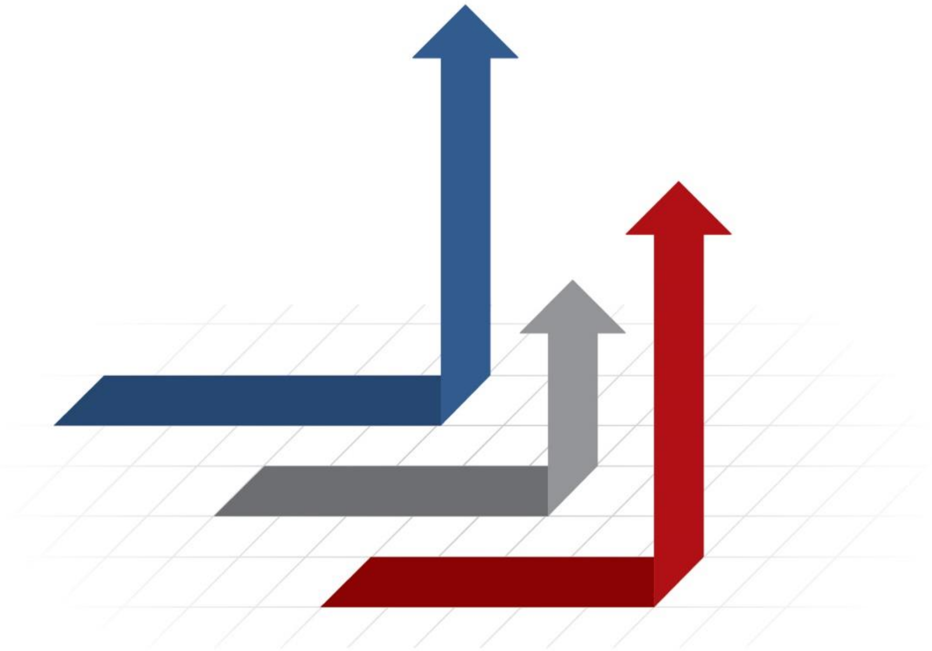
MINISTRY OF FINANCE

STABILITY PROGRAMME UPDATE 2021-2024



APRIL 2021

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PREFACE

In accordance with the provisions of the Stability and Growth Pact (SGP), the Republic of Cyprus submits its Stability Programme (SP) for the period 2021-2024 as approved by the Council of Ministers on 22nd April 2021. 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 been submitted to the European Commission on 30th April 2021 in accordance with the requirements of the European Semester and takes into account the key policy orientations provided in the Annual Sustainable Growth Survey.

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

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

The analysis and forecasts contained in this document are based on data available at end- March 2021. The macroeconomic forecasts contained herein have been endorsed by the Fiscal Council.

CHAPTER 1: OVERALL POLICY FRAMEWORK AND OBJECTIVES

The structure and content of this Stability Programme follows the requirements of the Code of Conduct and presents the macroeconomic and budgetary outlook for the forecasting horizon 2021-2024, taking into account the application of the general escape clause of the SGP that has been activated on 20th March 2020.

The general escape clause, following the European Commission Communication adopted on 3rd March 2021, will continue to apply in 2021 and current preliminary indications suggest it will continue to apply and be de-activated as of 2023. As part of the European Semester spring package in May 2020, and following a dialogue between the Council and the Commission, the Commission will assess the deactivation or continued activation of the general escape clause on the basis of the 2021 Spring Forecast. Country-specific situations will continue to be taken into account after the deactivation of the general escape clause. In case a Member State has not recovered to the pre-crisis level of economic activity, all the flexibilities within the SGP will be fully used, in particular when proposing fiscal policy guidance.

Rather than treating measures taken to contain the COVID-19 outbreak, including the direct cost to contain the pandemic and measures designed to limit the socio-economic effects of the pandemic as one-offs, the Commission proposes that Member States present them under the General Escape Clause. This approach is favoured because the General Escape Clause allows Member States to undertake the measures necessary to deal adequately with the crisis, while departing from the budgetary requirements that would normally apply under the Union’s fiscal framework. Therefore, this is the approach followed in this Stability Programme Update.

1.1 Policy Strategy

The outbreak of the pandemic in early 2020 posed a very significant health risk that required immediate response in order to avoid the collapse of the national health system and a devastating loss of lives. In order to halt the spread of the virus and flatten the infection curve, severe restrictive measures were imposed, economy-wide, including a general lockdown in the second semester of the year. The flattening of the infection curve by restricting economic activity and imposing travel restrictions would inevitably steepen the macroeconomic recession curve and, therefore, decisive action on an unprecedented fiscal support package was needed to cushion the contraction in GDP and employment and avoid the pandemic turning into a major economic, financial and social crisis. The economic landscape continues in uncertain territory in 2021, with the pandemic force still not adequately curbed and economies in Cyprus and across Europe functioning amid significantly restrictive measures.

The response of the government was immediate, swift and forceful, comprising of a package of budgetary, liquidity and policy measures to sustain the health system, support businesses and secure jobs. In 2020, the total impact of the support package amounted to around €2.6 bn. The actual fiscal impact of the package amounted to 3.6% of GDP. In 2021, as a range of support measures continue to apply, the fiscal impact is estimated to amount to 3.4% of GDP. The application of some measures extends on to 2022-2024, namely the interest subsidy schemes and the tax credit for voluntary rent reduction.

The budgetary and liquidity measures affect both the expenditure and the revenue side of the accounts of the general government. The table below presents the support measures with an impact on the accounts of the general government for the years 2021-2024:

Table i.1: Support measures with a fiscal impact, 2020-2024

% of GDP		**2020**	**2021**	**2022**	**2023**	**2024**
impact from covid-19 related measures with an impact on the expenditure side of the accounts of the general government						
Scheme supporting Companies for Total or Partial Suspension of their Operations	The scheme provides wage compensation to the employees of the businesses that were forced to suspend their operations by a decree of the Minster of Health and/or a decision of the Council of Ministers. Businesses which their operations are directly related to the above-mentioned businesses experiencing losses of their turnover due to the Covid-19 pandemic are also eligible, or businesses with partial suspension of operations experiencing certain decline in their turnover compared to the year before due to the Covid-19 pandemic. An important requirement is that businesses taking part in the scheme shouldn't have dismissed any employee as from 1/3/2020, for the period that the company is under the scheme and an additional period equal to the period the company benefits from the scheme plus 1 month.	1.74	0.98	-	-	-
Strengthening of the public health sector	This measure aims to strengthen health services by supporting spending and investment in employment of additional medical staff, enhancing equipment and infrastructure, enhancing ambulance services, enhancing the centre of testing (Institute of Neurology and Genetics) and helpdesk services.	0.20	0.54	-	-	-
Overseas student allowance	A €750 allowance is provided to cover the costs of students attending university overseas so they do not return to Cyprus during Easter holidays.	0.05	-	-	-	-
Special absence leave	Subsidised leave to parents when schools, private or public, nurseries, childcare or other educational institutions suspend their operations. Estimates are based under the assumption of 50.000 recipients for as long as schools stay closed.	0.09	0.02	-	-	-

% of GDP		**2020**	**2021**	**2022**	**2023**	**2024**
Suspension of NHS increased contributions	Provision for the suspension of the increased of NHS contributions of all employers, employees/pensioners and the state. The increase of contributions took place 1st March 2020 as per the related to the National Health System Law. The measure provides for the suspension of contributions increase for three continuous months (April-June 2020) in order to support the disposable income of employees, self-employed and lower business cost. The timetable for the implementation of Phase 2 of the NHS was not affected.	-0.02	-	-	-	-
Sickness allowance	Support to employees that will need to be absent from their jobs, either due to health issues (vulnerable groups), or they are over their 65th year of age, as per the decree of the Ministry of Health.	0.05	0.00	-	-	-
Small business support scheme	Support to businesses that employ up to 5 people, provided they keep their employees and experience turnover decrease. The scheme provides for a subsidy of 70% of employees' salary with a duration of three continuous months.	0.18	0.11	-	-	-
Repatriation	For the purposes of the ongoing gradual repatriation of Cypriots, the scheme covers mainly the cost of drugs and medical supplies and the cost of accommodation of the repatriates in the context of the quarantine, since upon entering the Republic of Cyprus, the repatriates are required to mandatory isolation at premises indicated by the State for 14 days from arrival. As the repatriation operation is processed through charter flights, a relevant grant has been provided.	0.05	-	-	-	-
Subsidization scheme of very small and small enterprises and self-employed	It applies to very small and small businesses and self-employed workers who employ up to 50 employees that were approved and subsidised through the Special Schemes of the Ministry of Labour, Welfare and Social Insurance, to cover part of their rent and operating costs.	0.48	1.04	-	-	-
Special Support Allowance for The Unemployed	Covers any person who is registered as a regular unemployed person in the Employment Service Register and received unemployment benefits, for which he/she has exhausted the right to be paid.	0.06	0.07	-	-	-
Interest Subsidy Scheme for new business loans	Interest Subsidy Scheme for new business loans	-	0.09	0.09	0.05	0.02
Interest Subsidy Scheme for housing loans	Interest Subsidy Scheme for housing loans	-	0.05	0.05	0.05	0.04

% of GDP		2020	2021	2022	2023	2024
Expenses related to various consumables for the prevention of the spread of covid-19	Expenses related to various consumables for the prevention of the spread of covid-19	0.03	-	-	-	-
Other expenses for possible needs related to the second wave of the pandemic crisis	Other expenses for possible needs related to the second wave of the pandemic crisis, which were included in the Supplementary Budget for 2021	-	0.23	-	-	-
Total Impact on the Expenditure Side		**2.94**	**3.13**	**0.13**	**0.10**	**0.06**
impact from covid-19 related measures with an impact on the revenue side of the accounts of the general government						
Suspension of NHS increased contributions	Provision for the suspension of the increased of NHS contributions of all employers, employees/pensioners and the state. The increase of contributions took place 1st March 2020 as per the related to the National Health System Law. The measure provides for the suspension of contributions increase for three continuous months (April-June 2020) in order to support the disposable income of employees, self-employed and lower business cost. The timetable for the implementation of Phase 2 of the NHS was not affected.	-0.21	-	-	-	-
Revenue loss from special support wage subsidisation schemes	Revenue loss from social security contributions and NHS contributions stemming from wage subsitisation schemes, which are not subject to any contribution	-0.43	-0.26	-	-	-
Reduction of the VAT special rates	Reduction of the VAT special rates for hotel accommodation and restaurants as from 1st July until the end of 2020	-0.07	-	-	-	-
Tax credit for voluntary rent reduction	Tax credit for voluntary rent reduction. Income Tax Law amendment for the grant a tax credit equivalent to 50% of the reduction granted to the amount of rent (rent reduction between 30-50%). Valid for any three months in the tax period of 2020.	-	-	-0.10	-	-
Total Impact on the Revenue Side		**-0.70**	**-0.26**	**-0.10**	**-**	**-**

In addition, the support package of the government included policy measures with no fiscal impact or measures without an immediate impact on the accounts of the general government, but provided much needed liquidity to households and enterprises and supported specific sectors of the economy (particularly tourism). Some of the main measures that fall in this category and implemented over the period 2020-2021 include:

- Social security contributions:
  - extension of the deadline for the submission of objections
  - postponement of the repayment of overdue social contributions
- Extension in the submission of income tax returns for companies, the self-employed and employees
- Acceleration in VAT and corporate tax refunds
- Temporary suspension of VAT payments
- Direct taxation:

  - suspension of defense contribution attributed to deemed dividend distribution (Jan – Apr 2021)
  - write-off of surcharge related to overdue income tax returns
- Suspension of loan installments (9 months)
- Support to HERMES due to suspension of airport operations
- Foreclosures suspensions
- Extension of the ESTIA scheme
- Participation of the Republic of Cyprus in the «Pan-European Guarantee Fund»
- Government Guarantee Scheme to the EIB for loans to SMEs
- Frontloading of mature development projects
- Introduction of price ceilings on personal hygiene products
- Extraordinary support to the tourism sector in the form of government guarantees related to credit notes issued for the cancellation of contracts due to the pandemic of COVID-19, in case of insolvency of the issuers.

National Recovery and Resilience Plan

Cyprus' "National Recovery and Resilience Plan" (the "NRRP" or the "Plan") is being drafted in accordance with the criteria set by the relevant EU Regulation. The plan includes reforms and investments to address, inter alia, challenges identified in the European Semester, particularly the country-specific recommendations for Cyprus adopted by the Council. Furthermore, it includes measures to address the challenges of the green and digital transitions, covering the relevant Flagship Areas and contributing to the dimensions outlined in the 2021 Annual Sustainable Growth Strategy.

Moreover, the plan includes: (a) the national priorities as reflected in the last National Reform Programme; (b) existing national strategies and action plans, notably the National Energy and Climate Action Plan of January 2020 and the National Digital Strategy of June 2020; (c) the new growth strategy for Cyprus, currently at an advanced stage of preparation.

The first draft was submitted to the Commission at the end of January 2021. The final programme is provisionally expected to be submitted by the end of April 2021.

According to the latest draft of the plan, the total estimated budget of the NRRP amounts to €1.25 billion, out of which €1.06 billion (in current prices) will be allocated in the form of a grant and €0.2 billion (in current prices) in the form of a loan.[1]

Preparatory actions

The Council of Ministers'(CoM) decision of 22nd August 2020 approved the overall priorities and governance structure for the NRRP, according to which the NRRP will be prepared by the Directorate General for European Programmes, Coordination and Development (DG EPCD), in cooperation with the Ministry of Finance (MoF) under the political guidance and supervision of the Minister of Finance. In order to safeguard the necessary coordination, two committees have been set up under the Presidency of DG EPCD, one consisting of all

[1] The analysis and projections in this Stability Programme, as approved by the Council of Ministers of 22nd April 2021, are based on data available by end of March and therefore do not take into account loans in the context of the NRRP.

Ministries responsible for policy areas to be covered by the NRRP, and another consisting of the three Ministries with policy responsibilities relating to the green transition and the Deputy Ministry responsible for digital policy. The latter was set up in order to ensure co-ordination as regards the green and digital elements of the NRRP.

In preparing the Plan, extensive consultations have taken place with key stakeholders. Through this collaborative process, Cyprus has produced a plan that reflects the country’s challenging, yet attainable, ambition to recover and emerge from the COVID-19 crisis more resilient and to enhance its potential for sustainable long- term growth.

Strategic Objective

The strategic goal of the NRRP is "to strengthen the resilience of the country's economy and potential for economic, social and environmentally sustainable long-term growth and prosperity."

Through the reforms and investments of the Plan, Cyprus is expected to emerge as:

a) a country with high levels of resilience, productivity and competitiveness through a sustainable model of long-term growth, through a reformed and efficient public administration, a more efficient judicial system and a modernized tax system,

b) a country where the education system and workforce development are aligned with the skills needed for the future,

c) a country that is one of the pioneers in green and digital transition,

d) a country with a resilient health system that follows best practices from top health systems around the world.

Policy Axis and Components

To deliver this vision, the NRRP contains reforms and investments under the following Policy Axes and their respective components:

1. Public health and civil protection - lessons from the pandemic

Objective: The first Policy Axis includes measures that will contribute to increasing the resilience, quality, efficiency and readiness, of services provided by the General Health System. By assuring the availability of the necessary infrastructure, equipment and procedures including digitalisation, emphasis will be placed on strengthening public hospitals to become more competitive and able to deal with future health crises. Included under this Axis are also investments to strengthen civil protection and, in particular, the use of smart technologies for the effective handling of emergencies.

2. Accelerated transition to a Green Economy

Objective: Policy Axis 2 seeks to make a significant contribution to green transition and environmental sustainability, through the achievement of national goals for climate neutrality, energy efficiency and renewable energy sources. It promotes reforms in the fields of climate and energy, sustainable transport, water resources management and the wider environment.

3. Strengthening the resilience and competitiveness of the economy

Objective: This Policy Axis aims at improving the competitiveness and resilience of the Cypriot economy through reforms and investments along horizontal, cross sectoral sub-components as well as sectoral actions deriving from the new growth model.

Complimentary to the other axes, this component includes measures that contribute to the promotion of a new model for growth and international competitiveness of the Cypriot economy, based on the results of the relevant study of the Cyprus Economy and Competitiveness Council. It includes investments and reforms to expand the productive base by strengthening the primary and secondary sectors of the economy, improving competitiveness and the business environment, supporting mainly small and medium-sized enterprises (SMEs), diversifying and strengthening the tourism product, modernizing the public administration and the local authorities, reforming and improving the efficiency of the judiciary sector, fighting corruption and enhancing transparency, research and innovation, and the resilience of the financial sector and the fiscal situation.

Table i.3: Indicative allocation of National Recovery and Resilience Plan*

Policy axis / Component	Estimated budget (*in EUR million*)	Percentage of total estimated budget (*%*)
1. Public health and civil protection - lessons learned from the pandemic	**74,1**	**5,9%**
1.1. Resilient and effective health system and enhanced civil protection	74,1	5.9%
2. Accelerated transition to a green economy	**469**	**37,6%**
2.1. Climate neutrality, energy efficiency and renewable energy penetration	307,6	24,7%
2.2. Sustainable transport	81,2	6,5%
2.3. Smart and sustainable water management	80,2	6,4%
3. Strengthening the resilience and competitiveness of the economy	**445,7**	**35,8%**
3.1. New growth model and diversification of the economy	169,5	13,6%
3.2. Enhanced research and innovation	64	5,1%
3.3. Business support for competitiveness	78,8	6,4%
3.4. Modernising public and local authorities, making justice more efficient and fighting corruption	88,9	7,1%
3.5. Safeguarding fiscal and financial stability	44,5	3,6%
4. Towards a digital era	**89,3**	**7,2%**
4.1. Upgrade infrastructure for connectivity	53	4,3%
4.2. Promote e-government	36,3	2,9%
5. Labour market, education and human capital	**168,5**	**13,5%**
5.1. Educational system modernization, upskilling and retraining	94	7,5%
5.2. Labour market	74,5	6%
Total RRP	**1,247**	**100%**
Green Transition	*≈ 560*	*≈45%*
Digital Transition	*≈408*	*≈33%*

** Notes:*

- *The amounts are indicative and will be finalised upon submission of the Plan to the European Commission.*
- *In addition to the measures included in the directly relevant Policy Axes (2 and 4), green and digital transition is complemented by measures with a green and / or digital dimension from the other Policy Axes. As a result, the % of the total cost of the Plan that contributes to the green or digital transition, it is not reflected from the in the total amount assigned to Policy Axis 2 for the Green Transition and Policy Axis 4 for the Digital Transition and actually exceeds the minimum percentages required by the Regulation (37% and 20%, respectively).*

4. Towards a digital age

Objective: The main objective of this axis is to ensure the digital transformation of Cyprus, without exclusions and through adequate access to communication infrastructure for all citizens. This will be achieved by providing 5G mobile and fiber optic network coverage for 100% of the population, including the development of 5G mobile telephony along major terrestrial corridors and universal and affordable Gigabit connectivity across all urban and rural areas.

The axis is a fundamental part of the overall policy for the digital transformation of Cyprus, promoting a new economic model with a vision for a dynamic and competitive economy, based on knowledge and digital and emerging technologies.

