impact of the recapitalization of the cooperatives, total expenditure in 2016 recorded a marginal increase of about 0.3% compared to the year before.

Compensation of employees exhibited a decline of 0.5% attributed mainly to the reduction in gratuity payments due to a significant reduction in retirements of state servants by 31.4% compared to the year before. To this end, pension outlays including lump sum payments decreased by 4.4% in 2016 vis-à-vis 2015. As a percentage to GDP, compensation of employees decreased to 12.6% in 2016 compared to 12.9% the year before.

Intermediate consumption declined at a rate of 5.6% mostly due to lower expenditures related to energy and energy products linked to the effects of declining internationally oil prices as well as lower expenditures related to security. As a percentage to GDP, Intermediate consumption decreased to 3.6% in 2016 compared with 3.9% the year before.

Despite the significant decrease in unemployment benefit payments in 2016 of the order of 12.4%, compared to the year before, social payments other than in kind increased by 3.8%, attributed to increased payments related to the Guaranteed Minimum Income (GMI) scheme by 17.1%, as the scheme was introduced in mid-2014 aiming at better protecting vulnerable groups and better targeting benefits to ensure public support for those most in need, including the working poor. The significant increase in GMI payments is associated with the fact that the scheme reached maturity in 2016. At the same time outlays related to allowance to pensioners declined by 20.6% partly offsetting the increase stemming from GMI. As a percentage to GDP, social payments increased to 14.3% in 2016 compared with 14.0% the year before.

Interest expenditure recorded a decrease of 5.3% in 2016, compared to 2015 levels due to a reduction in the weighted average interest rate on debt. As a percentage to GDP interest expenditure declined to about 2.6% in 2016 from 2.8% the year before.

Gross fixed capital formation recorded an increase of the order of 32.5% rising, as a percentage to GDP, to 2.5% in 2016 from 1.9% the year before associated with increased outlays for transport equipment and infrastructure development.

3.4 BUDGET FOR 2017

The 2017 Budget, as well as, the MTBF 2017-19 encompass a major part of the measures identified through the Public Financial Management (PFM) reform process which aim at increasing flexibility and accountability in the management of budgetary appropriations and safeguarding the achievement of targets set. An important part of the PFM reforms is the transformation of the budget from an input based and bottom-up budget to an output based top-down budget. Towards this direction, an activity based budget has been prepared, on a pilot basis, by all line ministries (except by the Ministry of Defense) and two government agencies (General Directorate European Projects Coordination and Development and the Treasury) in parallel with the existing budget. The total replacement of the traditional budgetary process with the activities based budgetary process will be completed with the introduction of the appropriate IT system that supports activity based budgeting.

The Budget for 2017 reflects the policy of the government for a growth friendly, prudent fiscal stance, safeguarding the maintenance of robust primary surpluses supporting a sustained reduction of public debt-to-GDP at a satisfactory pace. In this context, the Budget also reflects a continuation in the employment policies adopted by the government over the past few years and continues to place emphasis on the reallocation of government expenditure towards growth-enhancing activities and other policy priorities. A more detailed analysis on the revenue and expenditure components of the 2017 Budget is presented below.

Revenue

In accordance with the central macroeconomic scenario, total revenue in 2017 is forecast to decline to about 38.6% of GDP from 39.2% the year before, anticipated to record a positive rate of growth in absolute terms of the order of 2.4% compared to 2016.

Tax revenue, in absolute terms, is expected to exhibit a marginal rate of growth of about 0.2% compared to 2016, albeit declining as a percentage of GDP to 24.1% in 2016 from 25.1% the year before. The growth is fueled by increases in revenues from taxes on production and imports which are forecast to grow by 2.9%, in line with the improved economic activity reflected in an increase in consumption and despite the full-year effect of the VAT directive on e-services estimated to impact negatively by about 0.1 per cent of GDP. Taxes on production and imports are estimated to decline by 0.2 percentage points of GDP, falling to 15.1% in 2017 from 15.3% the year before. Taxes on income and wealth are estimated to decrease by about 4% compare to the year before, mainly due to the termination of the temporary tax measure on private and public sector emoluments amounting to 0.4 percentage points of GDP, which was introduced for the period 2011-2016, and the 2017 residual abolition of the immovable property tax amounting to about 0.1 percentage points of GDP. Taxes on income and wealth are estimated to decline by about 0.8 percentage points of GDP from 9.8% the year before to 9.0% in 2017.

Social Security contributions are forecast to exhibit an increase in 2017 by about 5.5% compared to the year before, reflecting developments in the economy and especially the labour market, reaching 8.7% of GDP compared to 8.6% the year before.

Revenue from property income is forecast to exhibit an increase in 2017 of 3.4% compared to the year before remaining unchanged, as a percentage of GDP, at 1.1% despite the lower dividend from the Central Bank Divided by about €33.5 million received in 2017 compared to the one the year before. The expected decline in Central Bank's dividend is fully compensated by the anticipated concession fee related to the assignment of the administration of Limassol Port to a strategic investor.

Finally, "other revenue", is estimated to record an increase of 8.8% in 2017, thus rising as a percentage of GDP by about 0.2 percentage points of GDP to 4.7% from 4.5% in 2016, as financing from the EU's Budget is expected to normalize and reach levels of the previous programming period.

Expenditure

Total expenditure will continue on a downward path, as a percentage of GDP, coming down to 38.4% in 2017 from 38.9% the year before. This corresponds to an increase in total expenditure of 2.9% in 2017, compared to 2016 level which is lower than nominal GDP growth rate.

In more detail, compensation of employees is forecast to exhibit an increase of 3.6% in 2017 compared with the year before, of which 1.1 percentage points are attributed to the additional personnel for security forces, whereas 1.5 percentage points are attributed to the termination of the temporary measure on public sector emoluments as of 1st January 2017. Expenditure for pensions and gratuities is expected to remain broadly unchanged. It should be noted at this point that, the government's employment policy for 2017 as provided in the Budget Law for 2017, foresees zero replacement rates, except from exceptions in specific sectors, mainly referring to health and education. In percent of GDP, compensation of employees is forecast to decline marginally to about 12.5% in 2017 from 12.6% the year before.

Intermediate consumption is forecast to increase by 1.9% mainly due to increases estimated in energy prices for 2017 which, in turn, increase government expenditure on electricity and fuel. In percent of GDP, intermediate consumption is estimated to decline by about 0.1 percentage points of GDP to 3.5% in 2017.

Regarding social transfers other than in kind, these are estimated to increase by 1.0%, contained by a combined drop in unemployment and redundancy payments forecast at 23.7%, in view of the continued improvement in the labour market envisaged under the central macroeconomic scenario of this Programme. The increase in social transfers other than in kind is attributed to increased payments in pensions and other social benefits for the year by about 4.5%. As a percentage to GDP, social transfers other than in kind are estimated to record a decline by 0.4 percentage points, declining to 13.9% of GDP in 2017.

Interest expenditure is forecast to record a decline of 1.5% in 2017, falling, as a percentage of GDP, to 2.5% in 2017 from 2.6% the year before. This development is attributed to the declining trend in the weighted average interest rate on debt.

Gross fixed capital formation is forecast to exhibit an increase at a rate of 15.2%, rising, as a percentage to GDP, by about 0.3 percentage points reaching 2.8% in 2017.

Other expenditure is estimated to exhibit an increase of about 3.4% remaining in 2017, as a percentage to GDP, at the levels of the year before of 2.7%.

