



EUROPEAN COMMISSION

Brussels, 7.6.2011
SEC(2011) 721 final

COMMISSION STAFF WORKING PAPER

**Assessment of the 2011 national reform programme and stability programme for
CYPRUS**

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

**on the National Reform Programme 2011 of Cyprus and delivering a Council Opinion
on the updated stability programme of Cyprus, 2011-2014**

{SEC(2011) 803 final}

1. INTRODUCTION

The Cypriot economy is currently recovering moderately after experiencing in 2009 the first economic contraction in thirty-five years. The downturn took a heavy toll on public finances. In response, the government has embarked on a fiscal consolidation programme and strengthened its structural reform agenda as confirmed in the National Reform Programme (NRP) and the Stability Programme (SP), submitted to the Commission on 6 and 7 May 2011 respectively. These documents also include the Cypriot commitments under the Euro Plus Pact with the objectives of fostering competitiveness, employment, public finance sustainability and financial stability.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1 RECENT ECONOMIC DEVELOPMENTS

Ahead of the financial and economic crises, the Cypriot economy had experienced a decade of high growth, averaging 3% per year, under conditions of low inflation and full employment. This long expansionary period was underpinned by a succession of demographic and adjustment processes, such as the 2004 EU accession and the euro adoption in 2008. Economic activity was driven by strong domestic demand, benefiting from a surge in credit growth, which took place against a background of falling risk premia, financial integration, capital liberalisation and excess liquidity in the banking sector. Furthermore, the confidence-boosting effects of EU accession and the subsequent euro adoption were not negligible. Coupled with one-off factors, such as high commodity and oil prices, on which Cyprus is highly dependent, this led to a surge in the current account deficit. Public finances also benefited from the institutional framework of EU membership and the preparation for euro adoption. These factors together with favourable cyclical conditions, asset buoyancy and a tax-revenue-rich composition of growth, as well as sizeable deficit-reducing one-off measures produced an improvement in the fiscal outlook up to 2008. Fiscal consolidation came mainly from the revenue side, while primary current expenditure restraint (especially the public wage bill and social transfers) was short-lived.

The international financial crisis led economic activity to contract in 2009 for the first time in 35 years, by 1.75%. The slowdown triggered a rather abrupt change in sectoral balance sheets, reflecting an increase of about 16pp of GDP in the private sector's savings, after five years of rising indebtedness and rapid credit expansion. The substantial savings of the private sector between 2008 and 2010 were reflected in meagre consumption and shrinking investment and, consequently, lower growth. The adverse effects of the crisis and discretionary measures taken in response to the economic downturn, in addition to considerable growth-composition effects, produced a deterioration of the fiscal outlook by 7 pp of GDP, leading to a deficit of 6% of GDP in 2009, and the triggering of the excessive deficit procedure (EDP). These developments were also reflected in a significant reduction of about 9 pp of GDP in the current account deficit between 2008 and 2010. Cyprus' labour market also suffered from the recession with unemployment reaching historical highs.

Despite stabilisation, the private sector remains highly indebted. Yet, this coexists, according to data from the Central Bank of Cyprus, with a very high level of private sector assets to GDP, amounting to 475% of GDP, of which household cash deposits account for 150% of GDP. Loans are collateralised not only against immovable property but also against deposits. The latter, which are the main source of financing of banks, have been growing steadily even during the crisis. However, non-performing loans (NPL) increased between 2009 and 2010. The cost of financing in Cyprus is higher in comparison to other euro-area countries, with

adverse effects on corporate profitability and households' balance sheets. Despite its relatively large size and high degree of openness, the banking and financial services sector has shown marked resilience in the face of the financial and economic crises. The Cypriot government has not adopted any specific package to stabilise the financial sector. It did however, through the special government bond scheme (SGBS), issue bonds (that mature at the end of 2012) to banks against high-quality collateral, so that the banks could obtain liquidity from the ECB – in the absence of alternative instruments, such as covered bonds, available in other EU Member States.

2.2 OUTLOOK

The Commission services 2011 spring forecast projects that economic activity will grow by 1.5% in 2011 and 2.4% in 2012. During this period, the contribution of the external sector to growth is set to gain ground, in line with an improved outlook for Cyprus' main trading partners. In addition, tourism is expected to benefit from political developments in other competing Mediterranean destinations. However, weak foreign demand for housing is likely to continue to weigh on the construction sector. Overall, the labour market is expected to benefit from the strengthening economic outlook, leading to a reduction of unemployment from its peak in 2010.

Despite the decline to around 9% of GDP in 2010, the current account deficit is still large and likely to constrain economic growth over the medium-term. High public sector dissavings need to be financed by either foreign debt or higher domestic private savings. The latter would imply lower output growth by crowding out private consumption or investment. In the medium term, the external deficit should continue to improve but at a moderate rate.

Overall, the risks to the baseline scenario are balanced. Demand may strengthen beyond expectations should growth of Cyprus' major trading partners surprise on the upside or should improved confidence and employment conditions lead to higher private consumption. Ongoing turmoil in the Middle East and North Africa may further strengthen Cyprus' status as a regional safe haven. On the other hand, risks associated with the large exposure of the financial sector are not negligible. Moreover, further price hikes for oil, on which Cyprus is highly dependent, could also weigh on growth.

3. MONITORING, PROCEDURAL ISSUES AND GOVERNANCE

In the light of the economic situation described above, the Cypriot Government adopted fiscal consolidation and reform measures, reflected in the Stability Programme (SP) and the National Reform Programme (NRP) and within the short-term commitments made by Cyprus under the Euro Plus Pact. These commitments concentrate on three areas: fostering competitiveness, fostering employment and enhancing the sustainability of public finances.