5. Employment, education and human resources

Objective: The fifth axis focuses on the development of the required skills and competencies in the existing and future workforce, so that it responds effectively to the demands and trends of the modern labour market, according to its current and future needs, including those arising from the green and digital transition. The proposed reforms and investments are in line with relevant European initiatives and priorities (European Skills Agenda, Pact for Skills, European Education Area, Digital Education Action Plan).

Included are also reforms and investments to address labour market weaknesses related to the need to facilitate market entry, especially for women with children, to improve the availability and access to early childhood education and care and to create a network of childcare facilities. It also aims to increase employment rates for young people outside of the workforce, education or training (NEET).

Box 1: Impact of NRRP implementation on output and employment

The Economics Research Department of the University has conducted a preliminary assessment of the short-term (period 2022-2026) economic impact of the Draft Recovery and Resilience Plan of Cyprus that was submitted to the European Commission last January. The results are based on an economic input-output model that has been developed and applied for Cyprus. The overall assessment of the impact of the draft NRRP shows that the measures increase value added (GDP) by over 550 million Euros in the short term, which translates to a GDP increase by 0.5 million Euros for each million Euros invested. The 550 million Euros increase from the NRRP measures suggests a 2.8% growth in GDP by 2026. In terms of employment, all measures together create more than 15000 jobs, or about 13 new jobs per million Euros invested.

The input-output model does not distinguish between different types of labour, e.g. skilled-unskilled, and therefore the impact of job creation in the context of the NRRP in term of sustainable economic growth cannot be directly assessed. However, the distribution of jobs across economic activities as simulated by the model indicates that the investments related to the Construction sector generate the highest number of jobs both within the sector as well as other sectors of the economy. On the other hand, the Information and Communications sector is simulated to experience a much smaller increase in employment but the high proportion of skilled labour in the sector creates more value added.

The work on the economic impact assessment is ongoing and is being revised as this Stability Programme is being drafted as more information becomes available in view of the submission of the final NRRP by end-April. Initial indications of this more in depth analysis point towards an even higher impact of the NRRP on GDP than the preliminary estimation of 2.8%.

1.2 Macroeconomic, budgetary and debt prospects

Output Growth Developments

Real output in 2020 contracted by 5.1% in real terms, as opposed to a 3.1% real growth in 2019. The negative GDP growth in 2020 was mainly driven by lower private consumption and exports. Private consumption decreased by 3.9% in real terms while government consumption recorded an increase of 13%. Gross fixed capital formation was influenced by decreases in construction and recorded a decrease of 2.1%. Real Imports declined at a rate of 5.8% mirroring the decline in private consumption, while exports, in real terms, also declined significantly at a rate of 17.4% reflecting the large decline in tourist arrivals.

The baseline medium term baseline scenario presented in this Stability Programme projects that the economy will enter into a recovery trajectory from 2021 onwards. Real GDP growth is forecast at 3.6% in 2021, 3.8% in 2022, 3.2% in 2023 and 2.8% in 2024. Growth in 2021 is still supported by government spending and will be reinforced by a normalization in private spending and investments, driven by the implementation of a significant number of projects in the areas of tourism, energy, transport and education and include, inter alia, the construction of marinas, a casino resort and an infrastructure development of the University of Cyprus.

Budgetary and Debt Developments

During the period 2015-2019, Cyprus achieved full compliance with the preventive arm of the Stability and Growth Pact (SGP). The general government headline deficit shrunk to a mere -0.9% of GDP in 2015 (excluding the one-off impact of the CCB, headline nominal balance was in surplus of 0.1% of GDP) and turned into a surplus of the order of 0.3% of GDP in 2016 and 1.9% of GDP in 2017. In 2018, general government headline balance turned negative with a recorded deficit of 3.5%, solely due to the one-off impact related to the Cyprus Cooperative Bank (CCB). Excluding the impact of the CCB, general government headline balance was indeed in surplus of the order of 3.6% of GDP. In 2019 public balances improved significantly due to the one-off government support to CCB and Cyprus achieved a headline nominal surplus of 1.5% of GDP.

All along this period, notably high primary surpluses were consistently achieved. In particular, excluding the impact of the CCB in 2015 and 2018, primary surplus increased from 3.2% of GDP in 2015 to 4.4% in 2017, 6% in 2018 and 3.8% in 2019.

The structural balance over the period of 2015-2018 overachieved the medium-term objective (MTO) and was in surplus of the order of 2.3%, 0.6%, 0.8% and 1.1% respectively. In 2019, the structural balance was exactly at the MTO of 0%.

The strong performance of the public finances was set to continue in 2020 and in the Draft Budgetary Programme for 2020 prepared in the Autumn of 2019, general government headline balance in 2020 was projected to be in surplus of 2.7% of GDP, with a primary surplus of 5.1%. The outcome of 2020, resulted in headline nominal budget deficit of 5.8% of GDP, recording a substantial deterioration to the autumn 2019 forecasts as documented in the Draft Budgetary Programme for 2021. This negative outcome, after four consecutive years of strong fiscal position, was exceptional as it resulted from the impact of the COVID-19 outbreak on the economic outturn, as well as due to the support measures of a one-off nature, targeting the consequences of the pandemic crisis on health, businesses and employment positions. The total fiscal impact of the support measures on the accounts of the general government was around 3.6% of GDP in 2020. The respective impact in 2021 is estimated at 3.4% of GDP.

Total revenue in 2020 decreased by 6.9% compared to 2019, mostly due to the fall to reduced VAT receipts - as a consequence of the restrictive measures that were imposed, as well as from a reduction of the special VAT rates as of 1st July 2020 until the end of 2020, as part of the support package - and a fall in revenues from direct taxes, in line with the developments in the labour market that were shaped by the pandemic. Total expenditure grew by 10.4% in 2020 compared to the year before, in particular due to an increase in social payments and subsidies as part of the implemented support measures. Compensation of employees also contributed to the increase in expenditure as this expenditure category increased by 5.8%, which in value terms corresponds to an increase that was more contained than what was expected in the last update of the Stability Programme.

In nominal terms, the deficit in the accounts of the general government reached about €1,213 mn in 2020 compared to a surplus of €341 mn the year before. Primary balance was also in deficit of about €762 mn (-3.6% of GDP) compared to a primary surplus of €850.6 mn (3.8% of GDP) in 2019.

In 2021, in light of the still on-going COVID-19 pandemic, it is forecast that the budget balance of the General Government will remain in deficit of about 4.7% of GDP. The deterioration of the budget balance in 2021, compared to a forecast of a much lower deficit during the preparation of the Budget 2021, is the outcome of the revised Budget voted by the Parliament end-January 2021 that included additional expenses related to the pandemic crisis of about 1.5% of GDP, additional expenditure through a Supplementary Budget early-April 2021, aiming to cover the needs for an extension of the special schemes of the government of about 1.1% of GDP, as well as the expectations for a lower positive economic growth during the current year. The primary balance is forecast to remain also in deficit during 2021, reaching -2.7% of GDP.

Going forward over the forecasting horizon of the Stability Programme, the headline budget deficit of the general government in 2022 is projected to decrease substantially to 0.9% of GDP and turn positive in 2023 and 2024, recording a surplus of 0.1% and 1.6% of GDP respectively.

At the end of 2020, the General Government public debt stood at approximately 118.2% of GDP, or €24.8 bn, increasing by twenty-four percentage points compared to 2019, when debt-to-GDP stood at 94% which in absolute numbers corresponded to €20.9 billion. Due to the emergence of the pandemic, debt increased to cover the increased financing needs of the government to finance the support measures taken by the State to cushion the economy from the pandemic, in addition to the need to finance the public deficit and the decisive increase in cash liquidity reserves as a precaution action, due to the uncertainty of the Covid-19 pandemic.

By the end of 2021, debt-to-GDP is projected to fall down to 112%, despite continued public support measures for the economy that will stretch out until June 2021, due to debt reduction actions and the improved macroeconomic conditions. Real GDP is projected to rise by 3.6% and GDP deflator by 1.2%, yielding a growth in nominal GDP of around 4.9%. By the end of the forecasting horizon in 2024, debt-to-GDP continues to fall, facilitated by the projected nominal and primary surpluses of the general government.

CHAPTER 2: ECONOMIC OUTLOOK

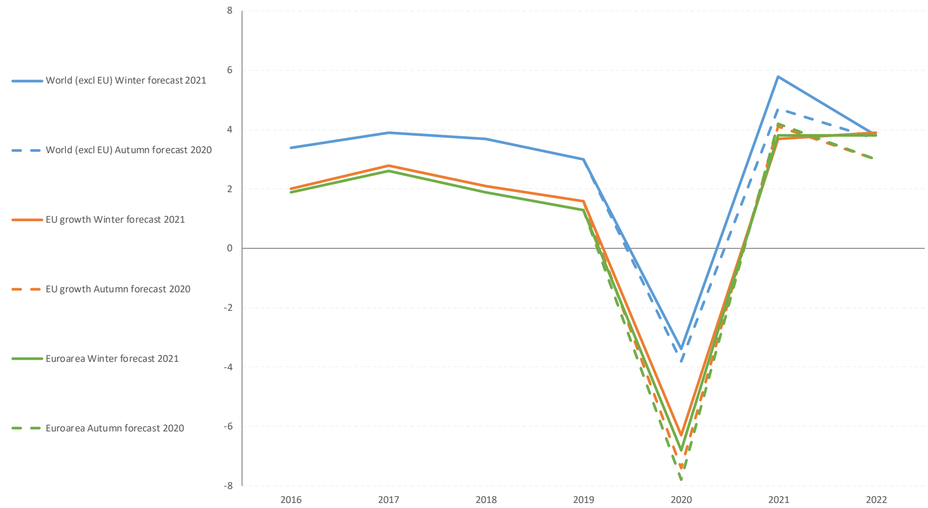
2.1 Macroeconomic Developments 2020

2.1.1 Global economy

According to the European Commission Winter Forecast 2021, the world economy (excluding the EU) contracted by an estimated 3.1% in 2020, compared to a growth of 3.0% in 2019. Growth is expected to resume stronger in 2021 at 5.2% and 3.8% in 2022.

Economic contraction in the EU in 2020 is estimated at 6.3%, compared to 1.6% growth in 2019. The economy in the euroarea contracted by an estimated 6.8% in 2020, compared to 1.3% growth in 2019. Within the euroarea, the loss in real output in 2020 was more prominent in Spain (-11%), Greece (-10%), Malta (-9%), Italy (-8.8%) and Portugal (-7.6%). In contrast, in Germany, Estonia, Luxemburg and Finland, the contraction in output was contained at around 3% in real terms. Going forward, real GDP growth is forecast to gain pace, at 3.7% in 2021 and 3.9% in 2022 in the EU and 3.8% in both years in the euroarea. Expectations are, however, somewhat subdued compared to the European Commission's autumn forecast 2020.

Figure 1: Real GDP growth, World (excl. EU), EU and the Euroarea, 2016-2022 (European Commission Winter Forecast 2021)



Note: Economic contraction in 2020 was less than originally expected, due to a positive outturn in the second half of the year, although 2021 started with renewed outbreaks, likely exacerbated by new more contagious variants of the virus, amid the roll-out of vaccinations in Europe and elsewhere.

Inflation in the EU, as measured by the Harmonised Index of Consumer Prices, decelerated further in 2020 to 0.7% and in the euro area to 0.3% (compared to 1.4% and 1.2% in 2019 respectively). The unemployment rate in the EU averaged at 7.4% in 2020, compared to 6.7% in 2019 and 8.0% in the euro area in 2020 compared to 7.5% in 2019.

The baseline forecast of the European Commission is based on the assumption that containment measures will remain strict throughout Q1:2021 and will ease thereafter with marginal containment measures in effect by the end of the year. Another important assumption is the gradual increase in the vaccinated proportion of the population during the second half the year. However, the uncertainty in the forecast is still quite high and we may see larger than usual revisions in subsequent GDP releases.[2] On the one hand, Europe is going through the second quarter of the year with strict quarantines still in place, while vaccinations on the other hand are hoped to provide adequate immunization or dramatically decrease hospitalisations, although different variants of the virus constantly pose a threat of regress.

The impact of COVID-19 on world trade was less pronounced than initially expected, thanks to the quick rebound of trade in goods, supported in part by medical imports, offsetting the decline of trade in services, driven by the collapse in international travel. A mild recovery in tourism is widely expected by analysts from the second half of 2021, thanks to the progress of vaccinations and the easing of restrictions imposed by the pandemic. According to the recent survey "Monitoring Sentiment for Domestic and Intra-European Travel", published in January 2021 by the European Travel Commission (a project co-funded by the European Commission), conducted among EU citizens, 52% of the respondents intending to travel in the next six months (a 5% increase from the previous wave of the survey), with 40% planning to visit another European country, as opposed to 36% vacationing domestically and 52% indicating willingness to travel by air to their destination. Within the EU, the European Commission published a proposal on 17th March 2021 on a Digital Green Certificate, aimed to facilitate safe free movement inside the EU during the COVID-19 pandemic.

Since the last Stability Programme, an agreement between the United Kingdom and the European Union on a Trade and Cooperation Agreement was concluded on 24th December 2020 and entered into force on 1st January 2021. Given the importance of Cyprus trade exchanges with the United Kingdom, the depth and breadth of the agreement was positively received by the authorities and economic operators and the focus now falls on its implementation.

2.1.2 Domestic economy

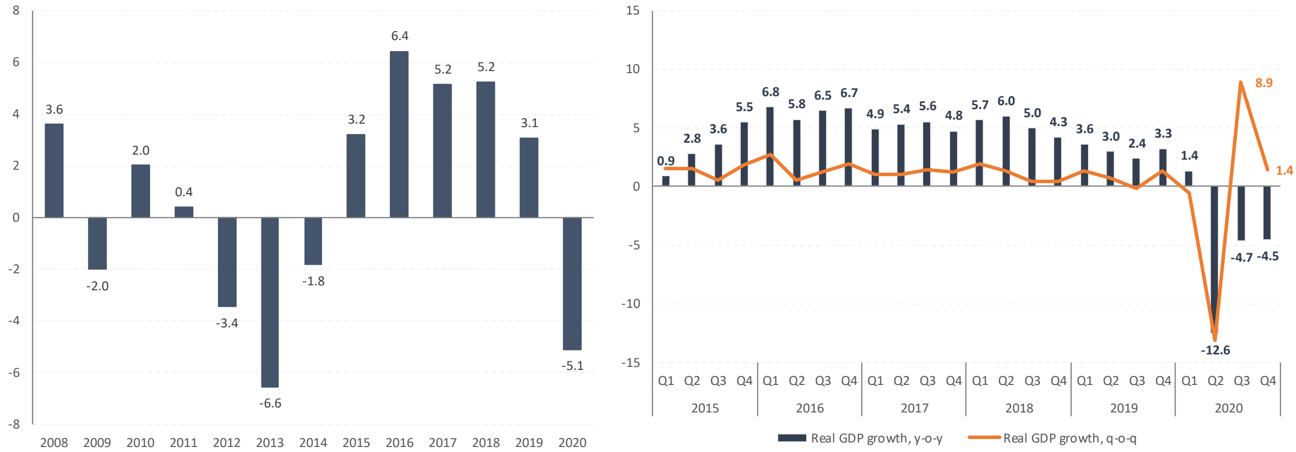
The Cyprus economy entered the COVID-19 crisis in 2020 from a considerably favourable macroeconomic and fiscal position. This allowed for a sizeable public support package that offered an effective countercyclical response to the crisis, while empowering the health sector with the necessary funds to cope with the increased demand, coupled with a massive testing and vaccination policy response. Real output in 2020 contracted by 5.1% in real terms, as opposed to a 3.1% real growth in 2019.

The negative GDP growth in 2020 was mainly driven by lower private consumption and exports. Private consumption decreased by 3.9% in real terms while government consumption recorded an increase of 13%. Gross fixed capital formation was influenced by decreases in construction and recorded a decrease of 2.1%. Real Imports declined at a rate of 5.8% mirroring the decline in private consumption, while exports, in real terms, also declined significantly at a rate of 17.4% reflecting the large decline in tourist arrivals.

On a quarterly basis, real output dipped by 12.6% in the second quarter of 2020, compared to the second quarter of 2019, partly recovering in the third and fourth quarters, containing the decline in real GDP to 4.7% and 4.5% respectively. In particular, real GDP increased by 8.9% in the third quarter of 2020, compared to the previous quarter and by 1.8% in the fourth quarter, compared to the previous quarter.

[2] Large revisions may also be expected due to the increased challenges faced by Statistical Services to produce the quarterly GDP estimates and the effect of the governmental support programmes on the economy.

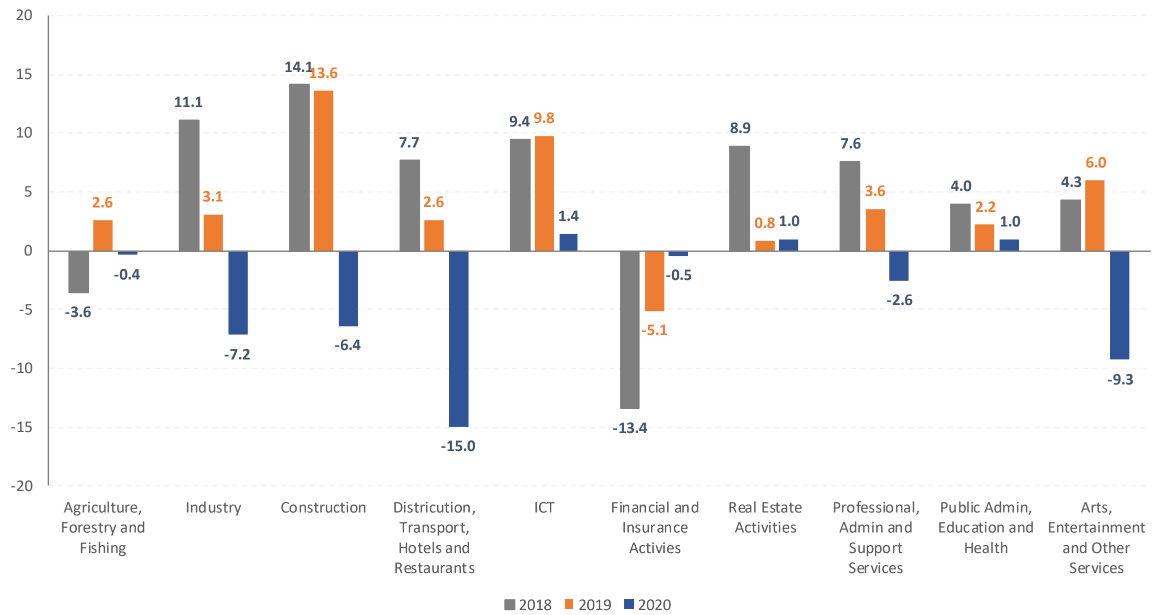
Figure 2: Real GDP growth, 2008-2020, annual % change



Source: CYSTAT

Given the nature of the crisis caused by a massive external shock and exacerbated by international travel restrictions, periods of lockdown and periods of severe restrictions in movement and business operations, the impact has spread over several sectors of the economy. In 2020, value added loss was most pronounced in the Distribution, Transport and Hotels and Restaurants sector, with a 15% decline in the value added of the sector, compared to the previous year. This mostly reflects the impact of the crisis on the tourism sector, that suffered a substantial slump because of the international travel restrictions. The sectors of Arts and Entertainment and Other Services suffered a significant loss, with value added falling by 9.2%, whereas the loss of value added in the Industry sector (including manufacturing) amounted to 7.2% and in Construction to 6.4%.