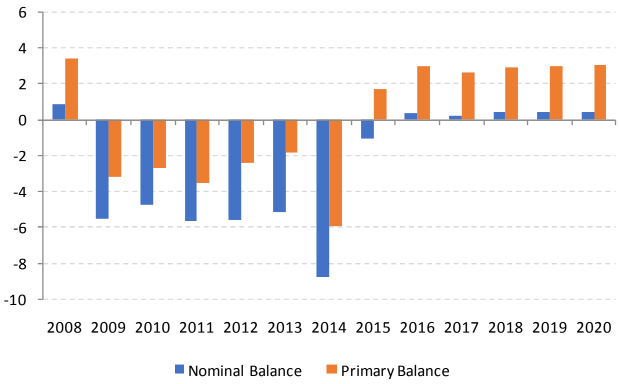
3.5 MEDIUM TERM BUDGET BALANCE 2018-2020

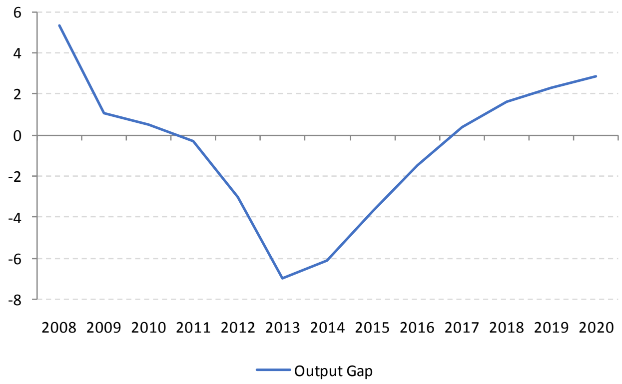
As outlined in the Policy Strategy part of this Chapter, taking stock of the upfront fiscal adjustment that has been achieved, the government aims at maintaining a growth friendly and prudent fiscal policy stance based on conservative macroeconomic assumptions which, locks in the fiscal achievements and the respect of the national MTO over the medium-term. This will result in the maintenance of high primary surpluses for the period 2017-2020, in order for the debt-to-GDP ratio to follow a declining path over the Programme horizon. Overall nominal budget balance will average a surplus position of 0.4% of GDP for the programming period, whereas primary surpluses will average at about 3.0% of GDP.

It should be pointed out that despite the gradual close of the output gap, the nominal balance exhibits a marginal deterioration of about 0.2 percentage points of GDP in 2017 due to the termination of the temporary tax measure on public and private sector's emoluments as from 2017, the phasing in of the VAT Directive on e-services and the residual abolition of the immovable property tax as of 1st January 2017. The overall impact of these measures is estimated at about 0.8% of GDP.

Following a period of recession during 2012-2014, output gap, according to the commonly-agreed methodology of the European Commission, turned negative rising to -3.0%, -7.0% and -6.1% of GDP in 2012, 2013 and 2014, respectively. Under the central macroeconomic scenario adopted in this Programme and based on the commonly-agreed methodology, the Ministry of Finance estimates that the output gap is still in the negative territory in 2015 and 2016 at -3.7% and -1.5% of GDP respectively, and then is forecast to turn positive reaching about 0.4% of potential GDP in 2017, gradually rising to 2.9% of potential output by 2020.

Figure 9: Nominal Balance, Primary Balance and Output Gap (% GDP)





Allocation of expenditure

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

Table XV: Functional classification of expenditure

% of GDP	2010	2011	2012	2013	2014	2015	2016	2020 f.
General public services	9.7	10.2	11.4	10.0	10.0	10.2	10.1	9.5
Defence	2.1	1.8	1.8	1.6	1.4	1.4	1.4	1.3
Public order and safety	2.2	2.0	2.0	2.1	1.7	1.7	1.7	1.6
Economic affairs	3.6	3.6	3.0	2.9	11.3	3.7	2.4	2.2
Environmental protection	0.3	0.3	0.3	0.4	0.3	0.4	0.4	0.6
Housing and community amenities	2.5	2.4	2.1	1.9	2.2	1.8	1.8	1.7
Health	3.0	3.1	3.0	3.1	2.6	2.6	2.6	2.8
Recreation, culture and religion	1.2	1.2	1.0	0.9	0.9	0.9	0.9	0.9
Education	6.7	6.5	6.1	6.5	5.7	5.7	5.6	5.3
Social protection	10.5	11.0	11.3	11.8	12.1	12.0	11.9	11.5
Total expenditure	**41.8**	**42.1**	**41.9**	**41.3**	**48.4**	**40.3**	**38.9**	**37.4**

Structural Balance and Fiscal Stance

One-off and temporary measures 2015-2016

In 2015, the GGBB was burdened with the costs associated with the liquidation of the state-owned airline company which, included the calling of government guarantees provided on loans granted to the company, as well as, providing for the compensation to redundant employees of the company. Overall, the one-off deficit increasing measures materialized in 2015 were estimated at €55 million or 0.3 percent of GDP. In 2016, no temporary or one-off measures were recorded.

The cyclically-adjusted balance and structural balance

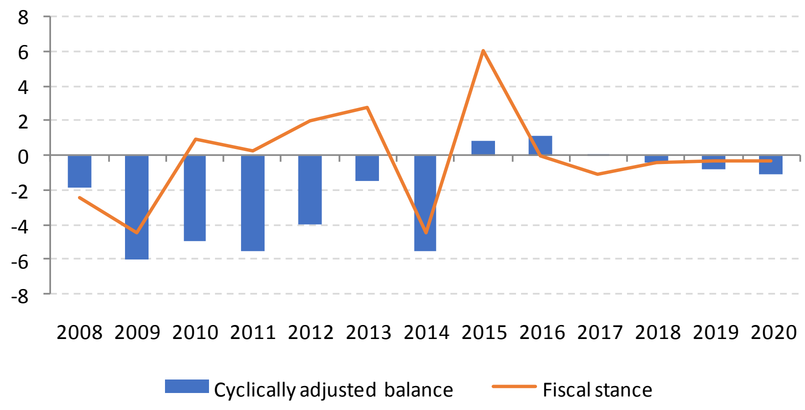
The cyclically-adjusted budget balance is forecast to decline from a surplus of 1.1% in 2016 to a balanced position in 2017. Given the appropriate fiscal stance under the circumstances, the cyclically-adjusted budget balance is projected to turn negative over the programming period reaching at about -1.1% of GDP by 2020 as the output gap widens further. In the absence of one-off and other temporary measures during the programming period, the structural balance path coincides with the cyclically-adjusted balance path.

Table IX: Cyclical developments

in percentage of GDP	2015	2016	2017	2018	2019	2020
Real GDP growth (%)	1.7	2.8	2.9	2.9	2.7	2.7
Net lending of general government	-1.1	0.4	0.2	0.4	0.4	0.4
Interest expenditure	2.8	2.6	2.5	2.5	2.6	2.6
One-off and other temporary measures[1]	-0.3	0.0	0.0	0.0	0.0	0.0
Potential GDP growth (%)	-0.8	0.5	1.0	1.6	2.0	2.1
Output gap	-3.7	-1.5	0.4	1.6	2.3	2.9
Cyclical budgetary component	-1.9	-0.8	0.2	0.8	1.2	1.5
Cyclically-adjusted balance	0.9	1.1	0.0	-0.4	-0.8	-1.1
Cyclically-adjusted primary balance	3.6	3.7	2.5	2.1	1.8	1.5
Structural balance	1.2	1.1	0.0	-0.4	-0.8	-1.1

[1] *Negative sign corresponds to deficit increasing measures*

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



Following the strong fiscal consolidation adopted during the 2012-2014 period, fiscal stance turned positive, reaching 6.0% of GDP in 2015. In 2016, fiscal stance was neutral due to the absence of extraordinary one-off measures, compared to 2015. As fiscal policy adjusts to a path that is marginally negative over the period 2017-2020, fiscal stance is forecast to be marginally negative averaging about -0.4%.