Cyprus ensured coherence between the two Programmes, which outline in an integrated manner fiscal consolidation efforts on the one hand and key structural reforms and other reforms underpinning macro-economic stabilisation on the other. The NRP, prepared in consultation with all stakeholders, who will also remain involved in the implementation and monitoring process, reflects well both short- and long-term priorities and challenges and the Euro Plus Pact commitments. The NRP also presents the measures of the Cypriot action plan for the Euro Plus Pact with a view to enhancing competitiveness, employment, public finance sustainability and financial stability (see Box 2)

Table: Cypriot Europe 2020 targets

Europe 2020 targets	Current situation in Cyprus ¹	Cypriot Europe 2020 target in the NRP
R&D investment (% of GDP)	0.47%	0.5%
Employment rate (%)	75.4% (2010)	75-77%
Early school leaving (%)	11.7% (2009)	Below 10%
Tertiary education attainment (%)	44.7% (2009)	46%
Reduction of number of people in or at risk of poverty or exclusion	176.000 persons or 22.2% of population (2008) ²	Reduction to 19.3%
Energy efficiency – reduction of energy consumption in Mtoe ³		Reduction in primary energy consumption: 0.46 Mtoe
Reduction in greenhouse gas emissions (from sources not covered by the Emission Trading System)	+5% ⁴	-5% ⁵
Renewable energy (% of total energy use)	4% (2008)	13%

4. POLICY CHALLENGES AND ASSESSMENT OF POLICY AGENDA

4.1 CHALLENGES

Cyprus faces a set of interrelated policy challenges: (i) reducing the high general government structural deficit and ensuring the long-term sustainability of public finances in view of population ageing; (ii) improving efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items including weaknesses in energy and transport infrastructure; (iii) ensuring wage and price adjustment to regain and sustain competitiveness; (iv) promoting innovation and ICT capacity mainly in the private sector to support investment, diversification of the economy and orientation towards high value-added goods and services; (v) restructuring the economy with emphases on high-skilled jobs and training of the low-skilled and disadvantaged groups.

Reducing the high general government structural deficit, mainly through current primary expenditure control, would be crucial in stabilising the economy and underpinning economic recovery. In particular, given that the long-term budgetary impact of ageing is projected to be significantly above the EU average, accelerating pension and healthcare reforms would strengthen the long-term sustainability of public finances. The unfavourable current budgetary

¹ Eurostat figures

² According to the NRP: 22.4%; according to Eurostat: 22.2%.

³ As estimated by the Commission. Mtoe = Million tonnes of oil equivalent

⁴ This quantity corresponds to the 2005-2008 evolution of the emissions not covered by the EU Emissions Trading System. As the scope of the Emissions Trading System evolved between 2005 and 2008, these emissions are estimated on the basis of the main relevant UNFCCC source categories (as opposed to the difference between total emissions and EU ETS verified emissions).

⁵ The national emissions limitation target defined in Decision 2009/406/EC (or "Effort Sharing Decision") concerns the emissions not covered by the EU Emissions Trading System. It is expressed as the minimum relative decrease (if negative) or the maximum relative increase (if positive) compared to 2005 levels

position is compounding the budgetary impact of population ageing on the sustainability gap. Fiscal consolidation in the short term and measures to address the high increase in pension and healthcare expenditure are important challenges.

Improving the quality of public finances through a redirection of public spending to growth-friendly policies could support potential output and social cohesion. Current government expenditure has grown strongly in recent years. The shift to less tax-revenue-rich economic growth requires improvements in public sector efficiency to shift expenditure to more growth-friendly and production capacity-enhancing structures, without risking choking off a nascent return to growth.

Appropriate wage and price adjustments are essential in order to regain and sustain competitiveness. In this context, the wage indexation mechanism (the cost of living allowance; COLA) which is part of the terms of employment, provides an automatic adjustment in the form of a percentage increase in the basic salary, twice a year. However, those benefiting most from this system have higher income, while the majority of the lowest-paid, such as unskilled workers, are not covered. Moreover, the uniform application of the mechanism does not allow wages to reflect productivity differences across sectors. It also connects wages to product prices rather than to productivity gains. The COLA also has a significant impact on public finances as it is an integral feature of pensions and other allowances. Ensuring that wage developments are in line with productivity would not only support the country's competitiveness but would also lead to a more efficient allocation of labour.

Cyprus is mainly a services-oriented economy and the role of the local goods production industry has hitherto been limited. Low private sector investment in new technologies and innovation remains a challenge as it hampers the structural adjustment towards higher valued-added activities and competitiveness.

Given the existence of significant skill mismatches in tandem with high educational attainment, a greater contribution from the educational system at all levels to human capital formation and innovative capacity would facilitate the restructuring of the Cypriot economy towards more high-skilled jobs and increased labour productivity. In particular, this could be achieved by strengthening the links between tertiary education and research and innovation systems, but most importantly through investment in new technologies and improvements in the business environment and innovation.

Box 1 – Commitments and actions under the Euro Plus Pact

The following intentions and measures are reported by Cyprus in the context of the Euro Plus Pact:

First, in order to foster competitiveness, the government is discussing with the trade unions the containment of public sector wages, aiming at zero contractual salary increases in the public sector during the next year. Moreover the government intends to initiate a public dialogue with trade unions for containing the public sector payroll in the medium-term and re-designing the Cost of Living Allowance (COLA) in order to limit nominal wage increases in higher-income groups, thus making the system more equitable.

Second, the government intends to strengthen structural competitiveness by improving the Digital Society with the finalisation by 2011 of the National Digital Strategy, which includes measures for attaining full broadband coverage of Cyprus by the beginning of 2012. Also, given Cyprus' high dependence on imported oil, support schemes for the Promotion of Energy Conservation were resumed again as of April 2011, so as to diminish the quantities of imported oil. Furthermore, new legislation will be introduced in 2011, which will provide the legal basis for the promotion of renewable energy sources.