Figure 3: GDP growth, production approach, 2018-2020, annual % change

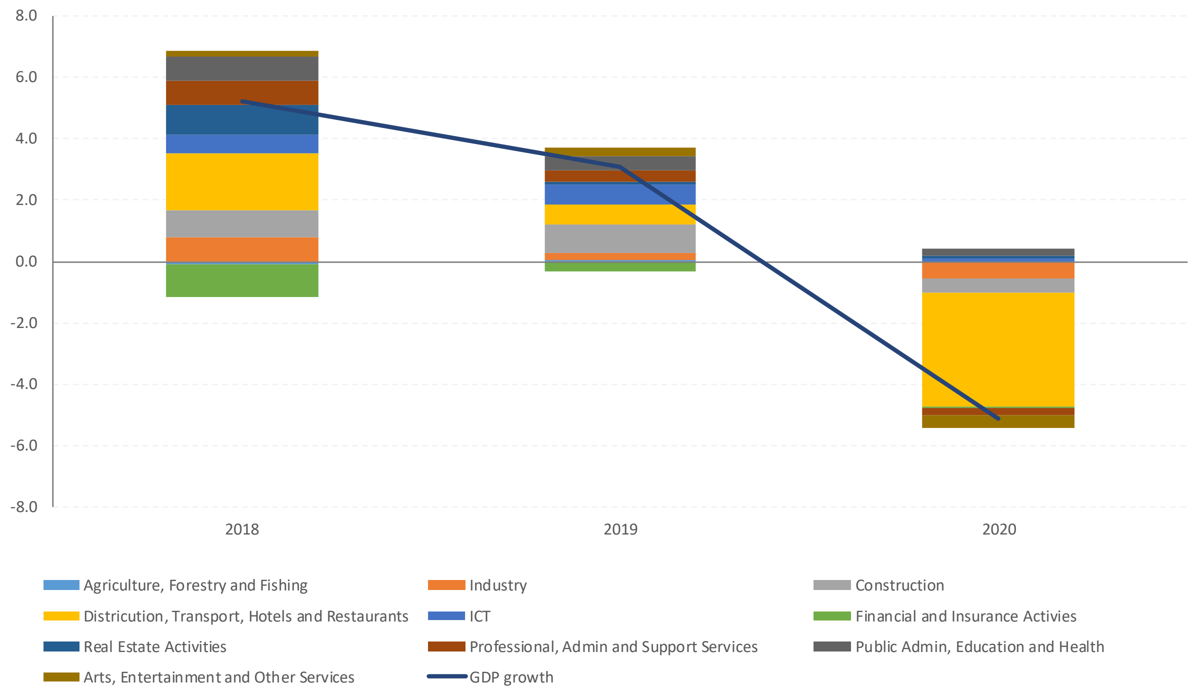


Source: CYSTAT

The termination of the Cyprus Investment Programme (CIP) since October 2020 is expected to affect primarily growth prospects in the real estate sector and construction, given that investments in real estate through the CIP constituted more than 60% of total investments through the program. However, the impact on GDP growth is mitigated (estimated at around 0.4 percentage points annually during the period 2021-2023, or around 1.3 p.p. cumulatively) due to the nature of investments in real estate through the CIP which concentrated in big construction projects for luxury developments, with the termination expected to drive a shift away from this segment of the real estate sector.

The impact of the crisis on the sectors of Professional, Administrative and Support Services was much less pronounced, with the value added falling by 2.6%, compared to the previous year. The impact on the sectors of Financial and Insurance Activities and in the Agricultural sectors was marginally negative. On the other hand, the Information, Communication and Technology sectors as well as Real Estate Activities and Public Administration, Education and Health sectors, increased their value added in 2020, in annual terms, by 1.4%,1.0% and 1.0% respectively.

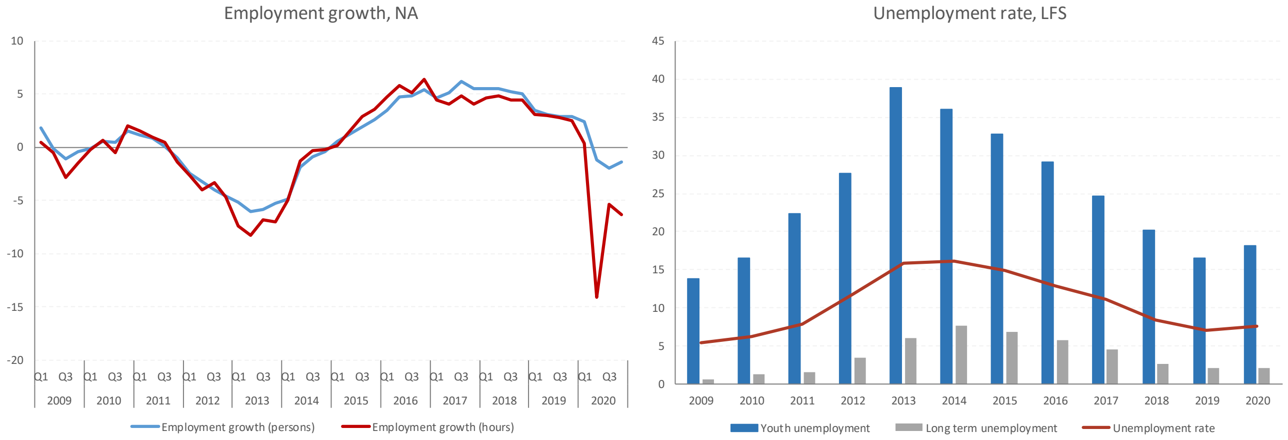
Figure 4: Sectoral contributions to output growth 2018-2020, percentage points



Source: CYSTAT

The labour market was affected negatively by the pandemic, although not in par with the fall in output. **Employment** in 2020 decreased by 0.6% in comparison to 2019, but it is necessary to state that the decrease of hours worked was much higher than the reduction persons employed, which was around 6.4%, indicating that employers selected to avoid massive laying offs, possibly driven by the support schemes of the Ministry of Labour that included the prohibition of lay-offs in the eligibility criteria. Employment loss in terms of persons employed was significantly more prominent in the sector of Hotels and Restaurants (-9.3% or -4.865 persons), and Transport and Storage (-4% or around -700 persons). In contrast, the construction sector recorded an increase in persons employed by 2.8% (1.021 persons), along with an increase in persons employed in the sectors of Education (2% or 618 persons), Health (2.1% or 428 persons) and Professional, Scientific and Technical Activities (2% or 620 persons).

Figure 5: Labour market



Source: CYSTAT

The **unemployment rate** in 2020 as measured by the Labour Force Survey, amounted to an average of 7.6%, recording an increase of 0.5 percentage points compared to the levels of 2019. Youth unemployment averaged at 18.2%, compared to 16.6% in 2019, while long-term unemployment averaged at 2.1%, remaining unchanged compared to 2019. The composition of unemployment indicates that youth and long-term unemployment still remain the major challenges of the labour market, but with encouraging signs of de-escalation. Youth unemployment peaked in Q2-2013 reaching a rate of about 40% of the labour force and pursued a downward path since then. Similarly, long-term unemployment peaked at 7.7% in 2014.

Table I: Selected economic indicators, 2018-2020, y-o-y %

	2018	2019*	2020*
GDP (constant prices)	5.2	3.1	-5.1
Public consumption	3.5	15.1	13.0
Private consumption	4.7	1.8	-3.9
Gross Fixed Capital Formation	-5.2	2.0	-2.1
Exports	8.0	-0.4	-17.4
Imports	4.5	2.0	-5.8
Tourist arrivals (000's)	3,938.6	3,976.8	631.6
Tourist arrivals growth	7.8	1.0	-84.1
HICP	0.8	0.5	-1.1
Labour productivity growth (persons)	-0.1	0.0	-4.6
Employment growth	5.3	3.1	-0.6
Compensation per employee	1.3	1.9	-3.2

Source: CYSTAT

Compensation per employee decreased in 2020 by 3.2%, compared to the preceding year, following an increase of 1.9% in 2019. The decrease in this ratio in 2020 reflects the reduction in compensation of employees, despite the decrease in employees. Productivity in persons in 2020 fell by 4.6% due to the fact that employment in persons declined by 0.6% compared with the 5.1% decrease in GDP. As a consequence, nominal unit labour costs increased in 2020 by 1.5%, following an increase of 1.9% in 2019 while real unit labour cost in 2020 decreased by 2.6% following an increase of 1.6% in 2019.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), turned negative reaching -1.1% in 2020 from 0.5% in 2019. Inflation is driven by developments in international oil prices, with a significant impact on domestic prices of energy products. For the period January-December 2020, compared to the corresponding period of the previous year, the largest changes were noted in Transport (-5%) and Housing, Water, Electricity, Gas and Other Fuels (-3.8%). The HICP, excluding energy and seasonal food, in 2019 was less negative of the order of -0.6%.

According to the latest **Balance of Payments** data for 2020, Cyprus' current account balance recorded a deterioration, with the deficit increasing from €1,406.0 million (-6.3% of GDP) in 2019, to €2,476.4 million (-11.8% of GDP), in 2020. The significant increase in the current account deficit resulted mainly from a lower surplus in services (from €4,396.6 million to €2,881.2 million) and, to a much lesser extent, a larger deficit in secondary income (from -€269.6 million to -€303.0 million). The aforementioned adverse developments were partly offset by lower deficits in goods (from -€4,634.4 million to -€4,177.1 million) and in primary income (from -€898.7 million to -€877.5 million). It is worth mentioning that the developments in the period under review, especially in services, were greatly affected by the COVID-19 pandemic.

Table II: Balance of Payments, 2011-2020 *in per cent of GDP*	Goods Balance	Services Balance	Trade Balance	Income Balance	Current Account Balance	Current Account Balance (adj. for SPEs)
2008	-30.1	17.4	-12.8	-2.0	-14.7	…
2009	-21.6	16.3	-5.3	-1.3	-6.7	…
2010	-24.1	15.7	-8.3	-2.4	-10.7	…
2011	-21.5	17.7	-3.8	1.5	-2.3	…
2012	-19.4	17.5	-1.9	-2.0	-3.9	…
2013	-17.7	19.3	1.6	-3.1	-1.5	…
2014	-18.8	19.8	0.9	-5.0	-4.1	-4.4
2015	-18.1	20.7	2.6	-3.1	-0.4	-1.0
2016	-22.0	23.7	1.7	-5.9	-4.2	-0.6
2017	-24.6	24.2	-0.4	-4.9	-5.3	-1.7
2018	-21.2	22.7	1.5	-5.5	-3.9	-3.0
2019	-20.8	19.7	-1.1	-5.2	-6.3	-6.8
2020	-19.9	13.7	-6.2	-5.6	-11.8	-11.4

Source: Central Bank of Cyprus

With the introduction of the ESA2010 and BMP6 statistical methods, total imports and exports of Cyprus include, among other, the economic transfer of mobile transport equipment and activities of ship owning SPEs. This methodological change skews statistics in the current account balance, disproportionately negatively due to the characteristics of the Cyprus economy, given the relative significance of the international business and shipping sectors. What is important for approaching the economics behind the numbers is that they neither concern transactions nor are they affected by domestic developments and, hence, do not have a real impact on the economy. The resulting current account deficit adjusted for the impact of Special Purpose Entities

(SPEs), that is, classifying SPEs as non-residents, stood at €2,384.5 million (-11.4% of GDP) in 2020, compared with a deficit of €1,510.0 million (6.8% of GDP) in 2019.

The **international investment position (IIP)** recorded a deterioration in 2020, presenting a net liability position of €29,446.0 million, compared with a net liability position of €27,252.4 million in 2019.

The deterioration was mainly due to the decreases recorded in portfolio investment and, to a smaller extent, financial derivatives, while these changes were partly compensated by the improvements in direct investment, other investment and reserves. In parallel, the deterioration in the net international investment position in 2020 was driven by negative net transactions, net exchange rate revaluations and net price changes, which were partially offset, by positive net other volume changes. With the corresponding data being adjusted for the impact of SPEs, IIP recorded a net liability position of €1,837.4 million in 2020, compared with a net liability position of €8,980.0 million, in 2019.

The gross external debt increased to €189,307.3 million in 2020 from €189,212.0 million in 2019. The external assets in debt instruments increased to €112,421.0 million, up from €109,001.9 million in 2019. Consequently, net external debt decreased by €3,323.8 million to €76,886.2 million, in 2020. Adjusted for the impact of SPEs, gross external debt reached €59,769.4 million in 2020, compared to €60,572.6 million, in 2019. The corresponding net external debt indicator increased to -€869.8 million, compared with -€998.7 million in 2019.

2.1.3 Financial sector developments

As the pandemic effects continue to evolve, banks face rising risks on asset quality, profitability and capital levels. Additionally, the legacy issue of non-performing exposure management remains a key priority. Notwithstanding this, the Cypriot banking system is supported by a resilient capital position and surplus liquidity.

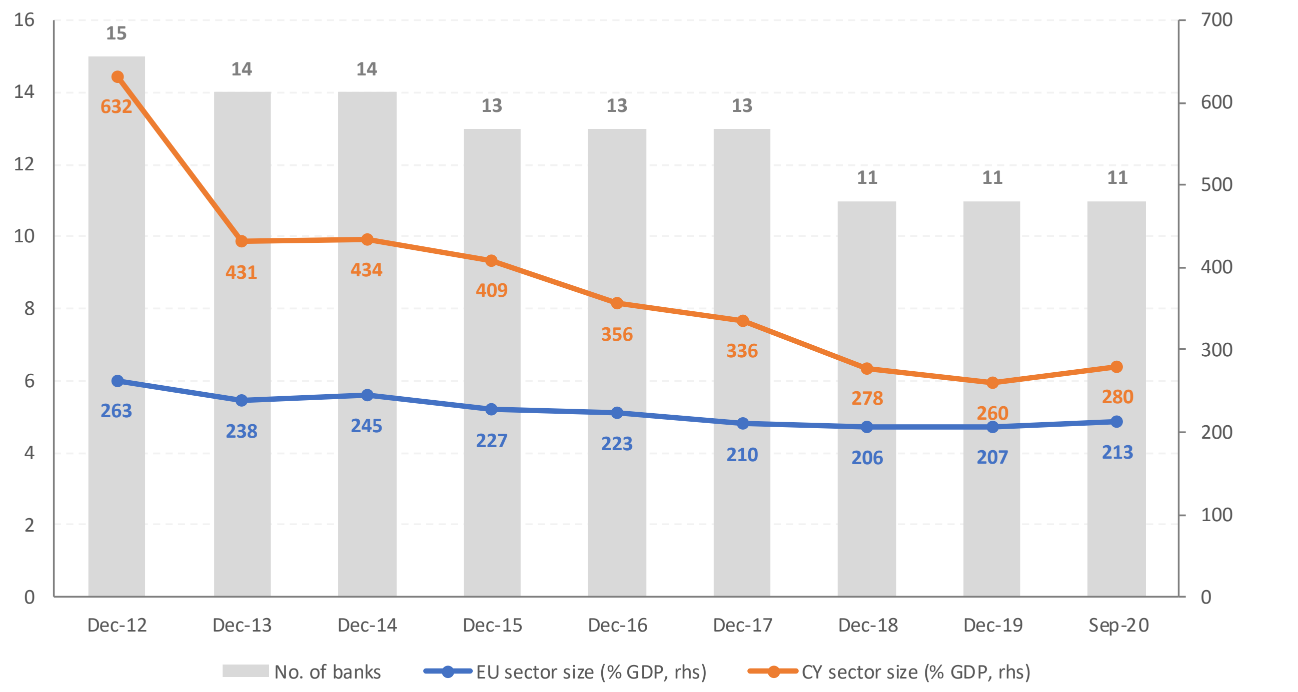
Banking sector overview

Over the past three years (2018-2020) the banking sector asset size has remained broadly stable, with the year-end closing figure of €59 bn of assets or 280% of GDP. In terms of breakdown, banks have been following a shift towards less risky assets, namely cash and government bonds, which together make up one third of their balance sheet. Loans remain naturally the largest asset category at about 50% of total assets, albeit being lower than the respective European average.

The banking sector remains well capitalised. The CET1 ratio reached 17.6% at end 2020 recording a small increase compared to 17.3 % at end 2019, following a reduction in risk weighted assets. Similarly, the solvency ratio increased to 20.3% from 19.9% at end 2019. Profitability remains a challenge, as it is throughout Europe, amidst a low-interest environment and intensified by the pandemic hit on economic output. Profitability turned negative again in 2020, following two preceding profitable years mainly due to higher loan loss provisioning.

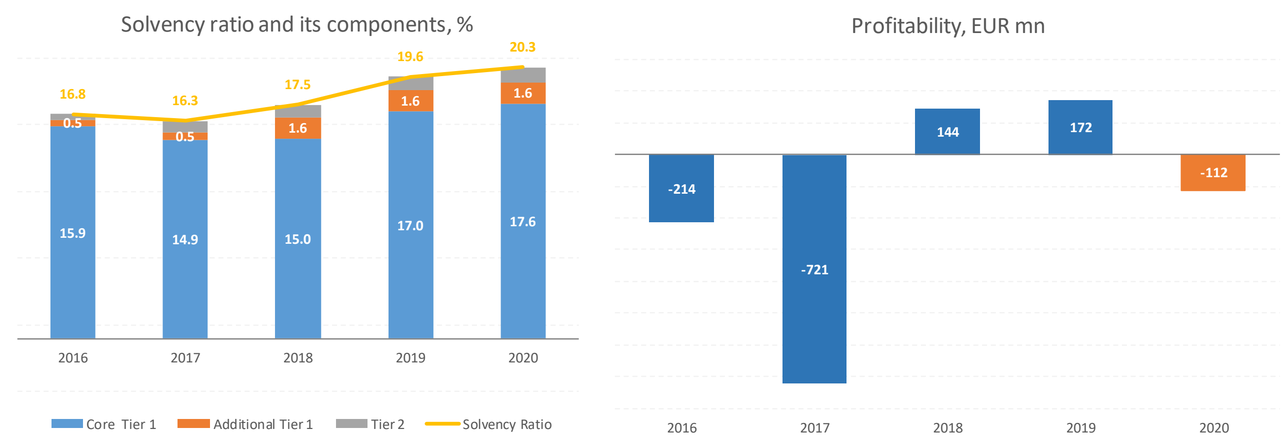
In terms of liquidity Cypriot banks continue to maintain relative high buffers, with both Liquidity Coverage Ratio and Net Stable Funding Ratio considerably exceeding the regulatory minimum requirement. Liquidity is deposit-funded in Cyprus, with the share of other instruments, such as bonds, quite low. Domestic deposits have been resilient over 2020, stemming mostly from households whereas corporate deposits declined to absorb the liquidity shock and as a result of the imposition of negative interest rates at the beginning of the year. Non-resident deposits continue to decline as a result of proactive risk mitigation measures by credit institutions.