3.7 DEBT MANAGEMENT

The Public Debt Management Strategy 2016-2020

The medium term public debt management strategy (MTDS) extends to a 3-5 year horizon and is endorsed by the Council of Ministers. The presently active Strategy covers the period 2016-2020. It is intended to lead public debt management in the post EU-IMF programme period, which commenced in April 2016. The drafting of the strategy benefited from the IMF-World Bank Guidelines on Public Debt Management, as well as from technical assistance provided by the European Stability Mechanism concerning the internal organisation, the IT infrastructure and the investor relations-market intelligence function of the Public Debt Management Office (PDMO).

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

- smoothening of maturity profile of public debt and extension of maturity of marketable debt;
- risk mitigation through increased cash reserves and management of foreign exchange and interest rate risks;
- development of the government securities markets;
- minimisation of marketable debt borrowing costs.

Concrete actions and, where possible, quantitative targets for each guideline are included in the strategy. The MTDS 2016-2020 has been published in early 2016.

Financing actions in 2016

The year marked the last disbursement from the EU-IMF financing with a tranche of €126 million disbursed in early 2016. Overall, €7.25 billion was utilized from the available Financial Assistance Programme envelop of €10 billion.

The main financing of the year formed the issuance of a new 7-year Euro Medium Term Note of €1 billion at a coupon of 3.75% and yield rate of 3.80%. The benchmark bond added a further point in the sovereign yield curve of Cyprus after the three issuances of the years 2014-2015 and attracted a larger and diversified pool of investors from Europe and the US. Furthermore, two bonds were auctioned in the local market to meet demand by domestic investors. A €75 million 2-year bond at a coupon of 2.00% was priced at a yield of 1.83% while, a €222 million 7-year bond carrying a coupon of 3.25 % was priced at a yield of 3.23%. Finally, the domestic retail product attracted €283 million throughout the year.

The regular 13-week Treasury Bill auctions continued. The weighted average yield was 0.57% recording a gradual decline during the year.

Despite the downwards rally towards the end of 2015 the sovereign yields of Cyprus increased briefly in the first quarter of 2016 peaking around the time of the exit from the Macroeconomic Adjustment Programme in March. Afterwards and despite major events internationally, namely the UK referendum and US election results, the Cyprus bonds demonstrated overall resilience with some short periods of yield steepening. By year end all bonds had tightened in a range between 20 to 103 basis points compared to the beginning of the year. The new bond issued in July maturing in 2023 performed strongly in the secondary market with the year closing 36 basis points tighter than its launch.

Proceeds from the debt issuances where used to conduct liability management operations. Investors were invited to sell their bond holdings to the issuer at market rates. With prices trading above par the investor interest was strong and total debt buybacks amounted to €548 million in nominal terms. They were executed on domestic bonds falling due in the medium term with focus on the years 2019-2020 which mark the peak in maturities. The weighted average coupon of repurchased bonds was 4.91%.

The debt management operations of 2016 contributed positively to the Cyprus' debt portfolio risk targets in line with the Medium-Term Strategy.

The weighted average maturity of total debt improved significantly in the years 2013-2016 reaching 7.4 years compared to an average maturity of 4.7 years at the end of 2012. This improvement is attributed to the official funding by the IMF-ESM loans, as well as to the long-term bond issuances. Indeed, the weighted average maturity of marketable debt was 4.9 years at end 2016 in relation to 2.7 years at the end of 2012. The share of debt that falls due imminently (within 1 year) and in the medium term (within 5 years) improved substantially reducing thereby the debt refinancing risk. By end 2016, the share of debt due within 1 year and 5 years reduced to 4% and 34% respectively, compared to 21% and 76% at end 2012. This outcome is attributed to the asset liability management transactions undertaken during the last couple of years which strategically intended to improve the debt maturity profile.

The weighted average cost of outstanding debt was 2.3% at end 2016 compared to 4.2% at end 2012. The cost has benefited significantly from the low interest rates of ESM/IMF loans and the current market rates which impact new issuances and older floating-rate debt indexed on Euribor.

The interest rate distribution of debt has changed significantly since 2013 due to the financing provided by the ESM and IMF at floating interest rates. By the end of 2016 the fixed-rate debt was 54% and the floating-rate debt was 46% compared to 88% and 12% respectively at the end of 2012. Despite its sharp increase the floating-rate debt relates to loans by supranationals (ESM, IMF, EIB) and commercial long-term bank loans with low margins over the basis. The fiscal impact from a potential interest rate increase is thus contained.

Table X: Net annual financing by source in 2016

	€ million
Government Securities	**401**
Treasury Bills	(100)
Retail bonds	278
Domestic bonds	(607)
EMTNs	830
Loans	**(60)**
Total net annual financing	**341**

The composition of the general government debt at end 2016 was as follows:

- Short-term public debt comprised 2% of total debt
- The distribution among loans and securities was 67% and 33% respectively
- The share of fixed interest rates in the public debt stock was 54%
- Public debt denominated in euro was 95%.

As presented in Table X, the net annual financing by source in 2016 was €341 million. The net financing shows the year's debt issuance minus the debt redemptions for the respective instrument.

Financing in 2017

The total financing needs of 2017 are estimated at €1.2 billion, of which 67% relates to debt redemptions and 33% concerns cash accumulation for pre-financing 2018. Cyprus is considering accessing the international market over 2017 with one benchmark new bond subject to market conditions in order, primarily to maintain cash reserves to a level sufficient to prefund the 2018 financing needs and, secondly, to enhance its re-established market presence. The syndicated international bond issuance will aim additionally to further develop the international bond yield curve, an effort which has been initiated in 2014 and has so far created five benchmark yield points. The expected issuance volume will be of the order of €0.5 billion. Moreover, a domestic seven-year bond of €0.3 billion was issued in January 2017 at a 3.25% coupon rate. The domestic Treasury Bill auctions are expected to provide on an annual basis €0.3 billion in order to roll over last year's stock. The annual financing will be completed through proceeds from the domestic retail bond and disbursements by the European Investment Bank for ongoing infrastructure projects.

The grade of completion of the financing plan 2017 at the end of first quarter 2017 was 25% with size of the cash buffers sufficient to cover the financing needs for the following 12-month period.