Third, to foster employment, further measures to strengthen prevention and inspection mechanisms will be promoted, in order to combat illegal and undeclared work. Furthermore, to address the mismatch between the highly skilled labour force and the large number of vacancies for low-skilled jobs, schemes will be promoted in 2011-2012 to enhance the competitiveness of enterprises, by encouraging them to undertake more innovative activities, as a means of creating more and better jobs, especially for the highly qualified domestic labour force. Similarly, also to reduce the mismatch of skills, it is envisaged that Post Secondary Institutes for Technical and Vocational Education and Training will be established by 2012, in order to increase the number of people attending Technical Vocational Education.

Fourth, with a view to ensuring the sustainability of public finances, the government is involved in a dialogue with unions for the restructuring of the public pension system, which is to be concluded by the end of 2011.

Finally, the government is determined to increase the resilience of the financial sector through the preparation of a framework draft law for dealing with financial crises and the establishment of a fully independent Financial Stability Fund, with a view to supporting and facilitating the resolution of distressed credit institutions.

The Cypriot commitments and actions confirm plans already announced to deliver reforms to address the country's structural weaknesses. The extensive involvement of the various stakeholders is in line with the Cypriot approach to social dialogue and conducive to building a strong consensus, which is necessary for delivering successful results. However, given the pressing conditions at the current economic juncture, the lack of a clear time frame on issues such as the public sector wages and pension system coupled with the need for immediate reforms, pose risks to the successful and timely implementation of reforms.

4.2 ASSESSMENT OF THE POLICY AGENDA

4.2.1 Macroeconomic policies

4.2.1.1 Public finances

The macroeconomic scenario underlying both the updated SP and the NRP envisage real GDP picking up in 2011, advancing by 1.5%, and gaining momentum to 2.5% in 2012. Thereafter, GDP is projected to accelerate further, growing above potential (as estimated by the Commission services for the spring 2011 forecasts) at 2.7% and 3%, respectively, in 2013 and 2014.

The Stability Programme's figures for 2010 do not appear to be the final outturn but rather an earlier estimate, which explains discrepancies with respect to the Commission services' figures. For 2011 and 2012 however, the programme contains a GDP growth scenario comparable to the Commission services' 2011 spring forecasts (see Table II). It is worth noting that despite comparable inflation projections, the Programme projects a higher GDP deflator for 2011. In terms of growth composition, the Commission forecasts project a stronger rebalancing of the economy in both 2011 and 2012 towards a less tax-revenue-rich pattern, with a higher contribution from net exports and a stronger correction in construction investment, on the back of weak foreign and domestic demand for housing. For 2011, the Programme projects that recovery will be driven mainly by a continuing positive adjustment of the inventory cycle. Despite the recovery in private consumption and investment, the Programme projects that imports will grow only moderately, while exports are set to accelerate as a result of gains in the export share of services (excluding tourism). Overall, the current account deficit is projected to gradually decrease by 0.5 pp of GDP annually, leading to a deficit of 5% by 2014.

The Programme also contains a slightly more favourable employment and unemployment scenario for 2011 than the Commission services' 2011 spring forecast, which has a relevant impact on the forecast of social contributions and social transfers respectively. The Programme envisages further, although relatively small, employment gains compared to the recent past due to the increased labour force participation of foreign workers and a gradual increase in the participation rate of female and older workers. Employment is forecast to grow by 0.5% in 2011, 0.8% in 2012 and at 1% thereafter. Despite the overall positive picture, the Programme envisages that in sectors more exposed to the external sluggish growth, such as hotels and restaurants and construction, further increases in unemployment will take place. The unemployment rate is set to embark on a declining trend, reaching 6% in 2011 and 5.3% by 2014.

All in all, despite being comparable to the Commission's services projected GDP growth path, the macro-economic scenario of the Programme entails some favourable assumptions, regarding the growth composition in 2011 and 2012 that remain markedly favourable thereafter, and which represent downside risks to the budgetary outcomes projected over the programme period.

The deficit outturn of 5.3% of GDP in 2010 was 0.7 pp of GDP better than planned in the previous programme. The improvement in the budget balance compared to 2009 was driven by a better performance in total expenditure, partly offset by a shortfall in total revenues, despite the higher-than-expected one-off revenue, associated with the profit on an interest-swap agreement and a transfer of higher-than-usual Central Bank profits. On the expenditure side, with interest payments almost on track, the improvement came from primary expenditure retrenchment associated with the withdrawal of fiscal stimulus measures associated with the European Economic Recovery Plan. In particular, compensation of employees, intermediate consumption, subsidies and gross fixed capital formation turned out to be lower than planned. However, these positive trends were partly offset by higher-than-planned social transfers, associated with the government's social cohesion policy; namely, the introduction of a targeted scheme for low-income households with at least one pensioner and increased social welfare benefits associated with higher number of migrant recipients and rising unemployment. Revenues were lower than expected due to the adverse impact of subdued activity in the construction and real estate sectors, as well as the significant deterioration in the growth of corporate profits in the financial sector, despite the mid-year hike in excise duties on petroleum products.

For 2011, the update projects a general government deficit of 4% of GDP, 1.1% below the Commission services' estimate of 5.1% of GDP, which envisages lower revenues associated with a less tax-revenue-rich composition. There are also differences in the composition of expenditure projections, with the Commission services forecasting higher compensation of employees and social transfers, offset by the programme's higher figure in other primary expenditure. The government has however expressed its commitment to adopt additional measures should deviations from the expected budgetary execution materialise.

The Programme foresees that the headline deficit will improve gradually from a target of 4% of GDP in 2011 to 2.6% in 2012, the deadline set by the Council for the deficit correction. Thereafter, the programme projects a continuation of the reduction of the budget deficit to 1.6% of GDP by 2014. By sub-sector of the general government, the budgetary improvement takes place in the central government balance. The surplus of the Social Security Fund is projected to decline by 0.25 pp of GDP due to increases in pension entitlements and in the number of beneficiaries, and an unchanged social security contribution rate over the whole period. The local government budget remains in balance. In parallel, the primary balance is projected to improve from a deficit of 3.1% of GDP in 2010 to a balanced position by 2012.