Figure 6: Banking sector size



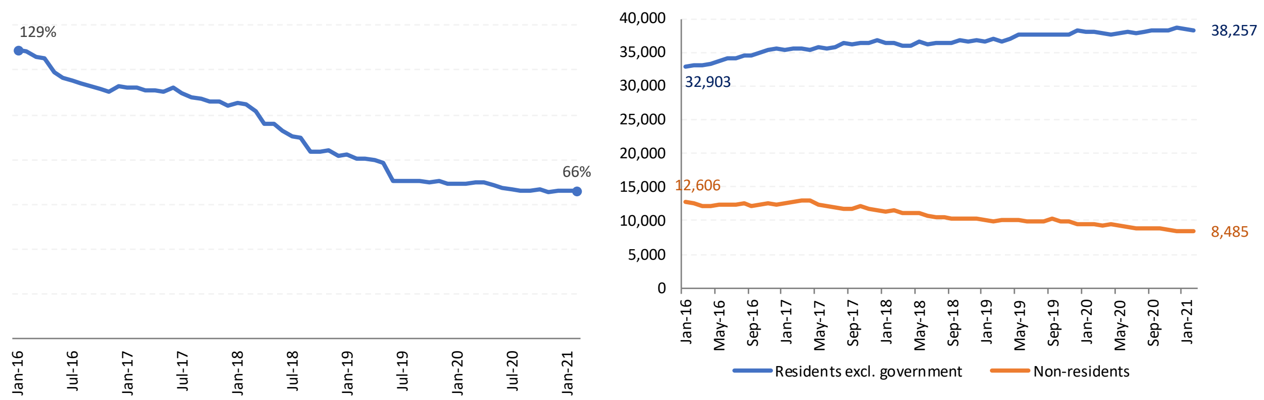
Source: Central Bank of Cyprus, ECB

Figure 7: Solvency and Profitability



Source: Central Bank of Cyprus, ECB

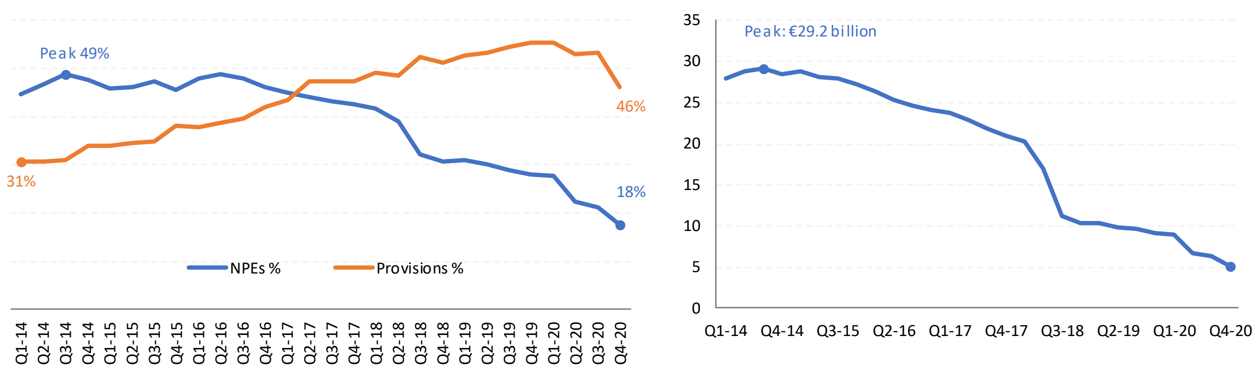
Figure 8: Deposits



Source: Central Bank of Cyprus

The loan asset quality remains the most important challenge that credit institutions face albeit the significant and steady progress achieved over the past years. Over 2020 non-performing loans reduced from €9 bn (28% of gross loans) at the start of the year to €5.1 bn (18% of gross loans). Of the remaining balance, close to half is provided for. The largest contribution in the NPL reduction comes from non-organic solutions, in particular sales and write-offs with around €2 bn and €1 bn respectively over 2020. The majority of the outstanding NPLs relate to households and SMEs, two segments which have been slower in the resolution progress compared to larger corporates. As of the first quarter of 2021, there were no clear effects of the pandemic on asset quality yet.

Figure 9: Non performing loans



Source: Central Bank of Cyprus

State Covid-19 support

As a response to the pandemic, the state reached out to the real economy inter alia through the banking channel, within the EU pandemic State Aid Temporary Framework 3. Indeed, the banking sector has been a facilitator in sustaining economic output during the current health and economic crisis.

Loan moratoria: Under the first payment moratorium, a suspension on capital and interest instalments was feasible for any loan in early arrears (fewer than 30 days past due) for the period of March to December 2020.

About half of the performing portfolio entered into moratorium; in total €11 bn of eligible €23 bn, plus further €0.7 bn categorised as non-performing, split roughly equally in corporate and household loans. The second moratorium was available in the period of January to June 2021, for selected categories of debtors. Participation was low, at about €0.1 bn. This notwithstanding, given the high take-up rate of the moratorium in Cyprus, a proactive and engaging risk and arrears management by credit institutions is essential in managing the possible emergence of new non-performing loans.

Interest rate subsidisation: The state launched two interest rate subsidisation schemes for new loans granted to households (mortgages only) and corporates in order to support debtors' liquidity and debt servicing capacity. The schemes provide for interest subsidisation for a total of 4 years. About €450 mn of loans granted to date are eligible for subsidisation, the majority of which falls in the household segment. The scheme is available for new loans granted until end 2021.

Government guarantees: In April 2021 the Council of Ministers approved a public guarantee scheme to further support corporate liquidity. Under the €1 bn guarantee scheme a total of €1.4 bn of guaranteed loans may be granted by end 2021 to corporates for any purposes other than repayment of existing debt. Potential losses will be split among the state and credit institutions in a ratio of 70:30. Creditors must pursue the liquidation of underlying collateral. The scheme will be operational after a Parliamentary vote of the state guarantee into law and an approval by the European Commission upon fulfilment of state-aid requirements.

Management of Non-Performing Loans

An effective **legal framework** underpinning the enforcement of debt collateral is important given the pre-2014 banking practice of loan granting based on collateral value rather than debtor income. The law underpinning the foreclosure framework was amended in 2018 for a more streamlined process, enhancement of the rights of creditors and prospective buyers and clarifying that old court decisions can be implemented under the new foreclosure regime. The 2018 framework gave an impetus for increased use of the foreclosure route for terminated loans. Foreclosures have been initiated for a gradually increasing number of properties concluding with an auction success rate[3] of approximately 20%. Including pre-auction voluntary solutions, the total success rate of foreclosures increases to more than 30% of initiated cases.

In June 2020 an amending law entered into force, following a Supreme Court decision validating its constitutionality as voted by the House of Representatives in 2019, under which new provisions in the foreclosure process were introduced and timelines are extended. The new framework has not been effectively tested to date.

Another important component in the resolution of NPLs has been the sales to entities outside the banking sector. Despite its extensive use, deficiencies remain in the secondary market of NPLs affecting the credit acquiring companies and their credit servicers.

In a package of three legislative bills, the rights of credit acquirers and credit servicers are brought at par to those of credit institutions as regards the access to the database of the Land and Surveys Department. Moreover, credit servicers are brought under the supervision of the Central Bank of Cyprus, similarly to credit acquirers. The three bills have been submitted to House of Representatives in early March 2021.

3 Defined as Sales through auctions/Auctions conducted.

In parallel, the Ministry of Finance has submitted to the House of Representatives a bill named «Evidence (Amending) Law 2020», which aims to enable credit acquiring companies to have the same treatment in the submission of loan accounts as evidence before Court concerning cases of debt, i.e., the presentation of accounts to be accepted as prima facie evidence, as is the case of credit institutions.

The enactment of these four bills will render the credit acquirers in the markets for distressed loans essentially equal to the credit institutions. The aim is the increase of the overall resolvability of NPLs held by credit acquirers affecting both their existing as well as potential new portfolios.

The **Estia scheme** was launched in 2019 with the aim of tackling NPLs collateralised by primary residences under a burden-sharing arrangement between creditors, debtors and the state. Total submitted applications were around 6400, of which about a third was incomplete. By end Q1-2021 the majority of applications had been assessed and about €0.2 bn of NPLs were approved to enter the scheme with some potential to grow further. About half of approvals are attributed to KEDIPES loans, and thus outside the banking sector. The examination of applications has revealed that a considerable share of applicants exceeded the income and wealth criteria.

The Ministry of Finance is currently investigating the potential for a new role for the **transformation of KEDIPES** so that the asset parameter expands to manage bad loans across the banking sector. The national Asset Management Company, once commitments under the European Commission's State Aid decision no. 34335 concerning KEDIPES are addressed, will aim the acquisition of NPLs collateralised by primary residences or primary business premises.

Non-bank financial sector

Since 2018 specialised **credit acquiring companies** have been established in Cyprus. There are in total 6 credit acquiring companies managing bad loans of around €12 bn in the economy. The largest credit acquirers are KEDIPES and Gordian Holdings, managing assets acquired from the former Cyprus Cooperative Bank and Bank of Cyprus respectively.

The **insurance sector** comprises 33 entities with total assets at end 2020 of €4.1 bn similar to end 2019. The majority of assets under management is invested in bonds and collective investment schemes. The Solvency Ratio at end 2020 reached 298%. Total underwritten insurance premia reached €970 mn at end 2020, of which about 60% in the non-life segment and 40% in the life segment.

Regarding **capital markets**, there were 788 supervised entities by Cyprus Securities and Exchange Committee at end 2020 exhibiting an increase compared to 746 supervised entities at end 2019 mostly in the fund management segment. Total employees are around 6900 persons or about one third of the total financial sector employees (2019 data). The majority in the capital markets sub-sector, at about 70%, is employed at Cyprus Investment Firms. In particular:

- *Cyprus Investment Firms*

As per 2020 data there are 242 CIFs, remaining stable compared to the year before. The sector's asset size, as per 2019 data, is at €9.1 bn. Financial products offered are mostly forex, binary options and traditional products.

- *Fund management*

The total number of authorised management companies and undertakings in collective investment reached 266 at end 2020, from 210 at end 2019.

Assets under management reached €8.6 bn at end 2020 exhibiting a small increase by €0.3 bn compared to the end of the previous year. Of this, the largest share is managed under Alternative Investment Funds. In terms of investment location, about €2 bn of assets are invested in Cyprus, mostly in private equity and real estate.

2.2 Macroeconomic outlook 2021-2024

2.2.1 GDP prospects 2021-2024

The medium term baseline scenario presented in this Stability Programme projects that the economy will enter into a recovery trajectory from 2021 onwards. Real GDP growth is forecast at 3.6% in 2021, 3.8% in 2022, 3.2% in 2023 and 2.8% in 2024.

Growth in 2021 is still supported by government spending and will be reinforced by a normalization in private spending and investments, driven by the implementation of a significant number of projects in the areas of tourism, energy, transport and education and include, inter alia, the construction of marinas, a casino resort and an infrastructure development of the University of Cyprus. The growth forecast for 2021 has been revised downwards since the autumn forecasting round due to a slower than expected recovery in the tourism sector. Indeed, tourist arrivals in numbers for 2021 are anticipated to double compared to the 2020 levels but remain significantly lower than the record performance of 2019, fueled particularly by the UK, Russia, Germany and other European markets. Tourist arrivals are projected to increase gradually over the forecasting horizon, reaching 2019 levels by 2024.

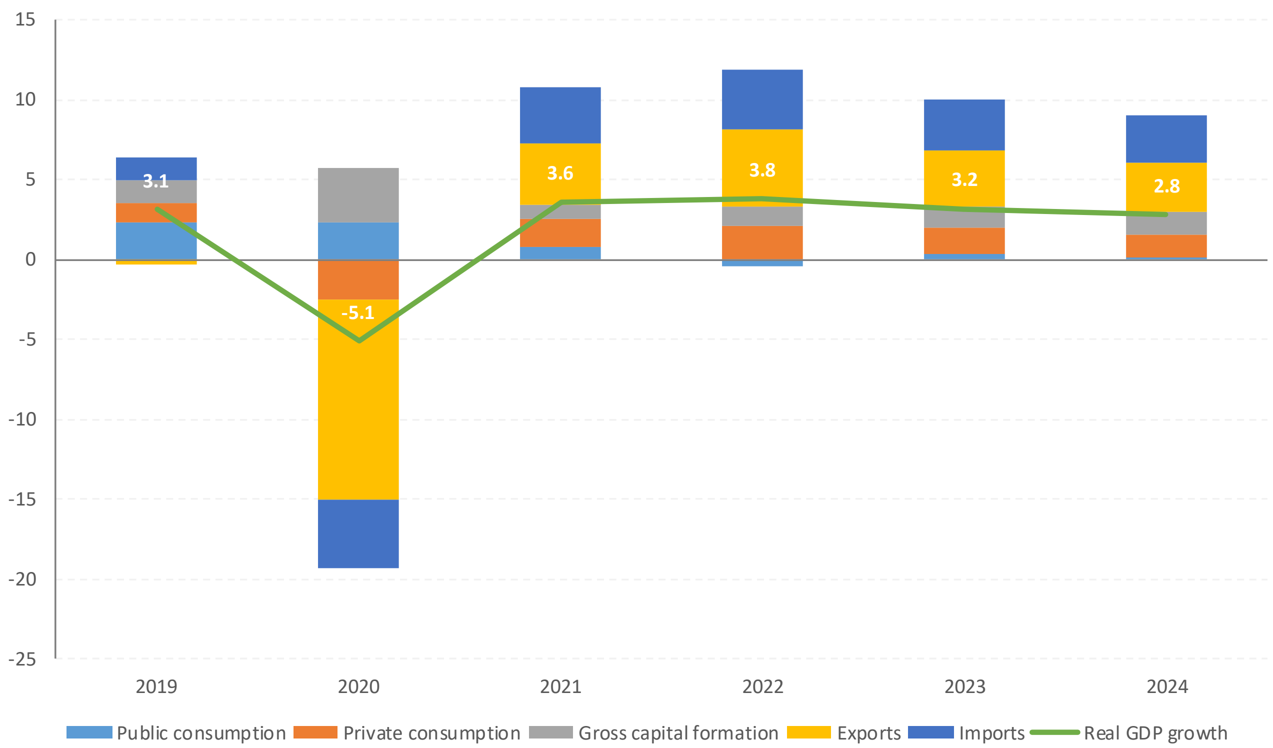
A little more than a year since the onset of the COVID-19 pandemic, forecasts for the medium term horizon are still surrounded by uncertainty, mostly depending on the evolution of the pandemic and the roll-out of the vaccination program. In addition, a key inter alia determinant to growth is the tourism sector and how fast it will recover. The fact that vaccines have indeed been developed by the scientific community for the virus, is a pivotal step towards setting the pandemic under control. However, mutations of the virus pose a threat on the effectiveness of the vaccines, which is an important factor in terms of reinstating confidence.

Vaccination programmes commenced in the beginning of the year but are developing in an uneven manner across EU countries and around the world, plagued by production shortages and hiccups surrounding the safety of the vaccines. In Cyprus, the vaccination programme is being carried out with relatively adequate speed, considering the limitations, and hopefully, health scares surrounding the vaccines will not derail the Ministry of Health from the inoculation goals that have been set out.

Daily coronavirus infections in Cyprus have more or less stabilized but at relatively high levels, with hospitalisations, especially concerning severe cases that need intensive care still not down to the desired levels. Hence, the pressure on the health system is still high and Cyprus, like a number of other European counterparts, is in the midst of restrictive measures that are deemed severe enough for a significant segment of economic activity. Deriving positive lessons from countries that have started to see significant improvement following the vaccination of a high proportion of their population (60% and over of the adult population, at least for the first dose of the vaccine), growth prospects in 2021 remain positive.

In the medium-term period 2022-2024, the outlook of the economy is forecast to be robust with increased growth prospects. The macroeconomic environment is expected continue improving and maintain the Cyprus economy sound with investment and domestic demand to be the main drivers to growth. Consumption expenditure will continue to have a positive contribution to growth, and remain strong but with a slowdown compared to 2021, due to improving employment developments and better access to finance, rather than wage increases. From 2022 onwards, external demand will become more significant as tourism gradually recovers. Imports are expected to grow in line with consumption and investment. All of the above, combined with the improved expectations regarding investment opportunities in the energy and tourism sectors, including the RRF, create a promising outlook for the prospects of the Cyprus economy. Real GDP growth is forecast to accelerate to about 3.8% in 2022 due to: a) improved tourism performance, b) higher private consumption due to a continued improvement in labour market performance and c) improved investment expenditure due, inter alia, to the implementation of RRF projects. Afterwards, growth will decelerate to 3.2% in 2023 and 2.8% in 2024, where the tourism sector is envisaged to return to its 2019 levels. From a sectoral perspective, growth is expected to originate mainly from retail trade, shipping, construction, manufacturing, other business services sectors and, gradually, tourism.

Figure 10: Contributions to GDP growth 2019-2024, percentage point change



Source: CYSTAT, MOF

Inflation, measured by the CPI, is estimated to turn positive in 2021 exhibiting an increase of 1.2% and then projected to accelerate and increase by 1.5% in 2022-23 and rising further to 2% in 2024.

Table III: Medium Term Framework, 2020-2024

change in percent	2020	2021	2022	2023	2024
Real GDP	**-5.1**	**3.6**	**3.8**	**3.2**	**2.8**
Government Consumption	13.0	3.7	-1.8	1.7	0.8
Private Consumption	-3.9	2.8	3.3	2.5	2.2
GFCF	-2.1	3.5	4.8	5.4	5.5
Exports	-17.4	6.2	7.6	5.3	4.6
Imports	-5.8	4.8	5.1	4.3	4.0
Deflator	-0.7	1.2	1.5	1.5	2.0
Nominal GDP	-5.8	4.9	5.4	4.7	4.8
HICP	-1.1	1.2	1.5	1.5	2.0
CPI	-0.6	1.2	1.5	1.5	2.0

Source: CYSTAT, MOF

The **current account (CA)** deficit had improved significantly in recent years, mostly due to a cyclical correction of the goods balance, while in 2020 the deficit increased significantly to -11.8% of GDP, marking a widening by 5.5 percentage points since 2019, due to the income and trade balances (-5.6% and 6.2% of GDP respectively). Over the medium-term, deficit is expected to decrease but remain relatively high, along with the improvement in the trade balance and in particular export of services (tourism). Although the direct and indirect effect of tourism does not exceed 10% of the GDP, in the CA the effect of tourism is more pronounced. This is the main reason that the CA deficit will remain relatively high and decrease slowly over the projection horizon. The income account will also gradually contribute to the decrease in deficit. The income account projection relies on the assumptions that the primary and secondary income account balances will hover around last year's average levels, in absolute terms, with a small improvement in time, while ship registration/deregistration will remain at 2020 levels.

2.2.2 Labour market

Developments in the labour market are surrounded by uncertainty for 2021 given that most government employment supporting schemes have expired in March, with the exception of the ones on the hotels industry, which will continue until June 2021.

The baseline macroeconomic scenario expects a reversal of the 2020 trend with employment back to a positive trajectory in 2021, at a rate of about 0.7% in terms of persons employed. The improvement in the labour conditions is expected to be slow and closely follow the recovery of the economy from the 2nd half of 2021 onwards. Developments will depend on a large extent on the tourism sector, since the main reduction in employment in 2020 was in the tourist industry. From 2022 onwards, employment is projected to grow at a rate of 2-2.5% on average. In the period 2022-2024, employment growth is foreseen to continue improving, as long as the economy performs a similar path.