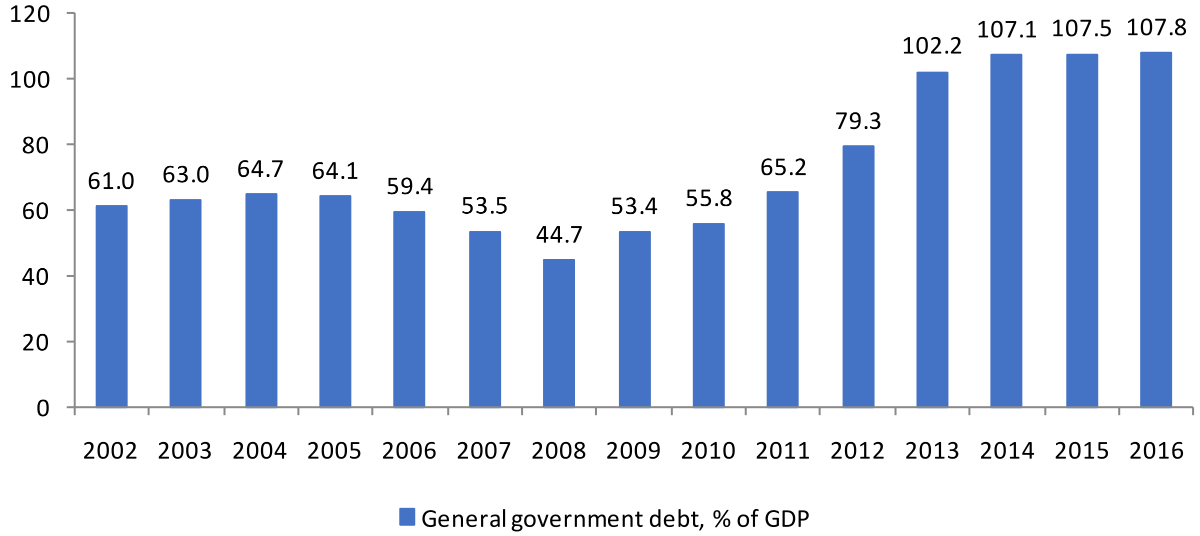
Table XI: Financing plan for 2017

Financing needs	**€ billion**
Short term treasury bills	0.3
Long-term bonds & loans	0.4
Cash accumulation	0.4
Total	**1.2**
Financing sources	**€ billion**
Treasury Bills rollover	0.3
Domestic bonds	0.3
Other sources (Retail bonds, EIB loans)	0.1
EMTN	0.5
Total	**1.2**

Note: Figures may not add due to rounding

As presented in Figure 11 below, the general government debt-to-GDP ratio in 2016 increased marginally to 107.8% from 107.5% in 2015, as a result of the accumulation of cash reserves. In absolute terms, general government debt remained broadly unchanged in the last two years reaching to about €19.3 billion at the end of 2016 which was marginally above the debt level at the end of 2015 of €19.0 billion.

Figure 11: Debt ratio



Debt developments

General government debt is projected at €19.4 billion or as a percentage to GDP at 104.0% at the end of 2017. The debt ratio in 2017 vis-à-vis the year before is forecast to decline by about 3.8 percentage points of GDP. Over the programming period 2017-2020, debt-to-GDP ratio is projected to exhibit a downward trend declining to about 99.7%, 94.6% and 88.8% by year end 2018, 2019 and 2020 respectively. The reduction in the debt-to-GDP ratio satisfies the debt criterion of the Stability and Growth Pact (SGP) which, states that for Member States that breach the 60% reference rate for the debt-to-GDP, an annual reduction should be safeguarded of at least 5% of the part of the benchmark value being in excess of the 60% reference rate (averaged over three years).

Table XII: General government debt 2016-2020

in percentage of GDP	2016	2017	2018	2019	2020
Gross debt ratio	107.8	104.0	99.7	94.6	88.8
Change in debt ratio	1.9	0.5	-0.3	-1.1	-1.5
Primary balance	3.0	2.6	2.9	3.0	3.0
Interest expenditure	2.6	2.5	2.5	2.6	2.6
Stock-flow adjustment	2.2	0.7	0.1	-0.6	-1.1

The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called “snow ball” effect. The positive stock flow adjustment in 2016, equivalent to 2.2% of GDP, reflects financial transactions undertaken by government in the form of currency and deposits accumulation, as well as financial transactions related to provision of loans to third parties. In 2017, the stock flow adjustment remains positive at about 0.7% of GDP owing to the accumulation of financial assets in the form of currency and deposits for pre-funding 2018 financing needs.

The contribution of SFA is projected to remain positive also in 2018 at around 0.1% of GDP and turn negative in 2019 and 2020 reaching 0.6% and 1.1% of GDP respectively, implying a decumulation of financial assets.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

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

Macroeconomic risks

The evolution in oil prices were a positive gain for households and businesses, strengthening domestic demand and lowering input costs, increasing the competitiveness of firms. The risk is associated with the evolution in oil prices, and specifically if oil prices rebound faster than the central scenario assumption. The high level of NPLs also poses a risk to the economy, especially if their amelioration is slower than envisaged. At the same time, faster debt repayment will weigh on private consumption.

From the perspective of the external macroeconomic environment, risks are related with developments in Greece, although the contagion risk is very low for Cyprus, developments in the UK economy following the decision to withdraw from the EU, as well as developments regarding Russia's relations and possible repercussions that could impact the euro-ruble exchange rate.

Fiscal Risks

Fiscal outcomes are correlated to the macroeconomic outcomes, which in turn affect primary balances, and are also affected by the evolution in interest rates.

The evolution of primary revenues and expenditure forms the basis for the primary balance forecast, along with the evolution of GDP. Risks to the primary balance forecast can arise especially from a different than expected outcome in tax revenues, or from unanticipated outcomes in primary expenditure.

The forecast on interest expenditure is based on both the existing stock of debt and projected debt issuance over the forecast horizon. Any unanticipated increase in the cost of borrowing represents a downside risk to the public finance forecast.

Contingent Liabilities

Government guarantees at the end of 2016 amounted to around €2.0 billion, representing almost 11.3% of GDP. Out of these, an amount of €0.3 billion, or 1.8% of GDP, is already accounted for in the general government debt; the remaining amount of €1.7 billion represents contingent liabilities, €0.2billion of which account for liabilities connected to the European Financial Stability Facility. Net of these, guarantees at the end of 2016 amount to about €1.5 billion, representing 8.4% of GDP.

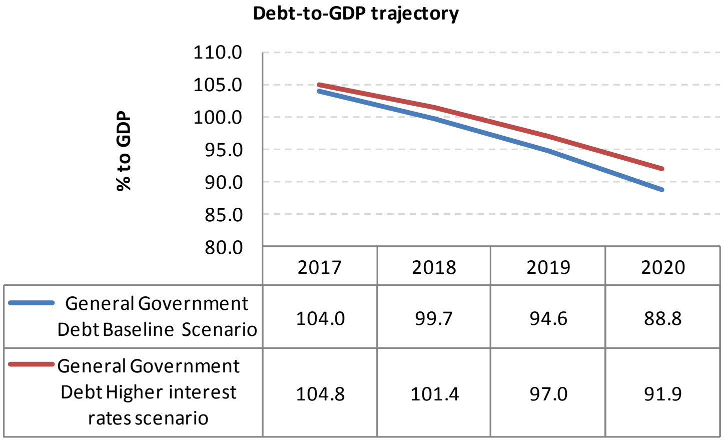
Sensitivity analysis

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

Scenario 1: Higher interest rate by 50 basis points annually

The first scenario assumes higher interest rates than the baseline scenario for each year over the programming period. In particular, the real interest rate increases by half of the 10-year historical standard deviation. Under this scenario, only the trajectory of general government public debt is affected which, however, continues to present a downward trend, declining to around 91.9% by 2020, compared to 88.8% under the baseline scenario.