The (recalculated) structural balance (i.e. in cyclically-adjusted terms net of one-off and other temporary measures) points to an improvement of the deficit from about 5% of GDP in 2010 to just below 2% of GDP in 2014. The annual fiscal effort is expected to average about 0.75 pp of GDP per year over the period 2011-2014. The fiscal consolidation plan required to comply with the correction of the deficit target by 2012 is distributed equally between 2011 and 2012.

According to the Programme, the cumulative reduction of the deficit amounts to 3.7% of GDP up to 2014 and it is solely expenditure-based. In particular, after an initial increase in 2011, revenues are set to fall back to 2010 levels. Over the period, increases in direct and indirect taxation are projected to be offset by a reduction in other revenue, while social contributions are set to remain unchanged. In 2011, revenue-supporting measures include the application of increased excised duty rates on tobacco products and reduced VAT rate on foodstuffs and pharmaceuticals as prescribed by the acquis, reintroduction of the reduced VAT rate on hotel and restaurant services, application of a levy on bank deposits, harmonisation of the water-pricing policy and the termination of the policy of reducing the excise duty on heating oil during the winter season.

On the other hand, expenditure is projected to follow a declining trend and is expected to fall by 3.75 pp of GDP between 2010 and 2014, mainly driven by cuts in current primary expenditure. In particular, compensation of employees and other expenditures are projected to fall by about 1.5 pp of GDP each, intermediate consumption by 0.75 pp and social payments and investment by another 0.25 pp each. On the other hand, interest payments are foreseen to rise by almost 0.5 pp, in line with higher stock of debt.

Box 1. Main measures

The 2011 budget entails a significant consolidation, mostly from the revenue side. The main revenue-supporting measures include the application of the minimum excise duties prescribed by the acquis on petroleum products, increased excised duty rates on tobacco products, application of the reduced VAT rate on foodstuffs and pharmaceuticals as prescribed by the acquis, reintroduction of the reduced VAT rate on hotel and restaurant services, application of a levy on bank deposits, harmonisation of the water-pricing policy. On the expenditure side, measures include a reduction in the overall number of employees in the broad public sector and containment of the growth rate of current expenditure, which are fully offset by social transfers to low-income households, and income support to Cyprus Airways.

Main budgetary measures (% of GDP)

Revenue	Expenditure
2011	
<ul style="list-style-type: none"> • Full-year impact from the application of the min. excise duties prescribed by the acquis on petroleum products (0.2%) • Increase excise duty on tobacco products (0.3%) • Application of the reduced VAT rate on foodstuffs and pharmaceuticals (0.4%) • Reintroduction of the reduced VAT rate on hotel and restaurant services (0.2%) • Application of a levy on bank deposits (0.35%) • Harmonisation of water pricing policy (0.05%) • Dividend income from semi-governmental organisations (-0.7%) • Interest rate SWAP (-0.2%) • Termination of reduced excise duty on heating oil during the winter season (0.05%) 	<ul style="list-style-type: none"> • Reduction in the overall number of employees in the broad public sector (-0.1%). • Targeting social transfers to low income households (0.1%) • Income support provided to Cyprus Airways (0.1%) • Compensating scheme for Eurocypria employees (0.05%) • Containment in the rate of growth current expenditure (- 0.1%)

2012	
---	<ul style="list-style-type: none"> • Reduction in the overall number of employees in the broad public sector (-0.1%) • Containment of the rate of growth of total wage bill in the public and broader public sectors (-0.2%) • Extension of the retirement age in Secondary Education and Police Service to 63 years (-0.2%) • Containment in the rate of growth current expenditure (-0.4%)
2013	
<ul style="list-style-type: none"> • Fee on the issuance of a 3-year special government bond (-0.1%) 	<ul style="list-style-type: none"> • Reduction in the overall number of employees in the broad public sector (-0.05%). • Containment of the rate of growth of total wage bill in the public and broader public sectors (-0.2%) • Containment in the rate of growth current expenditure (-0.2%)
2014	
---	<ul style="list-style-type: none"> • Containment of the rate of growth of total wage bill in the public and broader public sectors (+0.2%) • Containment in the rate of growth current expenditure (-0.3%)
<p>Note: The budgetary impact in the table is the impact reported in the Programme (SP or NRP), i.e. by the national authorities. A positive sign implies that revenue/expenditure increases as a consequence of the measure.</p>	

On the basis of the commonly agreed methodology, the structural balance deviates from the medium-term objective (MTO), which is reaffirmed as a balanced budget in structural terms, throughout the period. Overall, although the programme foresees an improvement in the structural balance, the MTO will not be reached within the programme period. The significant deviation from the MTO is problematic in the light of the large external imbalance of the Cypriot economy.

Budgetary outcomes could turn out to be worse than projected in the programme mainly due to favourable macroeconomic assumptions. According to the update, there are considerable downside risks associated with the timely implementation of fiscal consolidation measures, since consensus building may prove challenging, especially for certain socially-oriented measures. There are also non-negligible risks arising from the practice of adopting supplementary budgets during the course of the year, which often go beyond the intended reallocation of funds across various expenditure categories, into increasing discretionary current primary expenditure items. In the past this has been particularly more pronounced during electoral cycles, such as the one Cyprus is entering currently. Uncertainty also surrounds the anticipated consolidation measures, particularly from 2012 onwards, which are still to be agreed with the social partners and then, implemented. Risks also arise from the lack of a binding medium-term budgetary framework and fiscal rules.

The May 2011 update projects a progressive increase in the debt-to-GDP ratio up to 2012, before reverting to a declining trend for the remaining years of the programme. In particular, from 60.8% in 2010 and 61.6% in 2011, debt is expected to reach 62% of GDP by 2012, before falling to 60% by the end of the period. For the years 2011-12, debt is adversely affected by primary deficits and a stock-flow adjustment in 2012, due to the accumulation of

financial assets, which are partly offset by the effect of nominal GDP growth. The Programme's projections are slightly below the Commission services' spring 2011 forecast.