At the same time, the average annual unemployment rate is envisaged to pursue a downward path, pursuing a similar pace as economic growth, but with a delay, adhering to the norm that unemployment usually follows economic activity with a time lag. The declining path of unemployment is projected to maintain pace during 2021-2024, falling to 7.2% in 2021, to 6.7% in 2022, 6.0% in 2023 and to 5.5% in 2024. The reduction of the unemployment rate is triggered by improved economic activity, significant capital investment, resilient private consumption and the gradual return of tourism back to the 2019 levels in 2024, all leading to a sustained job creation.

Table IV: Labour market developments

	2018	2019	2020	2021f	2022f	2023f	2024f
Employment (persons) growth	5.3	3.1	-0.6	0.7	1.5	2.5	2.5
Unemployment rate	8.4	7.1	7.6	7.2	6.7	5.0	5.5
Compensation per employee, growth	1.3	1.9	-3.2	2.5	2.0	2.0	2.5
Nominal unit labour cost, growth	1.4	1.9	1.5	-0.4	-0.3	1.2	2.2
Real unit labour cost, growth	-0.1	1.6	-2.6	1.3	0.5	0.5	0.5
Productivity (persons)	-0.1	0.0	-4.6	2.9	2.3	0.7	0.3

Source: CYSTAT, MOF

Wages

Wage growth, as reflected in the compensation per employee, is expected to decrease by 3.2% in 2020 and is forecast to turn positive in 2021 as the economy picks up, while continue to grow at a moderate pace of 2% in 2022-2023 and up to 2.5% in 2024. Wage developments are projected to pursue the steady growth of the economy denoting an improved labour market performance.

Productivity and ULC

Based on the aforementioned forecasts in the labour market, productivity is estimated to have been negative in 2020 by 4.6%. In 2021, productivity is projected to turn positive to 2.9% and to 2.3% in 2022 mainly by the recovery of employment in persons and aligned by fluctuations in hours worked. In 2023 and 2024 productivity is expected to slow down to 0.7% and 0.3% respectively, signaling a moderate improvement and returning to more steady levels.

Nominal Unit labour cost (NULC) is forecast to follow a similar path to compensation per employee. In 2020 NULC is estimated to have increased by 1.5% following an increase of 1.9% in 2019. NULC is forecast to exhibit a decrease of 0.4% in 2021 and 0.3% in 2022 indicating that these are transition years, until the economy returns to its pre-crisis 2019 level, and then increase by 1.2% in 2023 and 2.2% in 2024. The projections in NULC underpin that cost competitiveness shall be sustained at a relatively moderate level.

Real unit labour cost (RULC) growth in 2020 was negative by 2.6%. Over the forecasting horizon 2021-2024, it is envisaged that RULC will pursue a steady pace, whereby price inflation is expected to offset any significant productivity fluctuation.

2.2.3 Price developments

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), recorded a decrease of 0.8% compared to the year before, mainly due to the drop in the prices of categories Housing, Water, Electricity, Gas and Other Fuels, as well as of Transport, which recorded the largest negative changes compared to the year before of 3.8% and 5%, respectively. The significant decrease in these price indices was the outcome of the drop in international oil prices during 2020 of about 35.1% (from a monthly average of $64.36 in 2019 to $41.76 in 2020). The highest price increases during 2020 were recorded in the prices of categories Recreation and Culture, and Food and Non-Alcoholic Beverages of about 2% and 1.3%, respectively.

In 2020 the Consumer Price Index (CPI) recorded a decrease of the order of 0.6% compared to the year before.

Table V: CPI by Economic Activity

	2015	2016	2017	2018	2019	2020	Jan-21	Feb-21
GENERAL INDEX	**-2.1**	**-1.4**	**0.5**	**1.4**	**0.3**	**-0.6**	**-1.6**	**-1.9**
LOCAL GOODS	-3.9	-2.7	1.4	2.0	1.9	-0.6	-5.2	-5.4
Local Agricultural	1.0	0.4	-0.7	2.4	3.3	1.9	-11.9	-12.4
Local Industrial	-0.5	-0.6	-0.7	-0.2	-0.4	0.9	0.5	0.7
Electricity and Water	-16.3	-13.8	12.1	9.3	7.5	-9.3	-10.9	-12.1
IMPORTED GOODS	-0.6	-0.4	-1.0	-1.1	-1.1	-0.7	1.2	-0.1
Imported Agricultural	0.7	-0.6	2.4	-5.2	-3.7	0.0	-3.8	-0.9
Imported Industrial (Excl. petr.)	-0.6	-0.4	-1.1	-1.0	-1.1	-0.7	1.4	-0.1
PETROLEUM PRODUCTS	-13.3	-7.6	7.1	6.0	-6.6	-9.1	-10.0	-8.5
SERVICES	0.0	-0.8	0.5	1.8	1.7	1.1	0.7	0.6
Rents	-1.2	-0.5	0.8	2.5	3.4	2.5	1.3	1.1
Repairs &maintenance of dwellings	-2.0	1.1	1.8	4.5	3.1	2.3	2.1	2.1
Transport	2.1	-14.1	0.5	6.6	4.3	1.0	6.1	6.3
Communication	1.0	-0.3	-1.0	-1.4	-1.6	0.7	-3.9	-3.9
Insurance	0.1	0.2	-2.5	0.8	0.4	0.7	0.8	0.8
Government services	0.7	-2.4	0.6	3.5	0.8	0.2	-1.3	-1.5
Education	-1.1	0.4	0.7	2.6	1.8	1.0	0.0	0.0
Medical care	1.0	1.6	1.1	0.8	0.7	0.7	0.4	0.4
Restaurants & Coffee shops	0.2	0.3	0.7	1.7	1.6	0.9	0.3	0.0
Personal & Household services	-0.6	-0.1	0.8	2.0	2.5	1.4	1.7	1.9

Source: CYSTAT

Analysis of CPI by economic activity indicates that the prices of categories Electricity and Water, as well as of Petroleum Products, contributed to this y-o-y decrease by 0.8 and 0.4 percentage points, respectively. More specifically, Electricity and Water price index decreased by 9.1%, attributed to the significant decrease that was recorded in international oil prices during 2020 of about 35.1%. For the same reason, Petroleum price index also recorded a substantial decrease during 2020 of about 9.1% compared to 2019.

On the other hand, all services sub-indices recorded an increase during 2020, contributing positively to the yearly percentage change of CPI by 0.4 percentage points, partly offsetting the significant negative contribution of Electricity, Water and Petroleum products prices.

Core inflation averaged at 0.1% during 2020, deviating by 0.7 percentage points above the headline inflation, indicating mainly the increases recorded on services prices.

2.2.4 Risks to economic outlook

The risks associated with the forecasts presented in this update of the Stability Programme are both on the upside as well as on the downside.

The most significant risk is the uncertainty surrounding the duration of the crisis, making it difficult to predict its potential scarring effects on the productive factors of the economy in the period of the next two years that will largely shape the kind of rebound that we will witness. As this Stability Programme is being drafted, daily infection rates are still relatively high and hospital capacities are constantly challenged. At the same, the vaccination programme is progressing but problems related to vaccine safety scares and the vaccines performance against mutations may delay the effective containment of the virus. Further on-off periods with the imposition of stricter restriction measures are not out of the picture yet. External demand developments will also depend on the developments in our main trading partner countries. The next few months will be pivotal in shaping future economic outcomes, especially in connection with the tourism sector.

However, taking into account the response of the scientific community to provide all means possible to control the pandemic, the positive signs from countries that have achieved high vaccination rates and the massive public support exerted and policies implemented, utilizing all national tools available, amid the collective response on a European level, not least via the NextGenerationEU, the risk of a prolonged economic crisis seems at this point on the low end of the possible outcomes.

Banking sector developments are still regarded as a source of downside risk mainly due to the percentage of non-performing loans (NPLs). Additionally, as the pandemic effects continue to evolve, banks face rising risks on asset quality, profitability and capital levels. Significant steps towards effectively reducing the level of NPLs are constantly being made, while the banking system is supported by a resilient capital position and surplus liquidity keeping any significant downside risks on a medium level at this juncture.

On the upside, the output growth forecasts presented in the Stability Programme are based on a partial inclusion of the impact of investments expected to be implemented under the RRP. This approach was deemed more prudent in anticipation of the final RRP to be submitted to the European Commission by end-April, and as more detailed information becomes available.

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

Regarding Brexit, since the last Stability Programme, an agreement between the United Kingdom and the European Union on a Trade and Cooperation Agreement was concluded on 24th December 2020 and entered into force on 1st January 2021. Risks from the impact of the agreement are considered to be broadly balanced.

CHAPTER 3: GENERAL GOVERNMENT BALANCE AND DEBT

3.1 Policy Strategy

From early 2020, fiscal policy is concentrated on measures to protect the economy from the outbreak of the COVID-19 pandemic crisis by alleviating its effects on economic metrics and on society, while reinforcing the ability of the health system to respond to the current demand. The overall aim remains the preservation of the core production factors of the economy, so as to facilitate a healthy rebound, once the crisis subsides.

During 2020 the government provided a series of measures with direct and indirect impact on the accounts of the general government of about 3.6% of GDP in total, as well as measures providing liquidity and convenience where needed to businesses and households. The NHS related activities during 2020 also impacted negatively on the accounts of the general government by about 1.3 percentage points of GDP.

3.2 General Government Balance 2020

The budget balance during 2020 recorded a substantial deterioration and turned into a deficit of 5.8% of GDP compared to a surplus of 1.5% of GDP the year before. This negative outcome, after four consecutive years of strong fiscal position, was due to the impact of the COVID-19 outbreak on the economy, which recorded a negative rate of growth of 5.1% in real terms during 2020, as well as due to the support measures of a one-off nature, targeting the consequences of the pandemic crisis on health, businesses and employment positions. In nominal terms, the deficit in the accounts of the general government reached about €1,213 mn in 2020 compared to a surplus of €341 mn the year before. Primary balance was also in deficit of about €762 mn (-3.6% of GDP) compared to a primary surplus of €850.6 mn (3.8% of GDP) in 2019.

Revenue

In 2020, total revenue as a percentage of GDP fell from 41.3% the year before to 40.8%, recording a decline of 0.5 percentage points of GDP. In value terms, total revenue decreased by 6.9% compared to 2019. Almost all revenue categories recorded a decrease during the year under review.

Tax revenue dropped by 9.7% during 2020, falling to 23.6% of GDP from 24.6% of GDP during 2019. Receipts from taxes on production and imports had the highest contribution to the negative growth of tax revenue, by -8.7 percentage points, and decreased by 14.3% in value terms, mostly due to reduced VAT receipts in line with the restrictive COVID-19 measures, as well as from a reduction of the special VAT rates as of 1st July 2020 until the end of 2020.

Revenue from taxes on income and wealth decreased by 2.6%, in line with the related to the crisis developments in the labour market. As a percentage of GDP, current taxes on income and wealth increased by 0.3 percentage points, from 9.7% of GDP in 2019 to 10% of GDP in 2020. It is worth mentioning that, despite the pandemic crisis, the generous packages of the government, which provided wage subsidisation as well as direct support to businesses, restrained losses from this revenue category.

Revenue from social security contributions increased by 1.1% during 2020, despite the negative labour market developments during the year under review. The positive growth in social security contributions was the outcome of increased contributions in the context of the NHS, which contributed by 7.5 percentage points to this year-on-year increase. As a percent of GDP, revenue from social security contributions increased from 10.7% in 2019 to 11.4% in 2020.

Property income declined by 29.7% mainly due to the non-payment of a dividend by the Central Bank of Cyprus during 2020, as well as due to the methodological treatment of the signature bonus related to the production sharing contracts for the exploration and exploitation of hydrocarbon reserves, which was reflected in the accounts of the general government in the three-year period 2017-2019.

Expenditure

Total expenditure in 2020 as a percent of GDP, exhibited an increase of 6.8 percentage points, from 39.8% of GDP in 2019 to 46.6% of GDP in 2020. In value terms, public expenditure increased by 10.4%, of which 7.2 percentage points are attributed to measures undertaken by the government to tackle the impact of the pandemic crisis.

Compensation of employees exhibited an increase of about 5.8%, mainly attributed to increased pensions and gratuity payments (contribution 1.5 percentage points), the gradual phasing out of wage cuts (contribution 1.3 percentage points) as well as to the government's contribution to the NHS as an employer (contribution 0.3 percentage points). Increments, as well as the granting of the cost-of-living allowance also contributed positively to this expenditure category during 2020 by about 1.3 percentage points in total. As a percentage to GDP, compensation of employees increased by 1.5 percentage points, from 12.3% in 2019 to 13.8% of GDP in 2020.

Intermediate consumption recorded a negative rate of growth of 7.7% compared to the year before. As a percent of GDP, intermediate consumption decreased by 0.1 percentage point, falling to 4.3% in 2020 from 4.4% the year before.

Social payments increased at a rate of 19.3% and had the highest contribution to the growth of public expenditure during 2020 by 6.6 percentage points. This substantial increase is mainly due to increased compensations of HIO to private health providers for their services in the context of the NHS (contribution to the increase of social payments, 13.6 p.p.), as well as due to COVID-19 related measures of wage subsidisation for employees that needed to be absent from work and for special unemployment allowances (contribution to the increase of social payments, 2.1 p.p.). As a percent of GDP, social payments increased from 13.6% in 2019 to 17.2% during 2020.

Expenditure category subsidies also contributed substantially to the growth of public expenditure during 2020, by 5.7 percentage points. This was the outcome of COVID-19 related measures mainly for the subsidisation of wages of employees of companies that experienced full or partial suspension of their operations, as well as for the one-off payments to companies to cover part of their operating costs (contribution to total expenditure growth by 5.7 percentage points). As a percent of GDP, subsidies increased by 2.5 percentage points, from 0.3% of GDP the year before to 2.8% of GDP in 2020.

Interest expenditure recorded a decrease of 11.4% in 2020 compared to the year before. As a percent of GDP, interest expenditure marginally declined from 2.3% in 2019 to 2.2% of GDP in 2020.

Finally, category other expenditure recorded a decrease of about 24.4% during 2020, declining as a percent of GDP to 3.4 percent compared to 4.3 percent the year before. This was the outcome of the one-off impact related to the methodological treatment of the amendment of Income Tax Law as of March 2019, which contributed to the growth of this expenditure category by 29.7 percentage points.

3.3 Budget 2021

In light of the still on-going COVID-19 pandemic, it is forecast that the budget balance of the General Government will remain in deficit during 2021 of about 4.7% of GDP. The deterioration of the budget balance in 2021, compared to a forecast of a much lower deficit during the preparation of the Budget 2021, is the outcome of the revised Budget voted by the House of Representatives end-January 2021 that included additional expenses related to the pandemic crisis of about 1.5% of GDP, additional expenditure through a Supplementary Budget early-April 2021 aiming to cover the needs for an extension of the special schemes of the government of about 1.1% of GDP, as well as the expectations for a lower positive economic growth during the current year.

The primary balance is forecast to remain in deficit during 2021, reaching -2.7% of GDP.

Revenue

In accordance with the baseline macroeconomic scenario, total revenue in 2021 is anticipated to record a positive rate of growth of the order of 10.1% compared to 2020, estimated to increase as a percentage to GDP by 2.1 percentage points, from 40.8% the year before to about 42.9% of GDP.

Tax revenue in 2021 is expected to exhibit a rate of growth of about 3.5% compared to 2020, yet decline as a percentage of GDP by 0.3 percentage points, from 23.6% in 2019 to 23.3% the year before. The increase of tax revenue in value terms, is mainly attributed to the expected growth in revenues from taxes on production and imports, which are forecast to exhibit an increase of 4.1% compared to 2020, in line with the anticipated increase in private consumption. As a percent of GDP, taxes on production and imports are expected to reach 13.5% from 13.6% the year before. Taxes on income and wealth are also expected to record an increase of about 2.7% compared to the year before, yet decline as a percentage of GDP, from 10% in 2020 to 9.8% in 2021.

Social Security contributions are forecast to exhibit a substantial increase in 2021 of about 9.9% compared to the year before. The increase on this revenue category is mainly the result of increased contributions during 2021 in the context of the NHS[4], contributing by 5 percentage points to the increase of this revenue category, as well as due to expected increased revenue of Social Security Funds, as nominal earnings are forecast to record an increase during the year under review, despite the loss from the wage subsidisations, which are not subject to any contributions. As a percent of GDP, revenue from social security contributions are expected to increase by 0.6 percentage points in 2021, reaching 12% from 11.4% of GDP in 2020.

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[4] As per the related to the National Health System Law, all employers, employees and the state are contributing to the System as of 1st March 2019, whereas contributions increased as of 1st March 2020 in the context of the 2nd Phase of the NHS, 1st June 2020. A measure was introduced as part of the package of the government to support the economy from the COVID-19 outbreak, suspending the increased contributions for three continuous months, beginning from 1st April 2020, in order to support the disposable income of the taxpayers and lower business cost.

Revenue from property income in value terms is expected to exhibit a substantial increase of about 33.1% in 2021, mainly due to the non-payment of a dividend yield by the Central Bank of Cyprus during last year. As a percent of GDP, this revenue category is expected to reach 0.9% from 0.7% the year before.

Finally, category “other revenue” is also expected to record a substantial increase of about 37.6% stemming mainly from the expected increase in revenue from the European Funds, taking also into account grants expected to be received in the context of the RRF, contributing 12.2 percentage points to the growth of this revenue category. Increased revenue of the Health Insurance Organisation (HIO) and of the State Health Services Organisation (SHSO) in the context of the NHS, are also expected to contribute positively to the growth of category “other revenue” during 2021, as well as revenue from goods and services related to the recovery of the tourism sector, like overflying charges and royalties for the operation of airports, which were substantially decreased during 2020. As a percent of GDP, this revenue category is expected to increase by 1.5 percentage points, from 5.1% the year before to 6.7% in 2021.

Expenditure

Total expenditure is estimated to exhibit an increase of 7.1%, reaching 47.6% as a percentage of GDP compared to 46.6% the year before. Almost all expenditure categories are expected to record an increase during 2021 compared to the year before.

In more detail, compensation of employees is forecast to exhibit an increase of 3.2% in 2021 compared to the year before, brought mainly from the gradual abolition of wage cuts, as well as from the increased expenditure in the context of the NHS, estimated in total at 2 percent of GDP. The provision of Cost of Living Allowance (COLA) and annual increments are also expected to contribute positively to the increase of this expenditure category, which is forecast to fall at 13.5 percent of GDP from 13.8 percent of GDP the year before.

Intermediate consumption is forecast to record an increase of 12.3% during 2021, brought mainly by increased expenses for the provision for the health care sector to combat the pandemic, which were included in the Supplementary Budget early-2021, contributing to the growth of this expenditure category by 8.5 percentage points of GDP. As a percent of GDP, intermediate consumption is estimated to increase by 0.3 percentage points, from 4.3% in 2020 to 4.6% of GDP during the year under review.