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

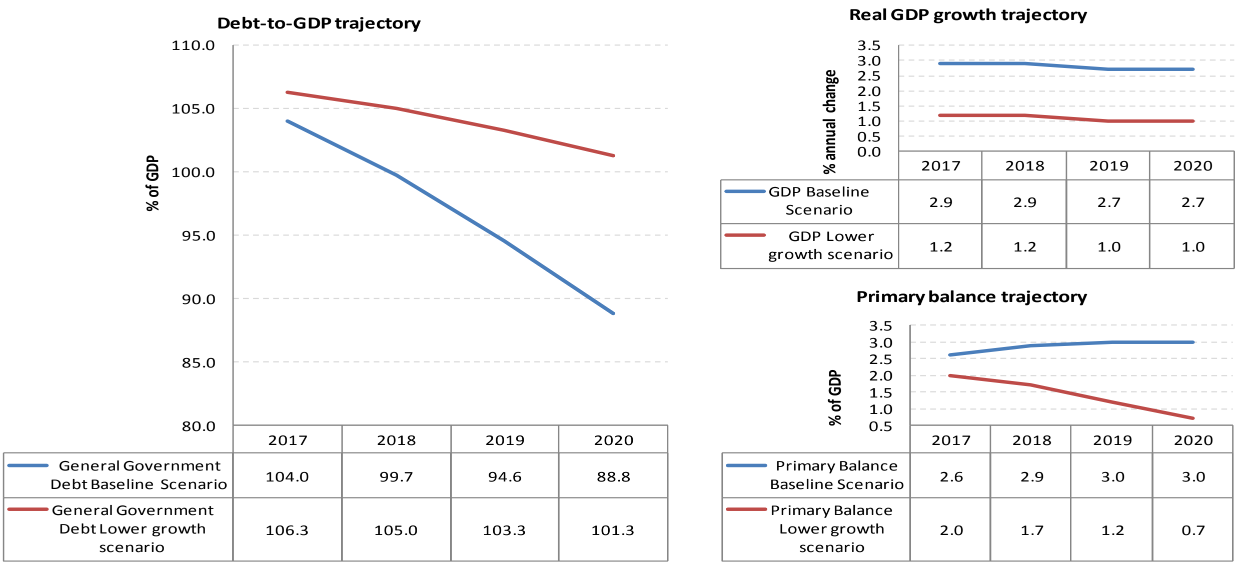


	2017	2018	2019	2020
General Government Debt Baseline Scenario	104.0	99.7	94.6	88.8
General Government Debt Higher interest rates scenario	104.8	101.4	97.0	91.9

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

Under this scenario, real growth in GDP is assumed to be lower by half of the 10-year standard deviation, for each year over the programming period, compared with the baseline scenario. Along with the real growth trajectory, Figure 13 below presents the trajectories for debt-to-GDP ratio and primary balance as percentage of GDP for the period 2016-2019. The debt ratio still projects a sustainable downward path over the medium term, declining to 101.3% by 2020.

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



	2017	2018	2019	2020
General Government Debt Baseline Scenario	104.0	99.7	94.6	88.8
General Government Debt Lower growth scenario	106.3	105.0	103.3	101.3

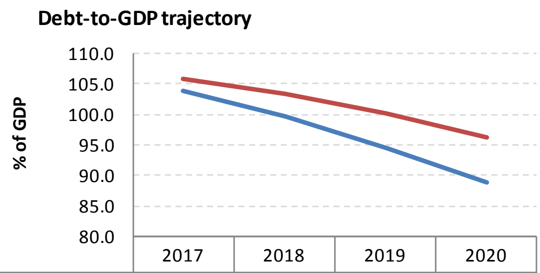
	2017	2018	2019	2020
GDP Baseline Scenario	2.9	2.9	2.7	2.7
GDP Lower growth scenario	1.2	1.2	1.0	1.0

	2017	2018	2019	2020
Primary Balance Baseline Scenario	2.6	2.9	3.0	3.0
Primary Balance Lower growth scenario	2.0	1.7	1.2	0.7

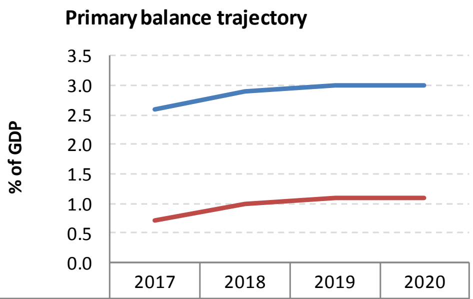
Scenario 3: Lower primary balance by half of the 10-year historical standard deviation

In the third scenario, primary balance as a percentage of GDP is reduced by half of the 10-year historical standard deviation for each year over the programming period. Under this scenario, even though the debt to GDP in 2020 is expected to be higher than the baseline, there is still a downward trend, where debt ratio declines to 96.2% by 2020.

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



	2017	2018	2019	2020
General Government Debt Baseline Scenario	104.0	99.7	94.6	88.8
General Government Debt Lower primary balance scenario	105.9	103.5	100.2	96.2

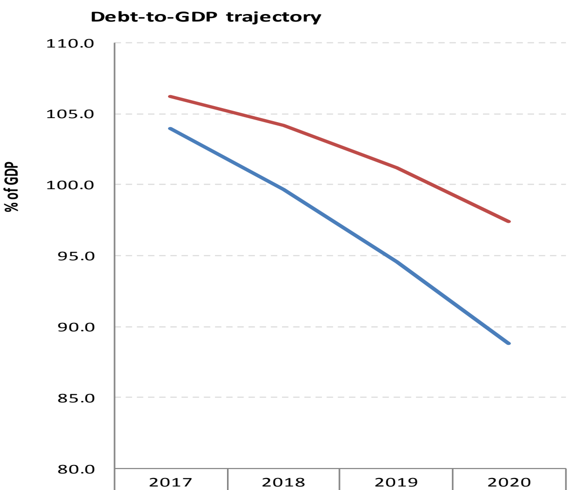


	2017	2018	2019	2020
Primary Balance Baseline Scenario	2.6	2.9	3.0	3.0
Primary Balance Lower primary balance scenario	0.7	1.0	1.1	1.1

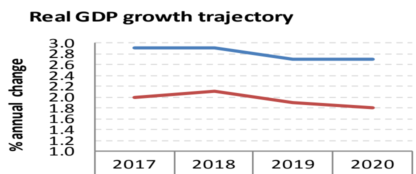
Scenario 4: Combination scenario

The combination scenario assumed that shocks occur simultaneously on real interest rates, real growth and in primary balance, of the order of 1/4 of their 10-year historical standard deviation. Under this scenario, even though the debt to GDP in 2020 is expected to be higher than the baseline, there is still a downward trend, declining to 97.4% by 2020.