The update's sensitivity analysis highlights the high importance of growth assumptions for the envisaged consolidation path. The moderate impact from interest rates differentials is due to the fact that the bulk of the debt stock, about 91% of public debt, is at fixed interest rates and relatively long maturities. Floating rate issuances consist mainly of bilateral loans between the Republic of Cyprus and supranational institutions such as the EIB. According to the Programme: the share of short-term debt in 2010 comprises 5% of the total debt; and the weighted average of the outstanding maturity of the public debt is estimated to be 6 years, while almost 100% of public debt is denominated in euro.

Overall, the balance of risks for the debt ratio projection is tilted to the downside due to risks associated with the growth prospects and the budgetary outcomes.

Cyprus is classified as high risk with regard to the long-term sustainability of public finances. The long-term cost of ageing is clearly above the EU average. The current budgetary position compounds the cost of ageing. Based on the current fiscal position, debt would increase to 89% of GDP by 2020. However, the full implementation of the Programme would be enough to put debt on a downward path by 2020. Ensuring sufficient primary surpluses over the medium-term, as already planned in the programme, and further reforming the social security system, in particular reforming the pension system so as to curb the projected substantial increase in age-related expenditures, would improve the sustainability of public finances.

In recent years, the authorities adopted policy measures to improve the adequacy and sustainability of the pension system. A pension reform, introduced on 1 April 2009, was mainly aimed at revenues and is likely to slow down the rise in pension expenditure only marginally. As such revenue improvements are not captured by the sustainability indicators, they are currently only considered as an additional factor in the category of alternative projections of the cost of ageing. Their inclusion would, however, not change the overall assessment. Moreover, until the updated projections are finally validated by the EPC, they can only be taken as "national projections". It is therefore evident that implementing further reforms to the pension system to address the high projected increase in pension spending would be necessary in order to put it on a more sustainable path, while ensuring that the pension system becomes more effective in reducing poverty risks in old age.

According to the NRP, draft legislation has been prepared to update the investment framework of the Social Insurance Fund (SIF), while the government has already deposited EUR 400 million (2.25% of GDP) to establish a EUR 1 billion (5.5% of GDP) real reserve by 2013. Further information on the proposed measure is needed in order to assess its possible impact on the long-term sustainability of the pension system. While reforms in the pension system of the public sector need to be enacted, the assessment of their impact will indicate whether further measures are needed to curb the projected substantial increase in age-related expenditure. It will be a key issue for Cyprus to adapt the pension system to demographic ageing by balancing years in work and in retirement; the effective retirement age needs to be linked to life expectancy. Also, providing incentives for extending the working life of women – primarily – and older workers, while removing the early retirement incentives provided by the public sector pension system, would be conducive in this respect.

The healthcare reform has hitherto met with significant delays. Recognising the structural problems of the current system, a reform process was initiated in 2001. The reform included the implementation of a National Health Insurance System (NHIS) and a reorganisation of public hospitals, which would render them autonomous units. However, during this decade,

the whole process made little progress and has been subject to long delays, while no concrete time frames for implementation are presented.

Cyprus currently has neither a set of fiscal rules nor a binding Medium-Term Budgetary Framework. Nor does it have an independent fiscal institution involved in the budgetary process. The existing framework provides only for one-year budgets, thus neglecting the medium-term perspective, while its rigid character has induced governments to resort to presenting supplementary budgets during the course of the year, which – beyond the intended reallocation of funds – have been used to increase current primary expenditure, especially during electoral cycles.

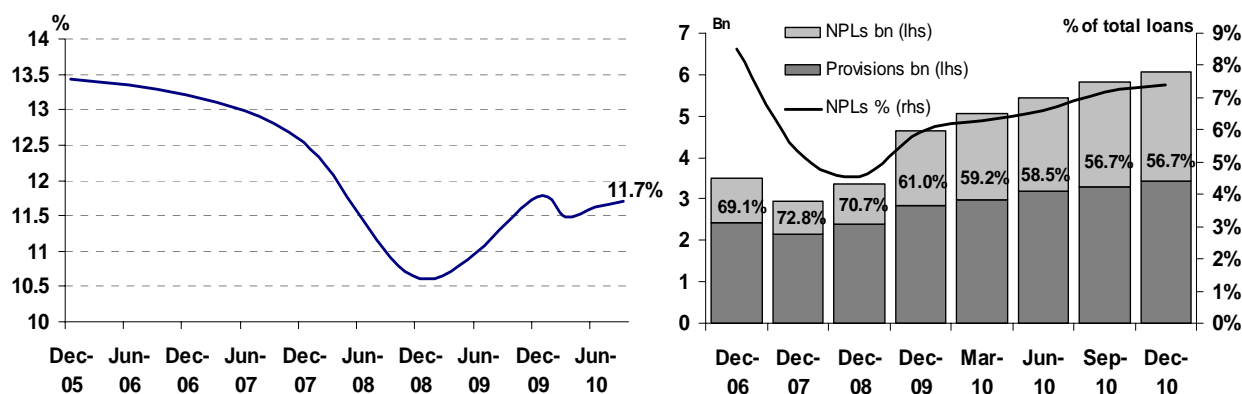
In the recent past, efforts have been made to improve the budgetary framework with the adoption of the Financial Management Accounting System (FIMAS), and the gradual introduction of a three-year Medium-Term Budgetary Framework (MTBF) and Programme and Performance Budgeting (PPB). According to the Programme, the new budgeting framework is expected – when fully implemented – to end the practice of having supplementary budgets and lead to a more effective and efficient budgeting process, thus contributing to the containment of expenditure. At the same time, the new budgeting process would set a sound basis for reallocating expenditure in favour of growth-enhancing activities consistent with the priorities set by the National Reform Programme. However, the phased introduction of a genuine fiscal framework is still in its early stages and hitherto not binding. It is envisaged that this framework will become the official (and only) budget method only from the fiscal year 2014 onwards, rather than 2012 as expected until recently. Therefore, its impact could become effective only in the medium term. Timely implementation of the new framework would be important for a successful and lasting consolidation of the public finances.