Social transfers, are expected to increase substantially by 8.4% in 2021, contributing the highest to the growth of public expenditure, by 3.1 percentage points. This increase is attributed to increased payments of the HIO to public health providers for inpatient health services in the context of the 2nd Phase of the NHS, which was introduced 1st June 2020. It is forecast that the increased expenditure in the context of the NHS in total, will contribute to the growth of this expenditure category by 7.9 percentage points. On the contrary, decreased expenditure from wage subsidisations for parental leave and for sickness allowance, are expected to impact the growth of social transfers by -0.6 percentage points. As a percent of GDP, this expenditure category is expected to increase by 0.6 percentage points, from 17.2% the year before to 17.8% in 2021.

Interest expenditure is forecast to record a decrease of 1.2% in 2021, and decline as a percentage of GDP from 2.2% in 2020 to 2 % in 2021.

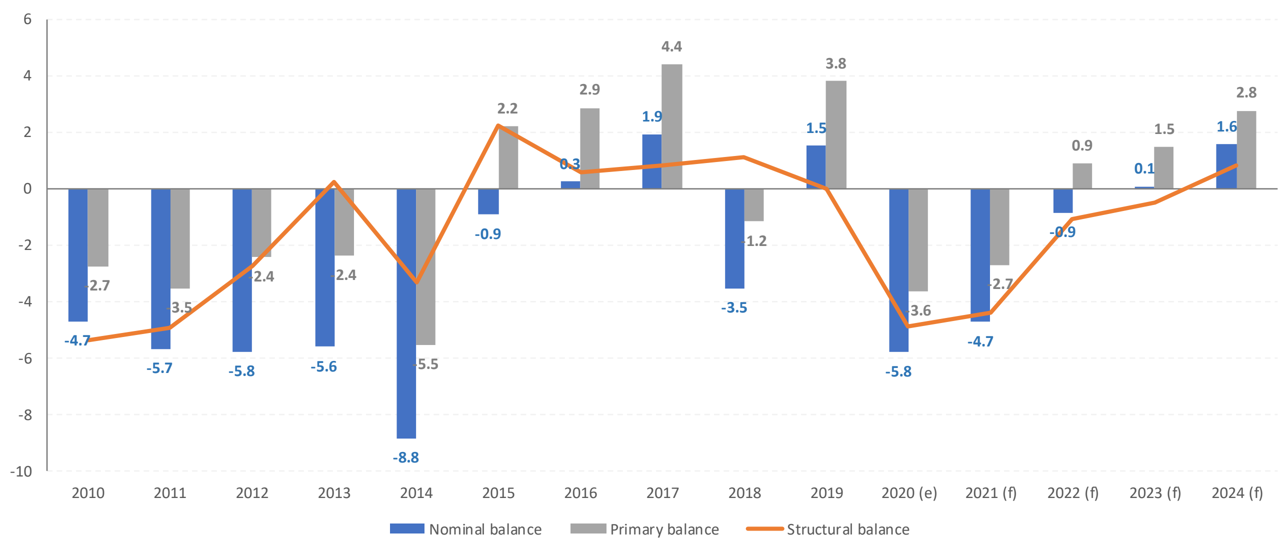
Gross fixed capital formation as a percent of GDP is forecast to exhibit a substantial increase of 0.7 percentage points, reaching to 3.6% from 2.9% of GDP in 2020. The y-o-y increase of 28.2% of this expenditure category, in value terms, is mainly attributed to the impact of the RRF.

Category 'other expenditure' is estimated to remain at 3.4% of GPD during 2021 and record an increase in value terms of around 2.6%, mainly due to increased expenditure included in the Supplementary Budget for possible extra needs to be met within the year, taking into account the ongoing pandemic crisis.

3.4 Medium-Term Budget Balance 2022-2024

Taking into account the baseline macroeconomic scenario, and after two continuous years of substantial budget deficits associated with the pandemic COVID-19 crisis, it is expected that the budget position will improve from 2022 onwards reaching a surplus of about 1.6% of GDP by the end of the programming period, allowing debt-to-GDP ratio to continue its downward path over 2022-24 at a satisfactory pace.

Figure 11: Nominal, Primary and Structural Balance (% GDP)



Source: CYSTAT, MOF

Total revenue in nominal terms is projected to record a y-o-y growth of 3.1% both during 2022 and in 2023, and increase further by about 4.9% in 2024 as a result of the increase in social security contributions as from 1st January 2024, according to the relevant Law. As a percent of GDP, total revenue is forecast to reach 42% in 2022 compared to 42.9% in 2021 and drop to 41.3% of GDP in 2023 and 2024, respectively.

On the expenditure side, it is projected that public spending will decline by 5.2% in 2022 compared to the year before, taking into account the withdrawal of the supportive measures related to the crisis, and then exhibit small y-o-y increases of 0.8% and 1.2% in 2023 and 2024, respectively. As a percent of GDP, total expenditure is forecast to drop to 41.2% in 2023 from 42.8% in 2022, and decrease further to 39.7% of GDP in 2024 mainly as a result of the impact from the termination of the gradual wage cuts, as well as from decreased interest payments.

It is worth-mentioning that interest payments are projected to follow a downward trajectory over the forecasting horizon, taking into consideration that the low interest rate environment in the European capital markets allowed the government to replace existing public debt with a relatively high cost with new funding mainly through EMTN issuances at lower interest rates.

Allocation of expenditure

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

Table VI: Functional classification of expenditure

% of expenditure	2013	2014	2015	2016	2017	2018	2019	2024 (f)
General public services	20.7	18.5	22.4	21.0	20.1	16.4	18.6	18.2
Defence	3.9	3.2	3.6	4.1	5.6	4.3	4.4	4.4
Public order and safety	5.0	3.6	4.2	4.4	4.5	3.9	4.3	4.3
Economic affairs	9.6	23.1	8.7	7.0	6.7	22.8	11.5	6.3
Environmental protection	0.6	0.5	0.9	0.7	0.8	0.6	0.7	1.7
Housing and community amenities	4.5	4.5	4.4	3.9	4.2	3.5	3.9	4.0
Health	7.2	5.4	6.3	6.7	6.8	6.2	9.5	13.8
Recreation, culture and religion	2.1	1.8	2.2	2.3	2.4	1.9	2.3	2.5
Education	14.8	11.3	13.9	14.6	14.4	11.8	13.5	12.4
Social protection	31.5	28.1	33.4	35.4	34.6	28.6	31.2	32.3
Total expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: CYSTAT, MOF

Finally, public debt is estimated to decrease further by 8 percentage points of GDP, declining to 103.9% of GDP at end-2022 compare to 111.9% of GDP at the end of the year before, and continue its downward trend during 2023 and 2024, falling to 99.5% and 92.9% of GDP, respectively.

3.5 Medium Term Objective (MTO)

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. By the termination of the activation of the escape clause, the MTO remains at a balanced fiscal position (0.0% of GDP) in structural terms.

Potential output estimates used for the calculation of the cyclical position of the fiscal policy are obtained from the commonly agreed methodology of the European Commission. Potential GDP is estimated to continue to grow, from 2% in 2020 to 2.4% in 2023 and 2.5% by the end of the programming period.

As a result of the real and potential GDP estimated evolution during 2020 and 2021, the output gap turns negative, from a positive 5.6% of GDP in 2019, to -1.8% and -0.7% of GDP, respectively. From 2022 onwards, the output gap turns positive reaching 1.5% of GDP in 2024.

The budget balance in cyclically-adjusted terms is estimated to have remained in deficit during 2020, despite the negative output gap of about 1.8% of GDP.

Cyclically adjusted balance (CAB) in 2020 is estimated at about -4.9% of GDP, due to the increase in public expenditure during the year targeting the consequences of the pandemic crisis as well as from revenue losses stemming from the measures undertaken. In 2021, CAB is expected to remain in deficit of about -4.4% of GDP, as the impact of associated to the crisis expenditure is forecast to remain. For the programming period 2022-2024 the CAB is forecast to remain in deficit, though at a lesser extend compared to the previous two years, reaching -1.1% and -0.5% of GDP in 2022 and then return to positive reaching 0.8% of GDP in 2024. In the absence of any one-off and other temporary measures during the programming period, the structural balance path coincides with the cyclically-adjusted balance path.

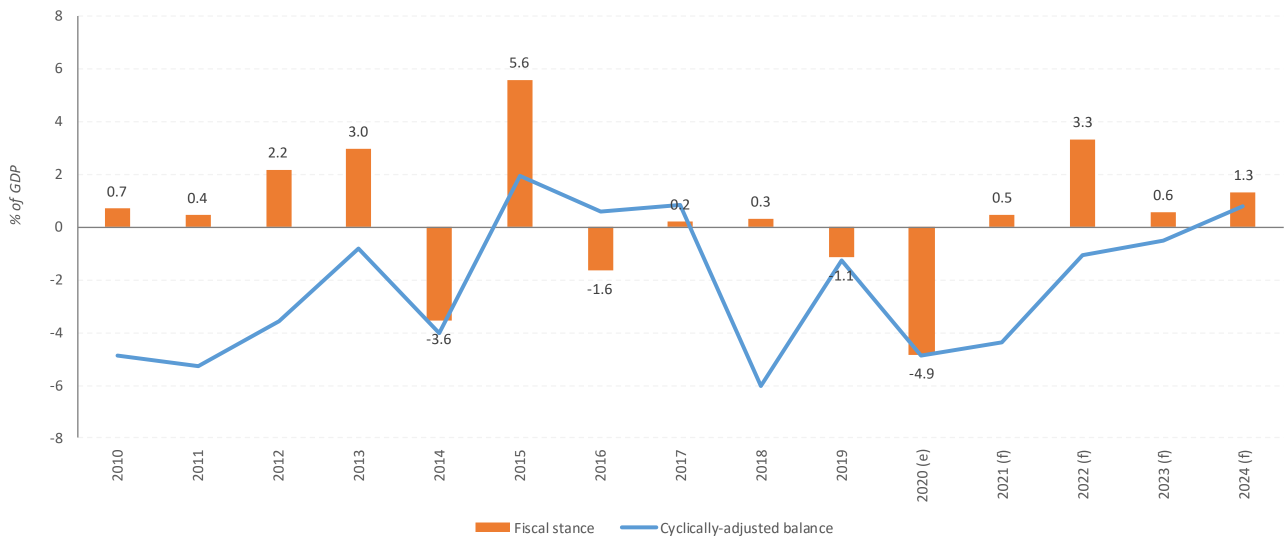
Table VII: Cyclical developments

in percentage of GDP	2019	2020	2021	2022	2023	2024
Real GDP growth (%)	3.1	-5.1	3.6	3.8	3.2	2.8
Net lending of general government	1.5	-5.8	-4.7	-0.9	0.1	1.6
Interest expenditure	2.3	2.2	2.0	1.8	1.4	1.2
One-off and other temporary measures	-1.3	0.0	0.0	0.0	0.0	0.0
Potential GDP growth (%)	2.5	2.0	2.4	2.7	2.4	2.5
Output gap	5.6	-1.8	-0.7	0.4	1.2	1.5
Cyclical budgetary component	2.8	-0.9	-0.3	0.2	0.6	0.8
Cyclically-adjusted balance	-1.3	-4.9	-4.4	-1.1	-0.5	0.8
Cyclically-adjusted primary balance	1.0	-2.7	-2.4	0.7	0.9	2.0
Structural balance	0.0	-4.9	-4.4	-1.1	-0.5	0.8

Source: Statistical Service and Ministry of Finance

Taking into account the output gap estimations adopted in this Stability Programme, which are derived from the commonly agreed methodology, and the fiscal forecasts for a medium-term horizon, where, at the time of their compilation uncertainty remains substantial, the structural balance for the period 2023-24 achieves the medium-term budgetary objective, averaging at 0.3% of GDP.

Figure 12: Cyclically-adjusted balance and fiscal stance (% of GDP)



Source: Ministry of Finance

3.6 General Government Debt

The Medium-Term Public Debt Management Strategy (MTDS) 2021-2023 which was approved by the Council of Ministers in October 2020 is focused on the following guidelines:

- Smoothening of debt maturity profile and maintaining the maturity of marketable debt at a satisfactory level compared to the EU average;
- Risk mitigation through increased cash reserves to cover the financing needs of the next 9-12 months and management of interest rate risks;
- Development of the government securities markets;
- Minimisation of marketable debt borrowing costs through the improvement of investor relations and expansion of the investor base.

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

Financing actions in 2020

The main source of funding to meet government needs came mainly through the issuance of European Medium-Term Notes (EMTN) totaling €4.5 bn. Despite the sizeable public borrowing from European markets, the government proceeded to absorb an additional €1.25 bn from domestic banks and private individuals in April 2020, with an issue of a 52-week Treasury Bill, exploiting the high liquidity of domestic banks and furnishing the government cash buffer with a surplus of funds. Prior to 2020, it is worth mentioning the execution of portfolio liability transactions, namely that of the early full repayment of the IMF loan, amounting to €717 mn, and the payoff of EMTN amounting to €668 mn.

A detailed statement of the annual financing in 2020 per source is presented in the table below.

Table VIII: Net annual financing per source, 2020

	€ mn
Treasury Bills	1475 [1]
Funding from EU program SURE	250
Retail bonds	48
Euro Medium Term Notes	4500
EIB-CEB loans	42
Total net annual financing	**6315**

1= An amount of €225 million concerns the outstanding amount of debt on a rolling quarterly basis. The remaining amount of € 1250 concerns the issuance of a one-year Treasury Bill.

The preparation of the initial Annual Financing Program 2020 (AFP 2020) provided for the coverage of financing needs of a total amount of approximately €2,3 bn. Based on the conditions at that time, this amount would have been enough to cover the financing needs of 2020 while maintaining a satisfactory amount of cash reserves available for covering at least the financing needs of next 9 months, as defined in the Medium-Term Public Debt Management Strategy.

In view of the measures taken by the Government to address the COVID-19 pandemic, the initial AFP 2020 has been revised three times (March 2020, July 2020 and August 2020) to meet the additional financing needs that had arisen, namely the need to support economic activity in the private sector which suffered from the lockdown and to sustain employment, in addition to the need to finance the budget deficit due to government measures to address the financial implications of the Covid-19 pandemic. In addition, a decision was taken to strengthen further the liquidity buffer of the Government.

A detailed statement of the initial and revised annual financing per source for 2020 is presented in the table below.

Table IX: Net annual funding1 per source, 2020

Financing source	Initial AFP 2020 € mn	1st Revised AFP 2020 € mn	2nd Revised AFP 2020 € mn	3rd Revised AFP 2020 € mn
Treasury Bills	300	1,550[2]	1,550[2]	1,550[2]
Retail bonds	100	100	100	100
Euro Medium Term Notes (EMTN)	1,850	3,750	4,500	4,500
Funding from EU program SURE	-	-	-	500
EIB-CEB loans	100	1000	100	100
Total net annual financing[1]	**2,350**	**5,500**	**6,250**	**6,750**

1=The total net annual financing of the annual funding plan refers to the maximum amount of funding.
2= An amount of €300 mil+lion concerns the outstanding amount of debt on a rolling quarterly basis. The remaining amount of € 1,250 million concerns the issuance of a one-year Treasury Bill.

As shown in the table above, the main source of financing in 2020 came through issuances of European Medium-Term Notes (EMTNs) at a total of €4.5 bn, an amount that had already been drawn from the international markets in January, April and July 2020. Specifically, in January 2020 a 10-year EMTN of €1,000 mn and a 20-year EMTN of €750 mn were issued, in April of the same year a 7-year EMTN of €1,250 mn and one 30-year EMTN amounting to €500 mn were also issued and finally in July a tap issue of €500 mn on an existing 5-year EMTN and a tap issue of another €500 mn on the 20-year EMTN accomplished maximum of funding through EMTN issuances. In addition, on April 2020, an amount of €1,250 mn was derived through the issuance of a one-year Treasury Bill. Due to these transactions, the Republic of Cyprus has achieved a significant cash reserve to cover not only the financing needs of the next 9 months but also to cover the increased needs due to the financial impact of the Covid-19 pandemic. Later on, in November 2020, an amount of €250 mn was received as a first disbursement of European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) following the COVID-19 outbreak.

If we exclude the amount of Treasury Bills that expire and are renewed during the year, the implementation rate of the 1st revised AFP 2020 reached 87% in April 2020 and by July on the 2nd revised AFP 2020 reached 92%. In conclusion, as shown in the tables above, the 3rd revised AFP 2020 was implemented by 93.5%, significantly shielding the cash reserves of the State.

In addition, a more sustainable public debt portfolio has been achieved with a low risk of refinancing, reducing financing costs in the medium term and extending the average remaining time of marketable debt to around 8 years, well above the target set in the MTDS.

Financing in 2021

The Annual Funding Plan 2021 was established by the Minister of Finance and is presented in Table X below. Due to the continuation of the COVID-19 pandemic and measures taken to support growth and jobs, during the first three months of 2021, the negative surpluses rise up leading inevitably to the increase of funding needs. Up to now, the implementation of AFP 2021 is around to 71% according to the issuance of a 5-year EMTN of €1,000 mn on 9th February, the disbursement of an amount of €229 mn from SURE program and the issuances of retail bonds (excluding rollover debt). At the beginning of April 2021, existing cash balance is estimated to be around 21.6% of GDP and by the end of the year 2021 it is estimated to be at around 10% of GDP and will be enough to cover the financing needs for the first nine months of 2022.

Table X: Net annual funding1 per source, 2021

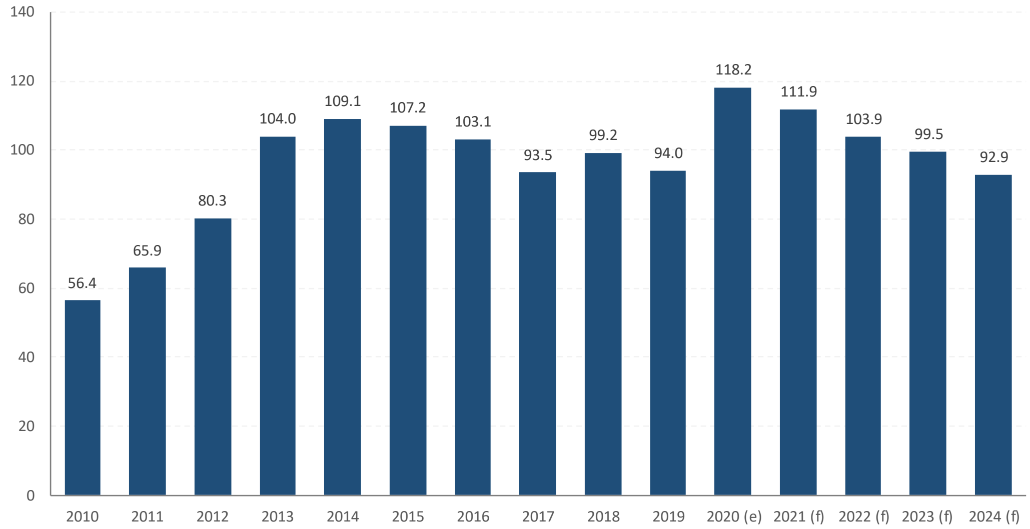
Financing source	**Initial AFP 2021 € mn**
Treasury Bills	225-300
Retail bonds	40
Euro Medium Term Notes (EMTN)	1,250
Funding from EU programs (RRF, SURE)	349[2]
EIB-CEB loans	100
Total net annual financing[1]	1,964-2,039

1=The total net annual financing of the annual funding plan refers to the maximum amount of funding. It is noted that pursuant to Public Debt Management Law the Annual Funding Plan is updated at least twice a year.