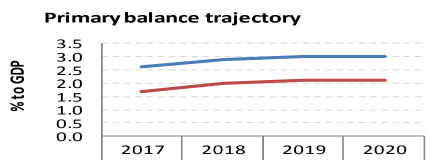
Figure 15: Debt to GDP, real GDP growth and primary balance as % of GDP trajectories under the combination sensitivity scenario



	2017	2018	2019	2020
General Government Debt Baseline Scenario	104.0	99.7	94.6	88.8
General Government Debt Combination scenario	106.2	104.2	101.2	97.4



	2017	2018	2019	2020
GDP Baseline Scenario	2.9	2.9	2.7	2.7
GDP Combination scenario	2.0	2.1	1.9	1.8



	2017	2018	2019	2020
Primary Balance Baseline Scenario	2.6	2.9	3	3.0
Primary Balance Combination scenario	1.7	2.0	2.1	2.1

5. SUSTAINABILITY OF PUBLIC FINANCES

Chapter 5 illustrates the overall situation as regards to the sustainability of public finances. In this chapter a more detailed analysis is performed on the projected development of the General Social Insurance Scheme (GSIS) and other public age-related expenditures, as well as the future evolution of the general government expenditures and revenues. For the purposes of this analysis, it is assumed that the budgetary situation evolves in line with the Stability Programme targets of 2017-2020. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2020 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government balance.

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

The amendment to the Social Insurance Law N.193(I)/ 2012, which was enacted on December 21st, 2012, introduced the following reform measures that were phased in gradually and aim to secure the long-term viability of the GSIS:

- As of January 1st 2013, actuarial reduction of pension entitlements from the GSIS by 0.5% per month for retirements earlier than the statutory retirement age of 65 years;
- Freeze of pensions (all types) under the GSIS for the period 2013-2016;
- Abolishment of the increase of pensions for a working dependent spouse under the GSIS as of 1 January 2013 (this applies only to new pensioners);
- Stricter eligibility conditions to old-age pension - as of 1 April, 2013 gradual extension of the minimum contributory period (one year per year) from the current 10 to 15 years over the period 2013-17;
- Increase of contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point (p.p.) of the increase which was legislated to take effect in 2014 as per 2009 GSIS reform – the above increase is distributed as follows: 0.5 p.p. from salaried employees and 0.5 p.p. from employers and 1 p.p. in the case of self-employed persons; and
- Introduction of an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy, to be applied for the first time in 2018 and the first revision will cover the period 2018-2023.

The pension projections incorporate a series of GEPS amendments as a result of the enactment of the amendment to the Pension Law N.216(I)/ 2012 in December, 2012 which, refer to the following reform measures aiming in the containment of the future increase in the GEPS:

- Closing of the scheme for new entrants to the public and broader public sector as of October 2011;
- Pension Benefit - the pension calculated for any service after the 1st of January 2013, will be based on the career average salary, revalued based on the changes of the Basic Insurable Earnings under the GSIS;
- Lump Sum Benefit - the factor for calculating the lump sum benefit for service derived as from January 1st, 2013, will be based on a factor of 14/3, irrespective of the total period of service;
- Normal Retirement Ages - early and normal retirement ages are gradually increased. Normal retirement age is gradually extended by 2 years;

- Early Retirement Reduction Factors - early retirement pensions accrued for service derived as from 1/1/2013 are actuarially reduced based on the period from the early retirement date to the statutory retirement date;
- Taxation of Lump Sum Benefit - the portion of the lump sum benefit which corresponds to the service after 1/1/2013 is taxable; and
- Commutation of Lump Sum Benefit - members have the option to commute part or all of their lump sum benefit into an annuity.

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

Note that public pension projections as included in this Stability Programme cover the pension expenditure of the GSIS, GEPS and Social Pension Scheme (SPS), which in total represent approximately 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 2015-2060. The main elements of the analysis are the long-term projections for public pensions, health long-term care and education expenditures. The base year for the projections is 2015[2] 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 primarily based on the latest available commonly agreed assumptions of the EPC-Ageing Working Group (AWG).

Table XIII, presents the key demographic and labour market assumptions used for the purposes of this year's Stability Programme exercise. These assumptions[3] are in line with those used in the 2015 Ageing Report: Underlying Assumptions and Projection Methodologies (published in November 2014) with certain adjustments made to reflect the recent experience.

Table XIII: Basic Demographic and Labour Market assumptions 2015-2060

	2015	2020	2030	2040	2050	2060
Total Fertility Rate	**1.33**	**1.39**	**1.46**	**1.51**	**1.56**	**1.59**
Life Expectancy at birth						
Males	79.4	80.1	81.5	82.8	84.1	85.2
Females	83.6	84.3	85.5	86.7	87.8	88.9
Participation Rates (15-64)	**74.5**	**77.6**	**77.7**	**77.9**	**78.8**	**78.6**
Males (15-64)	80.8	83.2	82.7	82.7	83.3	83.0
Females (15-64)	68.5	72.3	72.9	73.1	74.1	74.1
Net migration (thousand)	**-10.4**	**-0.3**	**2.8**	**6.0**	**8.8**	**7.9**

Regarding the population projections, the population growth is projected at around 24% in the time period 2015-2060, which is among the strongest population increase among the EU countries. Fertility rates, which

[2] For pensions, health care and education the base year is 2014 and for long-term care the base year is 2013 since no data are yet available until 2015.

[3] The projection period from the 2015 AWG report is 2015-2060.

have decreased between 2000 and 2014, are now projected to increase over the projection period from 1.33 in 2015 to 1.59 in 2060. Life expectancy also increases significantly. Gains in life expectancies over this period are for males 5.8 years and for females 5.3 years.

On the labour market, the total participation rate (15-64) is expected to increase by 4.1 p.p. between 2015-2060, mainly due to the increase in female participation rates (2.2 p.p. for males and 5.6 p.p. for females). Unemployment rate is expected to decline and stabilize at a low rate as from 2039. Table XIV presents the aggregate results of the projections for the public pension expenditure and the contributions over the period 2010-2060.

Table XIV: Projected public pension expenditure, contributions and reserves

in per cent of GDP	2010	2020	2030	2040	2050	2060
Total Expenditure[1]	6.9	9.2	9.7	9.9	9.4	9.5
Total Amount of Contributions[2]	7.0	7.1	8.3	9.3	9.2	8.9
Reserves of the GSIS	36.2	38.1	35.8	36.8	40.0	38.0

[1] Expenditure represents pension spending under GSIS, GEPS and SPS.

[2] Contributions arising from GSIS legislated schedule of contribution rates and GEPS employee contribution rate.

Results indicate a moderate increase in public pension spending of about 0.3% of GDP during 2020-2060. By 2050 contributions as a percent of GDP increase by 2.0 p.p. from 2020 with the excess of expenditure over contributions contained at relatively low level up to 2050.

In particular, total public pension expenditures are projected to increase from 6.9% of GDP in 2010 to 9.9% of GDP in 2040 and 9.5% of GDP by 2060. At the same time, contributions increase from 7.0% of GDP in 2010 to 9.3% of GDP over the period 2040 and reach 8.9% GDP by 2060. The low increase in public pension expenditures as a percentage of GDP over the period 2020-2060 is explained mainly by the 2012 pension reform, the demographics and the improved macroeconomic assumptions.

The accumulated reserve of the GSIS, peaked in 2015 reaching about 42.1% of GDP. From 2015 onwards, the GSIS reserves are expected to exhibit a gradual decline falling to about 38.0% of GDP by 2060.

In total, all age-related expenditure including spending on healthcare and education – which are based on the projection methodologies and assumptions of the EPC-AWG as adopted in 2014 for the purposes of the 2015 Ageing Report – are projected to increase from 18.1% in 2010 and then remain relatively stable over the period 2020-2060, hovering at around 20.1% of GDP.