4.2.1.2 *Financial sector*

In their recent downgrades of Cyprus' sovereign debt, apart of the fiscal outlook, rating agencies have also referred to the large size of the country's banking sector. Total bank assets currently amount to 925% of GDP (or 650% of GDP if foreign banks are excluded). These figures do indicate an oversized sector compared to the domestic economy, which requires strong vigilance and supervision. Another source of risk is the sector's exposure to Greece, where the three largest domestic banks have over 40% of their total lending.

Nevertheless, Cyprus's financial system seems to be strong enough to address potential challenges ahead. Capital and liquidity levels appear sound. The domestic banking sector has so far weathered the global financial crisis and the euro area's sovereign debt crisis well. Banks remain profitable with comfortable liquidity ratios levels (CAR at 11.7% in December 2010 – Graph A) and non-performing loans are relatively contained, although on an rising trend (NPLs at 7.4% of all loans in September 2010 – Graph B).

Graph A. Capital adequacy ratio (consolidated) Graph B. Non-performing loans & coverage ratio



Source: Central Bank of Cyprus

However, the banks' asset quality has deteriorated over the last year. This is a source of potential risk given the challenging domestic economic conditions in Cyprus. In particular, as regards domestic operations, the expected moderate growth in 2011 could exert further pressure on non-performing loans. Another important consideration is the increased, and high in absolute terms, level of non-performing loans that are not covered by provisions (Graph B). While net non-performing loans (net of provisions) are fully covered by tangible collateral (mostly real estate and deposits), the current dampened activity in real estate transactions raises concerns over the recoverability of such collateral. Attention needs to be given to profitability levels for the banking system in order to assess the sector's capacity to absorb higher levels of provisioning.

Meanwhile, the sector's reliance on deposits (rather than less stable sources of funding), conservative lending practices, close attention to capital and liquidity buffers and vigilant supervision are among the factors that have thus far provided a cushion during the crisis. These factors have helped shield the banking system from the pressures that are prevalent in many other countries. The ongoing risks in international financial markets call for a continuation of conservative balance sheet management as well as prudent supervision.

4.2.2 Labour market policies

Although Cyprus performs better than the EU average in terms of labour market outcomes, its labour market is characterised by large gender gaps in employment and pay, insufficient provision of cost-effective, well targeted active labour market measures, a gap in the provision of high-quality and affordable care facilities, and mismatches in the demand for and supply of skills.

Making work more attractive

Despite a female employment rate (in the age group 20-64) of 68.1% in 2009 (EU average: 62.5%), the labour market is characterised by strong gender imbalances, which represent a serious challenge in terms of limiting the potential for economic and employment growth. Gender segregation, the cost and availability of child care facilities, scarcity of flexible forms of employment and persistently high gender pay gap are acknowledged by the Cypriot NRP as serious hindrances to employment and growth development. In this respect, a number of interventions, designed and financially supported in the framework of the ESF, are being implemented, including an ERDF co-funded scheme aimed at enhancing entrepreneurship among women and young people. Moreover, the NRP sets a target to reduce the gender pay gap by 5 pp by 2015. However, the heavy reliance on the EU funding raises questions as to the projects' long-term effectiveness and sustainability once the

programming period ends. Lessening the impact of occupational and vertical segregation, promoting flexible and secure working arrangements, expanding access to quality and affordable care services and helping women to acquire entrepreneurial skills could be major pillars of an integrated and lasting policy to boost gender equality in employment.

Getting the unemployed back to work

The labour market also suffered during the crisis, with the impact concentrated in labour-intensive sectors such as construction, tourism and trade. From a low of 3.6% in 2008, the downward adjustment of the labour market during 2009 and 2010 pushed unemployment up to 6.5% in 2010, an historical high. Given the high numbers of immigrant workers in these labour-intensive sectors, they account for a third of the registered unemployed. While the long-term unemployment rate remains much below the EU average, it is on a rising trend, while youth unemployment rates are relatively high for a country with high educational attainment rates.

Regarding active labour market policies (ALMP), available data (2008) suggest a limited extent of investment in related policies, measured either as a percentage of GDP (about 0.1% of GDP against 0.5% EU average) or per person wanting to work. Since 2009 Cyprus has developed and implemented a mix of ALM and income-support measures to mitigate the adverse effects of the economic crisis on the labour market. Although employment incentive schemes have been used as a major activation measure, they have not always targeted the most vulnerable. The strengthening and modernisation of public employment services is ongoing. Shifting the focus of ALMP towards cost-effective measures, such as timely job search assistance targeted at particular groups (young, immigrants, long-term unemployed, etc.), better career guidance, and provision of start-up incentives and support for entrepreneurship would be beneficial. Measures combining work placement and training opportunities for young (secondary and tertiary) graduates would be conducive in this respect. Similarly, the swift completion of the Competence-Based Vocational Qualifications System could help to improve labour market matching and occupational mobility of the workforce through the recognition and transferability of skills across occupations and sectors.