2= An amount of around €125 million will be added, due to latest decision (31st March 2021) by the EU Commission as an extra amount of loan funding EU member States to cope with pandemic financial loses. Also, an amount of around €120 million is expected to be received as a grant during the second half of the year under RRF.

The general government debt -to-GDP ratio in 2020 increased to 118.2% compared to 94% the year before. The debt increase was partially due to the support measures taken by the government to preserve income and employment by re-covering (a large percentage of) salaries of workers in companies/organizations that “took the hit” of the pandemic general lockdowns, in various periods in 2020, as well as to absorb high fiscal deficits in the state’s budget. This increase in debt is attributed also to a decisive increase in cash liquidity reserves as a precaution action, due to the uncertainty of the Covid-19 pandemic. The net general government public debt was estimated at around 101% of GDP in 2020. Equivalently that means that the total of cash reserves was approximately 17 percentage points of GDP.

Figure 13: Debt ratio



Source: Ministry of Finance

Debt developments

The general government debt is projected at €24.6 bn or as a percentage of GDP at 111.9% at the end of 2021, as presented in Table XI below. The expected reduction of general government debt by 6.3 percentage points is attributed to the repayment of a significant amount of debt due within the year which is expected to be covered both through new debt issuances as well as through the utilisation of the cash buffer. During the programming period 2021-2024, debt-to-GDP ratio is projected to continue its downward trend declining to about 103.9%, 99.5% and 92.9% by year end 2022, 2023 and 2024 respectively. The debt-to-GDP ratio is projected to exhibit a reduction of 8 percentage points in 2022 compared to 2021, 4.4 percentage points in 2023 compared to 2022 and 6.6 percentage points in 2024 compared to 2023.

Table XI: General government debt 2020-2024

in percentage of GDP	2020	2021	2022	2023	2024
Gross debt ratio	118.2	111.9	103.9	99.5	92.9
Change in debt ratio	24.2	-6.3	-8.0	-4.4	-6.7
Primary balance	-3.6	-2.7	0.9	1.5	2.8
Interest expenditure	2.2	2.0	1.8	1.4	1.2
Stock-flow adjustment	18.4	-11.0	-8.9	-4.3	-5.1

Source: Ministry of Finance

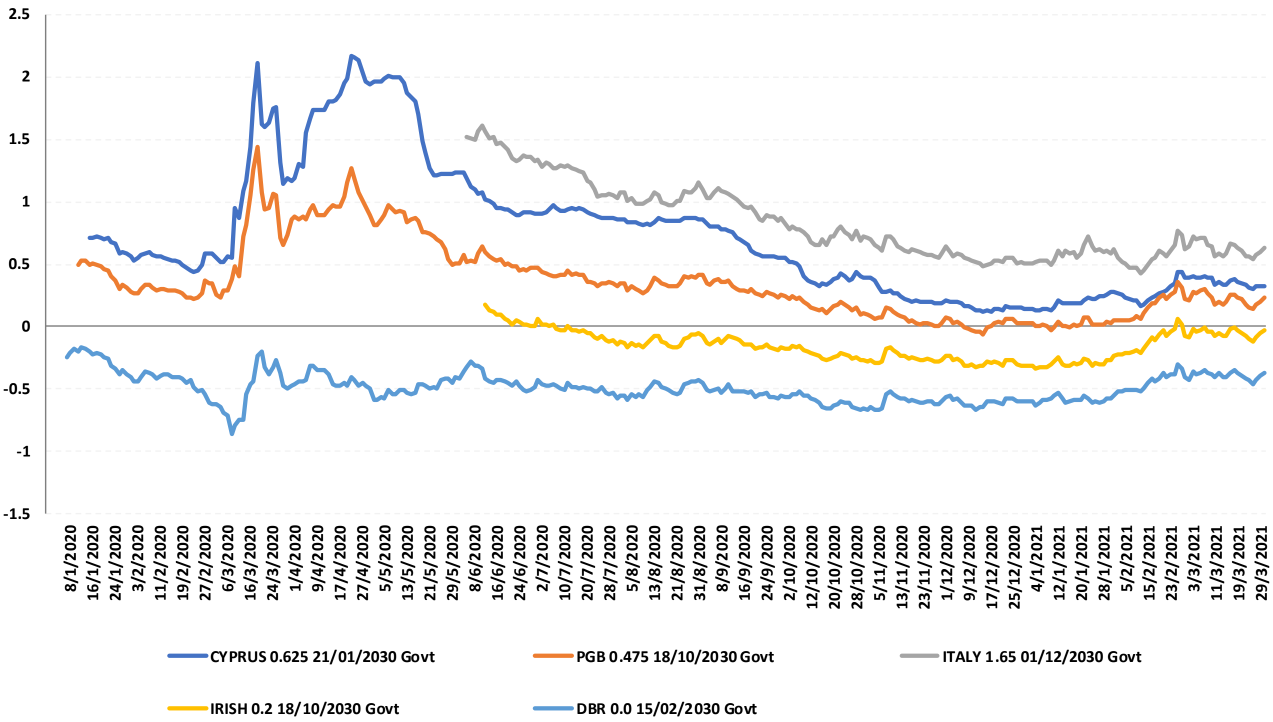
The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called “snow ball” effect. The substantial stock flow adjustment in 2020, equivalent to 18.4% of GDP, reflects the significant accumulation of liquid assets in the form of deposits related to the issuance of the total order of €6.1 bn during the year. In 2021 onwards, the stock flow adjustment turns negative owing to decreases in financial assets used for the repayment of debt.

Spreads – secondary market yields

This section focuses on the secondary sovereign market yields of Cyprus and selected Eurozone states for 10year government bonds due in 2030 (where available). As presented in Figure 10 below, the 2030 Cyprus sovereign market bond yield has shown relevant downward trend for the whole year 2020 especially after May 2020. The 2030 Cyprus bond performed very well and had tightened further during the year decreasing towards the end of 2020 by 178 basis points compared to the beginning of the year underpinned by the robust economic performance of the Cyprus economy resulting in a number of confirmations about the Cyprus’ sovereign ratings and by keeping the outlook stable from all the Credit Rating Agencies in 2020. Since the end of February 2020, the 2030 Cyprus sovereign market bond yield has exhibited an upward trend mainly because of the uncertainty in the initial period immediately following the Covid-19 outbreak and marked an increase by 1171 basis points towards the end of 10th April 2020 and also at 5th May an increase by 1654 basis points. As from May 2020, secondary market yields have started to declined and converged gradually to the pre-pandemic levels. The sovereign bond yields of selected Eurozone States exhibited a homogeneous output for the year 2020 and for the period January – March 2021, but with different rates of change.

With regards to spread developments, the Government bond yield spreads for Cyprus vs. Germany (DBR 0.0 15/02/2030) have fluctuated during the year and towards the end of 2020 decreased by 178 basis points compared to the beginning of the year reaching 737 basis points. During the period January - April 2020, the Government bond yield spread for Cyprus vs. Germany exhibited an increase, mainly due to the uncertainty around the Covid-19 outbreak, by 740 basis points reaching 1655 basis points. As from May 2020, the said spread took a downward course while by the beginning of November 2020 it converged towards the same level as in January 2020 at 929 basis points. Also it is noted that, in latest values, by the end of March 2021 the bond yields spread for Cyprus 10-year EMTN is still decreasing and, more specifically, the spread is decreased by 221 basis points reaching 694 basis points, compared with the afore-mentioned German 10-year bond.

Figure 14: Secondary market yields levels of Cyprus and selected Eurozone States (10-year government bonds)



Source: Bloomberg

CHAPTER 4: SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

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

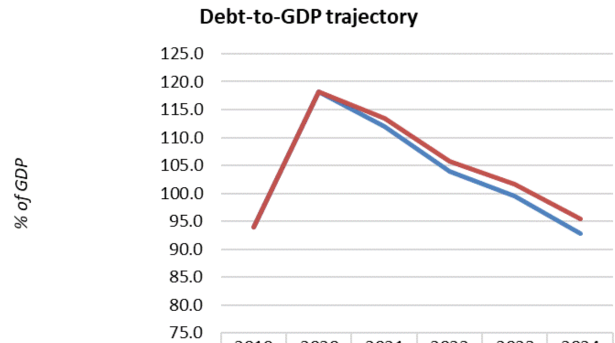
Sensitivity analysis

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

Scenario 1: Higher interest rate by 50 basis points annually

The first scenario assumes higher interest rates than the baseline scenario for each year over the programming period. In particular, the real interest rate increases by half of the 10-year historical standard deviation. Under this scenario, only the trajectory of general government public debt is affected which, however, continues to present a downward trend, declining to around 95.4% by 2024, compared to 92.9% under the baseline scenario.

Figure 15: Debt to GDP trajectory under the higher interest rate sensitivity scenario



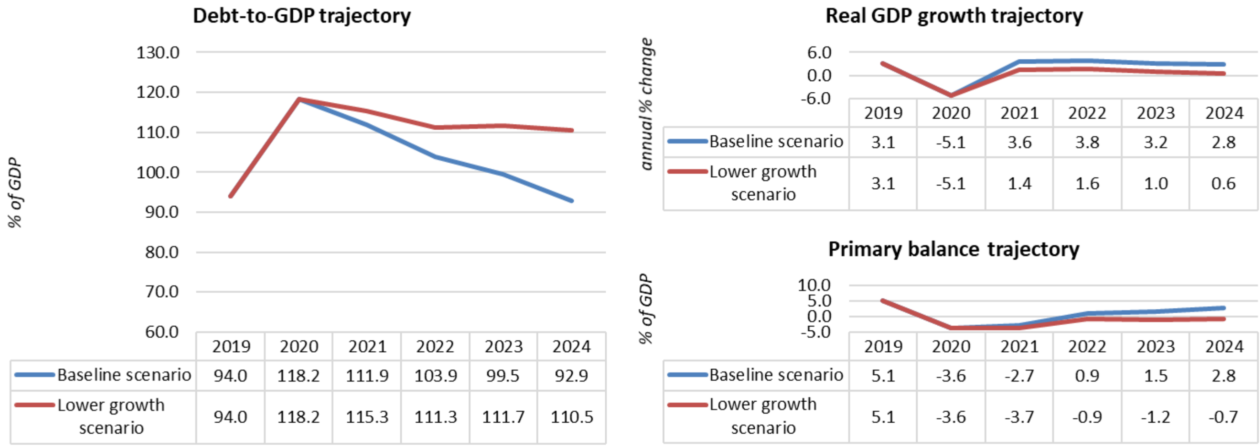
	2019	2020	2021	2022	2023	2024
Baseline scenario	94.0	118.2	111.9	103.9	99.5	92.9
Higher interest rate scenario	94.0	118.2	113.4	105.8	101.7	95.4

Source: Ministry of Finance

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

Under this scenario, real growth in GDP is assumed to be lower by half of the 10-year standard deviation, for each year over the programming period, compared with the baseline scenario. Along with the real growth trajectory, Figure 13 below presents the trajectories for debt-to-GDP ratio and primary balance as percentage of GDP for the period 2019-2024. The debt ratio still projects a sustainable downward path over the medium term, declining to 110.5% by 2024, exhibiting a deviation of about 17.6 percentage points of GDP compared to the projected outcome under the baseline scenario, due to the negative growth rates during 2012-2014 and 2020.

Figure 16: Debt to GDP, real GDP growth and primary balance as % of GDP trajectories under the lower real growth rate sensitivity scenario



Debt-to-GDP trajectory

	2019	2020	2021	2022	2023	2024
Baseline scenario	94.0	118.2	111.9	103.9	99.5	92.9
Lower growth scenario	94.0	118.2	115.3	111.3	111.7	110.5

Real GDP growth trajectory

	2019	2020	2021	2022	2023	2024
Baseline scenario	3.1	-5.1	3.6	3.8	3.2	2.8
Lower growth scenario	3.1	-5.1	1.4	1.6	1.0	0.6

Primary balance trajectory

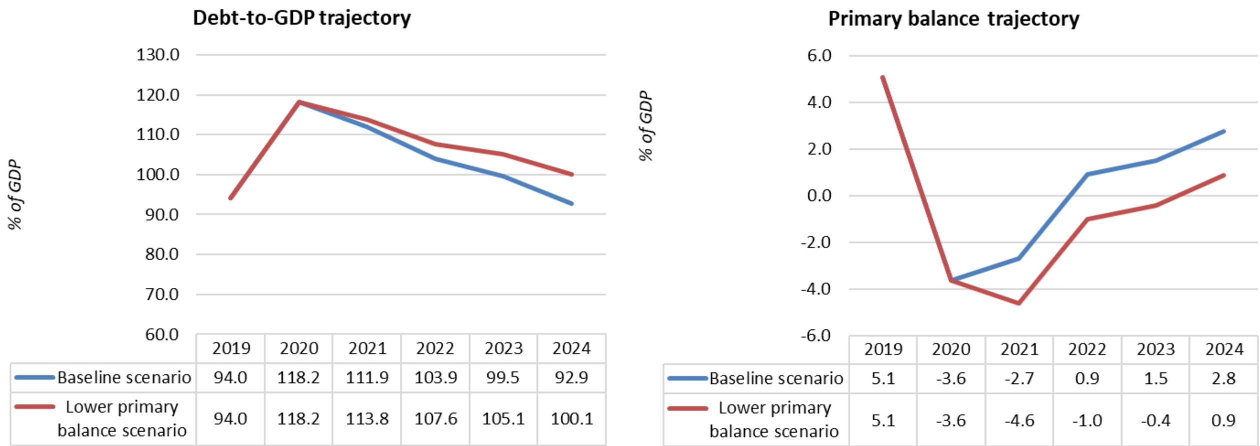
	2019	2020	2021	2022	2023	2024
Baseline scenario	5.1	-3.6	-2.7	0.9	1.5	2.8
Lower growth scenario	5.1	-3.6	-3.7	-0.9	-1.2	-0.7

Source: Ministry of Finance

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

In the third scenario, primary balance as a percentage of GDP is reduced by half of the 10-year historical standard deviation for each year over the programming period. Under this scenario, even though the debt to GDP in 2024 is expected to be higher than the baseline, there is still a downward trend, where debt ratio declines to 100.1% by 2024.

Figure 17: General government debt and primary balance trajectories under the lower primary balance sensitivity scenario (% of GDP)



Debt-to-GDP trajectory

	2019	2020	2021	2022	2023	2024
Baseline scenario	94.0	118.2	111.9	103.9	99.5	92.9
Lower primary balance scenario	94.0	118.2	113.8	107.6	105.1	100.1

Primary balance trajectory

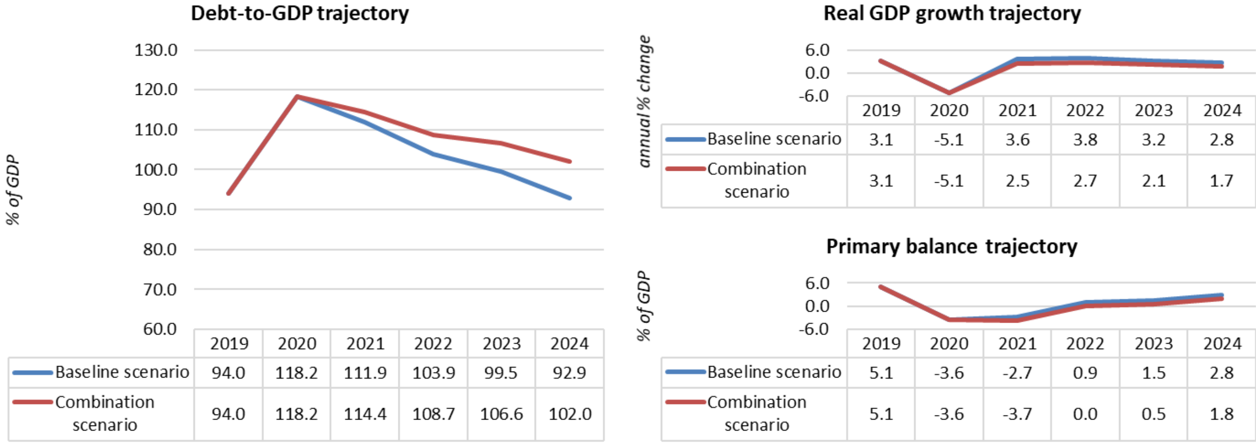
	2019	2020	2021	2022	2023	2024
Baseline scenario	5.1	-3.6	-2.7	0.9	1.5	2.8
Lower primary balance scenario	5.1	-3.6	-4.6	-1.0	-0.4	0.9

Source: Ministry of Finance

Scenario 4: Combination scenario

Under the combination scenario, it is assumed that shocks occur simultaneously on real interest rates, real growth and in primary balance, of the order of ¼ of their 10-year historical standard deviation. Under this scenario, even though the debt to GDP in 2024 is expected to be higher than the baseline, there is still a downward trend, declining to 102% by 2024.

Figure 18: Debt to GDP, real GDP growth and primary balance as % of GDP trajectories under the combination sensitivity scenario



Debt-to-GDP trajectory (% of GDP)

	2019	2020	2021	2022	2023	2024
Baseline scenario	94.0	118.2	111.9	103.9	99.5	92.9
Combination scenario	94.0	118.2	114.4	108.7	106.6	102.0

Real GDP growth trajectory (annual % change)

	2019	2020	2021	2022	2023	2024
Baseline scenario	3.1	-5.1	3.6	3.8	3.2	2.8
Combination scenario	3.1	-5.1	2.5	2.7	2.1	1.7

Primary balance trajectory (% of GDP)

	2019	2020	2021	2022	2023	2024
Baseline scenario	5.1	-3.6	-2.7	0.9	1.5	2.8
Combination scenario	5.1	-3.6	-3.7	0.0	0.5	1.8

Source: Ministry of Finance

CHAPTER 5: SUSTAINABILITY OF PUBLIC FINANCES

Chapter 5 illustrates the overall situation as regards 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 2021-2024. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2024 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government balance.

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

Table 7 in the Appendix includes an analysis of the long-term fiscal sustainability taking into account the impact of age-related changes in expenditure over the period 2020-2060. The main elements of the analysis are the long-term projections on public pensions, health long-term care and education expenditures. The base year for the projections is 2019 and therefore, figures for the subsequent years are projected. The projections undertaken for the purposes of the present Stability Programme are based on the latest available commonly agreed assumptions of the EPC-Ageing Working Group (AWG) formulated in 2020. Some figures for 2020 have become available, but for consistency reasons we use projected figures for 2020.

Table XII below, presents the key demographic and labour market assumptions used for the purposes of this year's Stability Programme. These assumptions are in line with those used in the 2021 Ageing Report, Underlying Assumptions and Projection Methodologies (published in November 2020) with base year 2019.