Health care expenditure is projected to marginally increase by 0.2 p.p. between 2013-2060, increasing from 3.0% of GDP in 2013 to about 3.2% in 2060. Long-term care expenditure is also projected to marginally increase from 0.3% of GDP in 2013 to 0.5% in 2060. This marginal increase is due to demographic factors and ageing population.

In contrast, education expenditure are projected to decrease during the period until 2060 to about 6.1% of GDP by 2060. This decrease is also due to demographic factors and the change in the age structure of the population.

Other age-related expenditures are expected to remain stable at 0.8% of GDP across the projection period as it was during the last year with available information.

On the revenue side, property income is expected to remain stable at 0.9% of GDP across the projection period as it is projected to be in 2020. In contrast, pension contributions are expected to increase by 1-1.1% of GDP each decade between 2020-2040, and finally decrease by 0.2 p.p. of GDP in 2060.

As a result of the above, total general government expenditure will decrease from 41.8% of GDP in 2010 to 37.3% of GDP by 2060. General government revenue is projected to increase from 37.0% of GDP in 2010 to around 39.7% of GDP in 2060.

Table 1a. Macroeconomic prospects

		2016	2016	2017	2018	2019	2020
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	15,789.9	2.8	2.9	2.9	2.7	2.7
2. Nominal GDP	B1*g	17,901.4	1.5	4.2	4.0	4.2	4.7
Components of real GDP							
3. Private consumption expenditure	P.3	10,677.7	2.9	2.3	2.3	2.3	2.3
4. Government consumption expenditure	P.3	2,529.7	-1.4	0.8	0.3	0.0	0.0
5. Gross fixed capital formation	P.51	2,697.4	25.9	0.2	6.5	5.2	5.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-68.0	-1.5	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	9,930.3	3.6	3.0	3.5	3.5	3.5
8. Imports of goods and services	P.7	9,977.3	5.3	1.0	3.2	3.2	3.2
Contributions to real GDP growth							
9. Final domestic demand		15,904.8	5.3	1.7	2.7	2.4	2.4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-68.0	-1.5	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-47.0	-1.0	1.2	0.2	0.3	0.2

Table 1b. Price developments

	ESA Code	2016 Level	2016 rate of change	2017 rate of change	2018 rate of change	2019 rate of change	2020 rate of change
1. GDP deflator		113.4	-1.3	1.3	1.0	1.5	2.0
2. Private consumption deflator		116.8	-1.1	1.3	1.0	1.5	2.0
3. HICP[1] [2015=100]		98.8	-1.2	1.1	1.0	1.5	2.0
4. Public consumption deflator		107.6	-0.4	2.2	1.8	2.1	2.2
5. Investment deflator (GFCF)		111.3	1.8	1.3	1.8	1.9	2.0
6. Export price deflator (goods and services)		111.8	-0.8	1.3	1.0	1.5	2.0
7. Import price deflator (goods and services)		112.0	-1.2	1.6	1.4	1.8	2.0

Table 1c. Labour market developments

	ESA Code	2016 Level	2016 rate of change	2017 rate of change	2018 rate of change	2019 rate of change	2020 rate of change
1. Employment, persons (thousands)[1]		379.8	2.7	2.2	2.0	1.7	1.7
2. Employment, hours worked[2] (thousands)		679,884	2.7	2.2	2.0	1.7	1.7
3. Unemployment rate (%)[3]		54,935	13.0	11.5	10.0	8.5	7.0
4. Labour productivity, persons[4]		--	0.1	0.7	0.9	1.0	1.0
5. Labour productivity, hours worked[5]		--	0.1	0.7	0.9	1.0	1.0
6. Compensation of employees (€ million)	D.1	8,035.7	2.2	3.5	3.7	3.8	4.1
7. Compensation per employee		24,074	-0.6	1.3	1.7	2.1	2.4

[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	2016	2017	2018	2019	2020
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.3	-4.5	-4.3	-4.1	-3.7
of which:						
- Balance on goods and services		*0.0*	*0.6*	*0.6*	*0.6*	*0.7*
- Balance of primary incomes and transfers		*-5.3*	*-5.0*	*-4.9*	*-4.7*	*-4.5*
2. Net lending/borrowing of the private sector	B.9	-5.7	-4.7	-4.7	-4.5	-4.1
3. Net lending/borrowing of general government	EDP B.9	0.4	0.2	0.4	0.4	0.4
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Table 2a: General government budgetary prospects

% of GDP	ESA Code	2016*	2016	2017	2018	2019	2020
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	64.4	0.4	0.2	0.4	0.4	0.4
2. Central government	S.1311	41.1	0.2	0.1	0.3	0.3	0.3
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	2.2	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	21.1	0.1	0.1	0.1	0.1	0.1
General government (S13)							
6. Total revenue	TR	7,019.4	39.2	38.6	38.4	38.4	37.9
7. Total expenditure	TE[1]	6,955.0	38.9	38.4	38.0	38.0	37.4
8. Net lending/borrowing	EDP B.9	64.4	0.4	0.2	0.4	0.4	0.4
9. Interest expenditure	EDP D.41	464.7	2.6	2.5	2.5	2.6	2.6
10. Primary balance[2]		529.1	3.0	2.6	2.9	3.0	3.0
11. One-off and other temporary measures[3]		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		4,488.2	25.1	24.1	24.0	23.9	23.7
12a. Taxes on production and imports	D.2	2,732.8	15.3	15.1	15.0	14.9	14.8
12b. Current taxes on income, wealth, etc	D.5	1,755.3	9.8	9.0	9.0	9.0	8.9
12c. Capital taxes	D.91	0.1	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1,537.5	8.6	8.7	8.8	9.5	9.6
14. Property income	D.4	190.4	1.1	1.1	1.0	0.9	0.9
15. Other[4]		803.3	4.5	4.7	4.5	4.1	3.8
16=6. Total revenue	TR	7,019.4	39.2	38.6	38.4	38.4	37.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		6,025.7	33.7	32.8	32.9	33.3	33.2
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	2,901.5	16.2	16.1	15.8	15.6	15.3
17a. Compensation of employees	D.1	2,256.0	12.6	12.5	12.3	12.2	12.0
17b. Intermediate consumption	P.2	645.5	3.6	3.5	3.5	3.4	3.3
18. Social payments (18=18a+18b)		2,563.2	14.3	13.9	13.6	13.3	13.1
of which Unemployment benefits[6]		85.2	0.5	0.4	0.3	0.3	0.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	5.1	0.0	0.1	0.1	0.0	0.0
18b. Social transfers other than in kind	D.62	2,558.1	14.3	13.9	13.6	13.3	13.0
19=9. Interest expenditure	EDP D.41	464.7	2.6	2.5	2.5	2.6	2.6
20. Subsidies	D.3	97.2	0.5	0.5	0.5	0.5	0.4
21. Gross fixed capital formation	P.51	447.2	2.5	2.8	2.8	3.2	3.2
22. Other[6]		481.2	2.7	2.7	2.8	2.8	2.8
23=7. Total expenditure	TE[1]	6,955.0	38.9	38.4	38.0	38.0	37.4
p.m.: Government consumption (nominal)	P.3	2,756.3	15.4	15.3	15.1	14.9	14.6

[*] in million of €

[1] TR-TE=B.9.