Balancing security and flexibility

The share of female employees working under involuntary fixed-term or part-time contracts is higher in Cyprus than the EU average (13.5% against 10% in 2009). In addition, the low conversion rates of temporary into permanent contracts suggest rather strong labour market segmentation. Meanwhile, unofficial evidence indicates that undeclared work seems to be widespread, and associated with cheap foreign workers. This is identified as a source of low labour productivity, which impedes potential investment in the creation of higher value-added jobs. Moreover, children of third-country migrants are estimated to comprise 15% of the school population. Due to the parents' low education, and the challenges of learning Greek and being assimilated into the Cypriot education system, these children are a high-risk category for dropping-out of the education system. Increased counselling and guidance efforts at schools with large numbers of migrants would help addressing the issue. The NRP signals awareness of the need to tackle undeclared work through a policy mix of better integration of legal migrants and reinforced inspection mechanisms. For this reason, a comprehensive action plan was adopted in 2010 for the integration of third-country nationals. Monitoring its effectiveness and adequacy and complementing it with further measures where needed, would appear to be crucial to its success. Regarding temporary work, Cyprus would benefit

from the adoption of a comprehensive policy, on the basis of flexicurity principles to counteract labour market segmentation and its adverse effects on pay levels, training and career prospects of temporary workers.

Education, skills and life-long learning

The strategic objective of Cyprus is to become a regional centre providing high value-added services as well as to exploit the growth and job-creation potential of the green and care sectors. Some of the building blocks are already in place. Cyprus' performance in education, with excellent results at both secondary and university levels, and with a tertiary attainment rate of 44.7% of the population aged 30-34, makes for a highly skilled population. While the tertiary attainment level of the adult population is one of the highest in Europe (34.1% in 2009), the newly established universities have encouraged even more people to enter higher education. Early school leaving is well below the EU average and public education expenditure is high. However, vocational education and training (VET) is not an attractive option. More importantly, high youth unemployment (17.8% in 2010) in tandem with a large proportion of people with high educational attainment in total unemployment (28.9% compared to a mere 16.1% EU average in 2008) signal a significant skills mismatch in the Cypriot economy. Also, participation in lifelong learning (7.8% in 2009) is low for a country with good educational levels, while the gap with respect to the EU average is more pronounced as regards access to lifelong learning of particular groups (low-skilled, older people and unemployed).

To address these issues, the NRP envisages the establishment of a series of new post-secondary VET institutions as of 2011-2012 together with the effective operation of the new Apprenticeship System in the school year 2012-2013. According to the NRP, the reform of the Upper Secondary and Technical Vocational Education and the development of new curricula are expected to be completed by 2015. Overall, the country's strategic objective of shifting from low to high productivity jobs would benefit greatly from the re-orientation of the education and training system to bring about a better mix of skills, to match with labour market demand. Key parameters of this re-orientation would include the reinforcement of vocationally-oriented skills and the upgrading of skills, particularly of the low-skilled and older workers.

Social inclusion and the fight against poverty

The percentage of the population at risk of poverty or exclusion in Cyprus stood at 22.2% in 2009 (176.000 persons), just below the EU average of 23.1%. However, the Cypriot population faces an unevenly distributed risk of poverty. While the at-risk-of-poverty rates for children (0-17) and adults (18-64) in 2009 were below the rates for the overall Cypriot population and the EU, the rate for the 65+ age group stood at 48.6%, the highest in the EU. To some extent, this can be attributed to an inadequate level of benefits for the elderly. However, the relatively low severe material deprivation rate for the 65+ age group (8.8% in 2009) as well as the low housing deprivation rate may be explained by widespread home ownership and home production (especially in rural areas) among the elderly, as well as the fact that the latter often receive support and in-kind benefits from their families.

The NRP puts particular emphasis on the elderly population, while simultaneously addressing the needs of other population groups at risk (children, working poor, unemployed and inactive, vulnerable groups). A cash-benefit scheme for pensioner households, whose total annual income is below the poverty threshold, was introduced in December 2009. Also, a monthly benefit for households with at least one pensioner with annual income below the poverty line was recently introduced as compensation for the VAT increase on foodstuffs and

medicines. Furthermore, according to the NRP, consultation for reforming long-term care and public assistance will be promoted during 2011-2012.

4.3 GROWTH-ENHANCING STRUCTURAL MEASURES

Cyprus is a small island economy depending primarily on services. Enterprises tend to be small and family-owned. The country faces a competitiveness problem linked to its specialisation in low-skills and technology thus slow-growth sectors. Therefore, the policy priority, also emphasised in the NRP, remains to restructure the economy towards high value-added product and services through the promotion of innovation, ICT and new-technology usage capacity, mainly in the private sector. This restructuring would lead to the creation of high-skilled jobs for the highly qualified national labour force, increase productivity and enhance Cyprus' growth potential.

Business environment

Financing for the private sector is problematic and the cost of credit remains high. The establishment of a Loan Guarantee Granting Facility is still awaiting political approval although its main characteristics have been agreed upon. Delayed payments by the public administration constitute an additional problem for SMEs. Although not among the worst performers (average delay of 75 days), Cyprus was below the EU average (of 66 days) in 2010.

Cyprus has the advantage of an effective and flexible administration and a culture of cooperation between the private and public sectors. This makes it easier to maintain an up-to-date legal framework and a generally favourable business environment. In this context, the one-stop-shop for registering new businesses is operational and all public procurement calls are conducted through a unique, SME-friendly, electronic platform. The "Point of Single Contact" provided for by the Services Directive has also been established and is online, containing extensive information on regulations applicable to various services sectors. However, it does not yet allow for online completion of administrative procedures. Furthermore, there are still practices that induce unnecessary administrative burdens, especially in some areas (urban planning, building permits). The mapping out of the necessary regulatory changes has been carried out in the framework of the National Action Plan for the Reduction of Administrative Burden, which targets an administrative burden reduction of 20% by 2012, but the corresponding reforms are still to be implemented.