Table XII: Basic Demographic and Labour Market assumptions 2019-2060

	2019	2020	2030	2040	2050	2060
Total Fertility Rate	1.33	1.34	1.38	1.42	1.46	1.49
Life Expectancy at birth						
Males	80.8	80.8	82.1	83.3	84.5	85.6
Females	85.1	85.0	86.1	87.2	88.3	89.3
Participation Rates (15-64)	**75.4**	**76.0**	**77.9**	**78.4**	**78.7**	**79.4**
Males (15-64)	80.4	80.8	81.6	81.8	82.1	82.8
Females (15-64)	70.6	71.4	74.5	75.3	75.6	76.2
Net migration (thousand)	**7.8**	**4.5**	**3.4**	**3.0**	**2.7**	**2.4**

Regarding the population projections, the population of Cyprus is projected to increase from its current level of 0.9 million persons in 2019 to 1.1 million persons in 2060. Fertility rates, which have decreased between 2000 and 2014, are now projected to increase over the projection period from 1.33 in 2019 to 1.49 in 2060. Life expectancy also increases significantly. Gains in life expectancy over this period 2019-2060 are for males 4.8 years and for females 4.2 years.

On the labour market, the total participation rate is expected to increase by 4.0 p.p. between 2019-2060, mainly due to the increase in female participation rates (2.4 p.p. for males and 5.6 p.p. for females). Unemployment rate (15+) is expected to decline and stabilize at a rate of 6.7.

Table XIII presents the aggregate results of the projections for the public pension expenditure and the contributions over the period 2019-2060.

Table XIII: Projected public pension expenditure, contributions and reserves

in per cent of GDP	2019	2020	2030	2040	2050	2060
Total Expenditure[1]	8.8	10.2	10.0	10.2	10.1	10.7
Total Amount of Contributions[2]	8.4	9.0	9.2	10.1	10.1	10.0

[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 in Table 7 presented in the Appendix indicate that over the period 2020-2060, the public pension spending, as percentage of GDP, is expected to increase by 0.6 p.p., from 10.2 per cent in 2020 to 10.7 per cent in 2060.

Over the same period, the pension contributions increase by 1 p.p. from 9.0 per cent in 2020 to 10.0 per cent of GDP in 2060, primarily due to the legislated future increases in the GSIS contribution rate over the period until 2039.

The accumulated reserves of the GSIS are expected to increase from 37.6% of GDP in 2020 to 44.4% of GDP in 2050 and then decline to 39.5% in 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 2020 for the purposes of the 2021 Ageing Report - are projected to decrease from 19.8% in 2020 to around 19.6% of GDP in 2060.

Health care expenditure is projected to marginally increase during 2020-2060, from 3.1% of GDP in 2020 to about 3.2% in 2060. Long-term care expenditure is also projected to increase by 0.2 p.p. during 2020-2060, increasing from 0.4% of GDP in 2020 to about 0.6% in 2060.

Additionally, education expenditure is projected to decrease by 0.7 p.p. from 5.2% in 2020 to about 4.5% 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 decline and then remain stable at 0.7% of GDP across the projection period.

On the revenue side, property income is expected increase and then remain stable at 1.0% of GDP across the projection period. In addition, pension contributions are expected to increase to 10% of GDP in 2060.

As a result of the above, total general government expenditure will decrease from 46.6% of GDP in 2020 to 40.5% of GDP by 2060. This is mainly due to the lower ratio in 2024 which is our base year for the accumulation of projected changes. General government revenue is projected to increase from 40.8% of GDP in 2020 to around 42.4% of GDP in 2060 due to the increase in contributions.

APPENDIX: STABILITY TABLES

Table 1a. Macroeconomic prospects

		2020	2020	2021	2022	2023	2024
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	20,527.8	-5.1	3.6	3.8	3.2	2.8
2. Nominal GDP	B1*g	21,000.3	-5.8	4.9	5.4	4.7	4.8
3. Private consumption expenditure	P.3	13,322.9	-3.9	2.8	3.3	2.5	2.2
4. Government consumption expenditure	P.3	4,294.1	13.0	8.7	-1.0	1.3	0.5
5. Gross fixed capital formation	P.51	4,076.3	-2.1	3.5	4.8	5.4	5.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	904.3	3.8	-0.9	0.0	0.0	0.0
7. Exports of goods and services	P.6	12,854.6	-17.4	6.2	7.6	5.2	4.6
8. Imports of goods and services	P.7	14,951.8	-5.8	4.8	5.3	4.2	3.9
Contributions to real GDP growth							
9. Final domestic demand		21,693.3	-0.6	4.3	2.8	2.9	2.6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	904.3	3.8	-0.9	0.0	0.0	0.0
11. External balance of goods and services	B.11	-2,097.2	-8.2	0.4	1.0	0.3	0.2

Notes

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

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

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

Table 1b. Price developments

	ESA Code	2020 Level	2020 rate of change	2021 rate of change	2022 rate of change	2023 rate of change	2024 rate of change
1. GDP deflator		102.3	-0.7	1.191	1.508	1.5	2.0
2. Private consumption deflator		103.0	-0.9	1.2	1.500	1.5	2.0
3. HICP[1] [2015=100]		99.7	-1.1	1.200	1.500	1.5	2.0
4. Public consumption deflator		98.6	0.7	1.9	2.1	2.1	2.4
5. Investment deflator (GFCF)		103.8	-0.1	1.2	1.5	1.5	2.0
6. Export price deflator (goods and services)		103.3	0.3	1.2	1.5	1.5	2.0
7. Import price deflator (goods and services)		101.2	-1.1	1.5	1.8	1.8	2.2

Table 1c. Labour market developments

	ESA Code	2020 Level	2020 rate of change	2021 rate of change	2022 rate of change	2023 rate of change	2024 rate of change
1. Employment. persons (thousands)[1]		439.6	-0.6	0.7	1.5	2.5	2.5
2. Employment. hours worked[2] (thousands)		746,404.6	-6.4	5.0	1.5	2.5	2.5
3. Unemployment rate (%)[3]		34.3	7.6	7.2	6.7	6.0	5.5
4. Labour productivity. persons[4]		46,698.9	-4.6	2.9	2.3	0.7	0.3
5. Labour productivity. hours worked[5]		27.5	1.4	-1.3	2.3	0.7	0.3
6. Compensation of employees (€ million)	D.1	9,538.2	-3.8	3.2	3.5	4.5	5.0
7. Compensation per employee (in €)		24,457.8	-3.2	2.5	2.0	2.0	2.5

[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	**2020**	**2021**	**2022**	**2023**	**2024**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-11.8	-11.2	-9.7	-9.0	-8.5
of which:						
- Balance on goods and services		-6.2	-6.2	-5.2	-4.9	-4.7
- Balance of primary incomes and transfers		-5.6	-5.0	-4.5	-4.1	-3.7
2. Net lending/borrowing of the private sector	B.9	-2.2	-6.4	-8.8	-9.1	-10.1
3. Net lending/borrowing of general government	EDP B.9	-5.8	-4.7	-0.9	0.1	1.6
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Table 2a: General government budgetary prospects

% of GDP	ESA Code	2020	2020	2021	2022	2023	2024
Net lending (EDP B.9) by sub-sector		**€mn**					
1. General government	S.13	-1,213.2	-5.8	-4.7	-0.9	0.1	1.6
2. Central government	S.1311	-1,555.6	-7.4	-6.3	-2.3	-1.3	0.2
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	14.3	0.1	0.1	0.1	0.1	0.1
5. Social security funds	S.1314	328.1	1.6	1.5	1.4	1.3	1.3
General government (S13)							
6. Total revenue	TR	8,574.7	40.8	42.9	42.0	41.3	41.3
7. Total expenditure	TE[1]	9,787.9	46.6	47.6	42.8	41.2	39.7
8. Net lending/borrowing	EDP B.9	-1,213.2	-5.8	-4.7	-0.9	0.1	1.6
9. Interest expenditure	EDP D.41	451.6	2.2	2.0	1.8	1.4	1.2
10. Primary balance[2]		-761.6	-3.6	-2.7	0.9	1.5	2.8
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)		4,952.1	23.6	23.3	23.0	22.9	22.8
12a. Taxes on production and imports	D.2	2,852.3	13.6	13.5	13.4	13.4	13.3
12b. Current taxes on income. wealth. etc	D.5	2,099.6	10.0	9.8	9.6	9.6	9.6
12c. Capital taxes	D.91	0.2	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	2,403.9	11.4	12.0	11.9	11.8	12.2
14. Property income	D.4	150.0	0.7	0.9	0.9	0.8	0.8
15. Other[4]		1,068.7	5.1	6.7	6.1	5.7	5.5
16=6. Total revenue	TR	8,574.7	40.8	42.9	42.0	41.3	41.3
p.m.: **Tax burden** (D.2+D.5+D.61+D.91-D.995)[5]		7,356.0	35.0	35.3	35.0	34.7	35.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3,799.6	18.1	18.2	17.3	17.0	16.7
17a. Compensation of employees	D.1	2,891.6	13.8	13.5	13.4	13.3	13.1
17b. Intermediate consumption	P.2	908.0	4.3	4.6	3.9	3.8	3.6
18. Social payments (18=18a+18b)		3,619.2	17.2	17.8	17.0	16.3	15.7
of which Unemployment benefits[6]		109.3	0.5	0.5	0.3	0.2	0.1
18a. Social transfers in kind supplied via market producers	D.6311. D.63121. D.63131	617.7	2.9	4.1	4.0	3.8	3.7
18b. Social transfers other than in kind	D.62	3,001.5	14.3	13.7	13.1	12.5	12.0
19=9. Interest expenditure	EDP D.41	451.6	2.2	2.0	1.8	1.4	1.2
20. Subsidies	D.3	578.2	2.8	2.6	0.5	0.4	0.4
21. Gross fixed capital formation	P.51	614.8	2.9	3.6	3.4	3.3	3.3
22. Other[6]		724.5	3.4	3.4	2.9	2.7	2.6
23=7. Total expenditure	TE[1]	9,787.9	46.6	47.6	42.8	41.2	39.7
p.m.: Government consumption (nominal)	P.3	4,237.1	20.2	21.3	20.4	20.2	19.8

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

	2020 Level (€mn)	2020 % of GDP	2021 % of GDP	2022 % of GDP	2023 % of GDP	2024 % of GDP
1. Total revenue at unchanged policies	8,550.50	40.7	41.5	40.3	39.4	39
2. Total expenditure at unchanged policies	8,713.00	41.5	40.8	39	37.3	36

Table 2c. Amounts to be excluded from benchmark

	2020 Level (€ mn)	2020 % of GDP	2021 % of GDP	2022 % of GDP	2023 % of GDP	2024 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	62.2	0.3	1.1	0.4	0.5	0.5
2. Cyclical unemployment benefit expenditure	9.7	0.0	0.0	0.0	0.0	0.0
3. Effect of discretionary revenue measures	24.2	0.1	1.3	1.6	1.9	2.4
4. Revenue increases mandated by law	-	-	-	-	-	-

Table 3. General Government expenditure by function

% of GDP	**COFOG Code**	**2019**	**2024**
1. General public services	1	7.4	7.2
2. Defence	2	1.8	1.7
3. Public order and safety	3	1.7	1.7
4. Economic affairs	4	4.6	2.5
5. Environmental protection	5	0.3	0.7
6. Housing and community amenities	6	1.6	1.6
7. Health	7	3.8	5.5
8. Recreation, culture and religion	8	0.9	1.0
9. Education	9	5.4	4.9
10. Social protection	10	12.4	12.8
11. Total expenditure (=item 3=22 in Table 2a)	TE	39.8	39.7

Table 4. General government debt developments

% of GDP	ESA Code	2020	2021	2022	2023	2024
1. Gross debt		118.2	111.9	103.9	99.5	92.9
2. Change in gross debt ratio		24.2	-6.3	-8.0	-4.4	-6.7
Contributions to changes in gross debt						
3. Primary balance	B.9+D.41	-3.6	-2.7	0.9	1.5	2.8
4. Interest expenditure	D.41	2.2	2.0	1.8	1.4	1.2
5. Stock-flow adjustment		18.4	-11.0	-8.9	-4.3	-5.1
of which:						
- Differences between cash and accruals		-0.8	0.0	0.0	0.0	0.0
- Net accumulation of financial assets		13.5	-5.5	-3.1	0.4	-0.5
p.m.: Implicit interest rate on debt						
6. Liquid financial assets8		0.0	0.0	0.0	0.0	0.0
7. Net financial debt (7=1-6)		0.0	0.0	0.0	0.0	0.0

Table 5. Cyclical Developments

% of GDP	ESA Code	2020	2021	2022	2023	2024
1. Real GDP growth (%)		-5.1	3.6	3.8	3.2	2.8
2. Net lending of general government	B.9	-5.8	-4.7	-0.9	0.1	1.6
3. Interest expenditure	D.41	2.2	2.0	1.8	1.4	1.2
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		2.0	2.4	2.7	2.4	2.5
contributions:						
- labour		1.0	1.1	1.2	0.8	0.8
- capital		0.9	0.9	1.0	1.1	1.1
- total factor productivity		0.1	0.4	0.5	0.5	0.5
6. Output gap		-1.8	-0.7	0.4	1.2	1.5
7. Cyclical budgetary component		-0.9	-0.3	0.2	0.6	0.8
8. Cyclically-adjusted balance (2 - 7)		-4.9	-4.4	-1.1	-0.5	0.8
9. Cyclically-adjusted primary balance (8 + 3)		-2.7	-2.4	0.7	0.9	2.0
10. Structural balance (8 - 4)		-4.9	-4.4	-1.1	-0.5	0.8

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

Table 6. Divergence from previous update

	ESA Code	2020	2021	2022	2023	2024
Real GDP growth (%)						
Previous update		-7.0	6.0	n.a.	n.a.	n.a.
Current update		-5.1	3.6	3.8	3.2	2.8
Difference		1.9	0.1	n.a.	n.a.	n.a.
General government net lending (% of GDP)	B.9					
Previous update		-4.3	-0.4	n.a.	n.a.	n.a.
Current update		-5.8	-4.7	-0.9	0.1	1.6
Difference		-1.5	-4.3	n.a.	n.a.	n.a.
General government gross debt (% of GDP)						
Previous update		116.8	103.2	n.a.	n.a.	n.a.
Current update		118.2	111.9	103.9	99.5	92.9
Difference		1.4	8.7	n.a.	n.a.	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	37.6	41.8	46.6	39.8	40.1	39.8	40.5
Of which: **age-related expenditures**	15.1	17.9	19.8	18.9	19.2	18.9	19.6
Pension expenditure	6.0	6.8	10.2	10.0	10.2	10.1	10.7
Social security pension	4.0	4.7	7.8	8.2	8.9	9.5	10.5
Old-age and early pensions	2.9	3.6	6.5	6.7	7.2	7.8	8.8
Other pensions (disability, survivors)	1.1	1.2	1.4	1.5	1.7	1.7	1.7
Occupational pensions (if in general government)[1]	2.0	2.1	2.3	1.8	1.3	0.6	0.2
Health care	2.6	3.0	3.1	3.0	3.1	3.1	3.2
Long-term care	0.2	0.2	0.4	0.4	0.5	0.5	0.6
Education expenditure[2]	5.6	6.5	5.2	4.7	4.7	4.5	4.5
Other age-related expenditures	0.8	1.3	0.9	0.7	0.7	0.7	0.7
Interest expenditure[3]	...	...	...	...	...	...	...
Total revenue	40.8	37.1	40.8	41.6	42.5	42.5	42.4
Of which: property income	0.6	1.4	0.7	1.0	1.0	1.0	1.0
Of which: from pensions contributions (or social contributions if appropriate)	5.8	6.9	9.0	9.2	10.1	10.1	10.0
Pension reserve fund assets	32.7	36.0	37.6	37.4	41.9	44.4	39.5
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	-0.9	1.5	0.3	0.8	1.9	1.8	1.7
Real GDP growth	5.1	2.0	-7.4	1.7	2.4	2.1	1.6
Participation rate males (aged 20-64)	82.9	80.4	80.8	81.6	81.8	82.1	82.8
Participation rates females (aged 20-64)	65.4	67.4	71.4	74.5	75.3	75.6	76.2
Total participation rates (aged 20-64)	73.9	73.6	76.0	77.9	78.4	78.7	79.4
Unemployment rate (15+)	3.9	6.3	8.4	8.4	7.6	6.8	6.7
Population aged 65+ over total population	12.4	12.7	16.5	19.6	20.9	22.4	25.1

[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	2020	2021
Public guarantees	16.7	15.3
Of which: linked to the financial sector	7.5	6.6

Table 8. Basic assumptions

	2020	2021	2022	2023	2024
EA: Short-term interest rate (3-months money markets)	-0.43	-0.54	-0.51	…	…
EA: Long-term interest rate (10-year government bonds, Germany)	-0.51	-0.3	-0.14	…	…
USD/€ exchange rate (annual average)	1.14	1.19	1.19	1.19	1.19
Nominal effective exchange rate of the EU (% change)	4.41	1.72	-0.18	…	…
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	6.54	-2.03	-0.12	…	…
World growth excluding EU (in PPP terms)	-2.9	5.9	4.2	…	…
EU 28 GDP growth	-6.1	4.4	3.9	2.3	1.9
Growth of relevant foreign markets [UK]	-9.9	5.3	5.1	2.0	1.8
World import volumes. excluding EU	-9.0	8.9	4.8	…	…
Oil prices (Brent. USD/barrel)	43.4	64.7	61.3	60.4	58.3

Table 9a. RRF impact on programme's projections - GRANTS

% of GDP	2020	2021	2022	2023	2024
Revenue from RRF grants					
1. RRF GRANTS as included in the revenue projections	0.0	0.6	0.4	0.4	0.4
2. Cash disbursements of RRF GRANTS from EU	0.0	0.6	0.4	0.4	0.4
Expenditure financed by RRF grants					
3.TOTAL CURRENT EXPENDITURE	0.0	0.0	0.0	0.0	0.0
4. TOTAL CAPITAL EXPENDITURE	0.0	0.6	0.4	0.4	0.4
of which:					
- Gross fixed capital formation	0.0	0.6	0.4	0.4	0.4
- Capital transfers	0.0	0.0	0.0	0.0	0.0
Other costs financed by RRF grants					
5. Reduction in tax revenue	0.0	0.0	0.0	0.0	0.0
6. Other costs with impact on revenue	0.0	0.0	0.0	0.0	0.0
7. Financial transactions	0.0	0.0	0.0	0.0	0.0

Table 9b. RRF impact on programme's projections - LOANS

% of GDP	2020	2021	2022	2023	2024
Cash flow from RRF loans projected in the programme					
1. Disbursements of RRF LOANS from EU	0.0	0.0	0.0	0.0	0.0
2. Repayments of RRF LOANS to EU	0.0	0.0	0.0	0.0	0.0
Expenditure financed by RRF loans					
3.TOTAL CURRENT EXPENDITURE	0.0	0.0	0.0	0.0	0.0
4. TOTAL CAPITAL EXPENDITURE	0.0	0.0	0.0	0.0	0.0
of which:					
- Gross fixed capital formation	0.0	0.0	0.0	0.0	0.0
- Capital transfers	0.0	0.0	0.0	0.0	0.0
Other costs financed by RRF grants					
5. Reduction in tax revenue	0.0	0.0	0.0	0.0	0.0
6. Other costs with impact on revenue	0.0	0.0	0.0	0.0	0.0
7. Financial transactions	0.0	0.0	0.0	0.0	0.0