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

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

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

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

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

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

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

	ESA	2016 Level	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
1. Total revenue at unchanged policies		7,019.4	39.2	38.6	38.4	38.4	37.9
2. Total expenditure at unchanged policies		6,955.0	38.9	38.4	38.0	38.0	37.4

Table 2c. Amounts to be excluded from benchmark

	2016 Level (€ million)	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	160.3	0.9	0.8	0.7	0.7	0.7
2. Cyclical unemployment benefit expenditure	16.7	0.1	0.0	0.0	0.0	0.0
3. Effect of discretionary revenue measures	0.0	0.0	0.0	0.0	0.0	0.0
4. Revenue increases mandated by law	0.0	0.0	0.0	0.0	0.0	0.0

Table 3. General Government expenditure by function

% of GDP	**COFOG Code**	**2015**	**2020**
1. General public services	1	10.2	9.5
2. Defence	2	1.4	1.3
3. Public order and safety	3	1.7	1.6
4. Economic affairs	4	3.7	2.2
5. Environmental protection	5	0.4	0.6
6. Housing and community amenities	6	1.8	1.7
7. Health	7	2.6	2.8
8. Recreation, culture and religion	8	0.9	0.9
9. Education	9	5.7	5.3
10. Social protection	10	12.0	11.5
11. Total expenditure (=item 3=22 in Table 2a)	TE	40.3	37.4

2015: including the equity injection to restore the capital base of the Cooperative Central Bank (€175 million)

Table 4. General government debt developments

% of GDP	ESA Code	2016	2017	2018	2019	2020
1. Gross debt		107.8	104.0	99.7	94.6	88.8
2. Change in gross debt ratio		1.9	0.5	-0.3	-1.1	-1.5
Contributions to changes in gross debt						
3. Primary balance	B.9+D.41	3.0	2.6	2.9	3.0	3.0
4. Interest expenditure	D.41	2.6	2.5	2.5	2.6	2.6
5. Stock-flow adjustment		2.2	0.7	0.1	-0.6	-1.1
of which:						
- Differences between cash and accruals		-0.7	0.0	0.0	0.0	0.0
- Net accumulation of financial assets		2.9	0.7	0.1	-0.6	-1.1
p.m.: Implicit interest rate on debt		2.5	2.4	2.5	2.7	2.9
6. Liquid financial assets8		33.9	33.2	32.1	30.1	27.7
7. Net financial debt (7=1-6)		73.9	70.7	67.7	64.5	61.1

Table 5. Cyclical Developments

% of GDP	ESA Code	2016	2017	2018	2019	2020
1. Real GDP growth (%)		2.8	2.9	2.9	2.7	2.7
2. Net lending of general government	B.9	0.4	0.2	0.4	0.4	0.4
3. Interest expenditure	D.41	2.6	2.5	2.5	2.6	2.6
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		0.5	1.0	1.6	2.0	2.1
contributions:						
- labour		0.1	0.4	0.6	0.6	0.6
- capital		0.4	0.4	0.5	0.6	0.7
- total factor productivity		0.0	0.3	0.6	0.8	0.9
6. Output gap		-1.5	0.4	1.6	2.3	2.9
7. Cyclical budgetary component		-0.8	0.2	0.8	1.2	1.5
8. Cyclically-adjusted balance (2 - 7)		1.1	0.0	-0.4	-0.8	-1.1
9. Cyclically-adjusted primary balance (8 + 3)		3.7	2.5	2.1	1.8	1.5
10. Structural balance (8 - 4)		1.1	0.0	-0.4	-0.8	-1.1

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

Table 6. Divergence from previous update

	ESA Code	2016	2017	2018	2019	2020
Real GDP growth (%)						
Previous update		2.2	2.5	2.5	2.5	n.a.
Current update		2.8	2.9	2.9	2.7	2.7
Difference		0.6	0.4	0.4	0.2	
General government net lending (% of GDP)	B.9					
Previous update		-0.4	-0.5	-0.2	0.4	n.a.
Current update		0.4	0.2	0.4	0.4	0.4
Difference		0.8	0.7	0.6	0.0	
General government gross debt (% of GDP)						
Previous update		105.6	101.7	97.8	90.5	n.a.
Current update		107.8	104.0	99.7	94.6	88.8
Difference		2.2	2.3	1.9	4.1	

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	37.4	41.8	37.4	37.4	37.2	36.9	37.3
Of which: **age-related expenditures**	15.2	18.1	20.2	20.1	20.0	19.6	20.1
Pension expenditure	6.0	6.9	9.2	9.7	9.9	9.4	9.5
Social security pension	4.0	4.8	7.0	8.2	8.8	9.0	9.4
Old-age and early pensions	2.9	3.6	5.3	6.3	6.8	7.1	7.7
Other pensions (disability, survivors)	1.1	1.2	1.7	1.9	2.0	1.9	1.6
Occupational pensions (if in general government)[1]	2.0	2.1	2.2	1.5	1.1	0.4	0.1
Health care	2.6	3.0	3.2	3.1	3.3	3.3	3.2
Long-term care	0.2	0.2	0.3	0.4	0.4	0.5	0.5
Education expenditure[2]	5.7	6.7	6.8	6.1	5.5	5.6	6.1
Other age-related expenditures	0.7	1.3	0.8	0.8	0.8	0.8	0.8
Interest expenditure[3]	...	...	...	...	...	...	...
Total revenue	40.6	37.0	37.9	39.0	40.0	39.9	39.7
Of which: property income	0.6	1.4	0.9	0.9	0.9	0.9	0.9
Of which: from pensions contributions (or social contributions if appropriate)	5.8	7.0	7.1	8.3	9.3	9.2	8.9
Pension reserve fund assets	32.7	36.2	38.1	35.8	36.8	40.0	38.0
Of which: consolidated public pension fund assets (assets other than government liabilities)	...	...	...	...	...	...	...
Systemic pension reforms							
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	-0.7	1.1	1.7	1.6	1.8	1.7	1.6
Real GDP growth	4.9	1.4	2.5	2.3	2.3	2.3	2.3
Participation rate males (aged 15-64)	82.9	80.4	83.2	82.7	82.7	83.3	83.0
Participation rates females (aged 15-64)	65.4	67.4	72.3	72.9	73.1	74.1	74.1
Total participation rates (aged 15-64)	73.9	73.6	77.6	77.7	77.9	78.8	78.6
Unemployment rate (15+)	3.9	6.3	8.5	7.2	4.8	4.8	4.8
Population aged 65+ over total population	12.4	12.7	16.3	20.5	23.1	25.5	26.8

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

Table 7a. Contingent liabilities

% of GDP	2016	2017
Public guarantees	11.3	10.9
Of which: linked to the financial sector	0.0	0.0

Table 8. Basic assumptions

	2016	2017	2018	2019	2020
EA: Short-term interest rate (3-months money markets)	-0.26	-0.30	-0.14	-	-
EA: Long-term interest rate (10-year government bonds, Germany)	0.09	0.38	0.59	0.59	0.59
USD/€ exchange rate (annual average)	1.11	1.07	1.08	1.08	1.08
Nominal effective exchange rate of the EU (% change)	0.29	-0.18	0.02	-	-
World growth excluding EU (in PPP terms)	3.2	3.7	3.9	3.9	3.9
EU GDP growth	1.9	1.8	1.8	1.8	1.8
Growth of relevant foreign markets [USA]	1.6	2.2	2.3	2.3	2.3
World import volumes, excluding EU	0.9	3.0	3.8	3.8	3.8
Oil prices (Brent. USD/barrel)	44.8	53.5	53.2	53.2	53.2