Cyprus adopted a horizontal law for the transposition of the Services Directive in July 2010. However, there are concerns regarding the completeness and thoroughness of the transposition into sector-specific legislation as many obstacles to establishment and free provision of services persist. These obstacles range from generally applicable ones such as authorisations required by local authorities for the establishment of any business activity or limited duration of authorisations irrespective of the service field and the risks involved, to very specific ones such as fixed tariffs applicable in respect of tourism services, economic needs tests and involvement of competitors in the authorisations for car rental, discriminatory treatment of construction companies from other Member States, bans for architects and engineers to exercising their profession as legal persons. For this reason, there are ongoing bilateral discussions between the Commission services and the Cypriot authorities, which are trying to ensure the urgent adoption of all the required changes to sector-specific legislation. Although Cyprus has the third lowest number of infringement proceedings a quick infringement resolution and a high early resolution rate, there is an increasing trend in the

number of cases. This has emerged together with an increased Single Market transposition deficit.

Research and innovation

The research system in Cyprus, practically built up mainly in the last twenty years, is much less developed than the overall economy and is predominantly financed by the public sector. The small critical mass, the lack of industrial base, the fact that 99% of enterprises are SMEs, mostly small to very small, and the services-oriented structure of the economy are not conducive in this respect. The business sector, which is focused on services and fragmented into many very small-sized enterprises, has not yet developed an innovation culture and it is very slow in adapting to knowledge-based competition. The research and development intensity of Cyprus is currently very low and if the spending target of 0.5% of GDP is maintained, Cyprus will have the lowest R&D investment in the EU by 2020. Moreover, an integrated Research and Innovation (R&I) policy is still missing. Although R&I is among the eight key priorities of the National Strategic Development Plan (2007-2013), the strategy is not accompanied by any Action Plan.

The adoption of a coherent long-term strategy for research, technological development and innovation (RTDI) is a positive step. Following the approval of the Strategy for R&I, an Action Plan towards the ERA 2020 vision will be prepared. The new Strategy for research and innovation (under development) could benefit from identifying a limited set of priorities in niche R&I areas, best fitted to the country's specific challenges. An Action Plan for implementation of the R&I strategy could provide concrete measures to make use of the unexploited R&I capacity through the development of an innovation culture in business and industry, notably in services, by adopting measures to improve regulation and business environment.

Cyprus has identified the main challenges it faces with regard to the development of the information society, in particular concerning broadband uptake, digital literacy and eGovernment services. The NRP contains a detailed and comprehensive strategy for the improvement of ICT, to be complemented by the Digital Strategy for Cyprus currently under preparation.

Energy and climate change

Cyprus is heavily dependent on oil imports for its energy use and faces challenges on the security and competitiveness of supply and sustainability. Its energy system is isolated, with no electrical interconnection to any other country in Europe. Cyprus has no gas market and a small electricity market dominated by the vertically integrated, 100% state-owned, Electricity Authority of Cyprus (EAC). A planned liquid natural gas (LNG) import facility should provide supply by 2014 although it has experienced several delays over the past few years. There is also potential for domestic gas production but there are still uncertainties surrounding this. Potential use of gas would have a significant impact on the energy efficiency of the power system and therefore help Cyprus to reach its energy consumption reduction target.

Cyprus has set as its national energy efficiency target "to save 463 kilotonnes (ktoe) of primary energy by 2020". While the target formulation is clear, its impact on the projected primary energy consumption is not. Setting up energy services companies would facilitate the uptake of energy services solutions. Given that the energy demand in summer doubles compared to that in winter due to the climate conditions and the fact that Cyprus is a tourist

destination, programmes are needed to specifically address these issues. Cyprus has submitted its National Renewable Energy Action Plan aimed at reaching its 13% target of renewable energy sources in final energy consumption by 2020. Timely implementation of strong support measures, particularly in the transport and electricity sectors, is not yet achieved..

In spite of the influence of the economic crisis, the recent trend in greenhouse gas emissions does not appear in line with the 2020 national target defined at the European level (-5% compared to 2005 levels). This means that additional emissions reduction measures and/or the use of flexibility mechanisms may be needed. It will be important to monitor progress in the road transportation sector given its weight in the national emissions and its current trend.

5. SUMMARY

Cyprus plans to correct its excessive deficit in 2012, in line with the deadline established by the Council. Thereafter, the Stability Programme update projects a continuation of the reduction in the budget deficit until the end of the programme period. However, the Medium-Term Objective, which the program reaffirms as a balanced budget, will not be met during this period. The budgetary outcomes could turn out worse than projected in the programme. In particular, significant downside risks are associated with favourable macroeconomic assumptions (especially, regarding growth composition in 2011-12), the timely implementation of fiscal consolidation measures, and the practice of adopting supplementary budgets during the course of the year. Moreover, given that Cyprus is entering an electoral cycle, which past experience has shown to be associated with expenditure over-runs, the downside risks to the budgetary targets are non-negligible. Risks also arise from the lack of a binding medium-term budgetary framework and fiscal rules. Therefore, it might prove necessary to compensate for possible revenue shortfalls and missed expenditure savings. At the same time, maintaining the largely growth-oriented consolidation course, including by taking steps to enhance the efficiency of social spending, would help to strengthen the long-term growth potential. Given that the long-term budgetary impact of ageing is well above the EU average, reform measures to control pension and health care expenditure are needed to control the projected increase in ageing-related expenditure. Finally, given the large size of the banking sector and the challenging economic and financial environments, strengthening further the prudent framework of banking supervision to ensure early detection of risks and the supervision of co-operative credit societies would be necessary to safeguard the sector's stability and its contribution to growth.

The policy measures stated in the NRP are in general consistent with the challenges identified by the Commission services and with the national targets derived from the Europe 2020 headline targets. They are likely to contribute positively to strengthening productivity and potential output growth and to enhancing the competitiveness of the Cypriot economy. However, given the significance of the medium-term challenges for the Cypriot economy, the reform agenda envisaged in the NRP lacks ambition. Several important aspects remain either unaddressed or are only partly tackled. Given significant skills mismatches, the country's strategic objective of shifting from low to high productivity jobs would benefit greatly from the re-orientation of the education and training system to bring about a better mix of skills, to match with labour market demand, as well as from the development of an innovation culture and a business sector better adapted to knowledge-based competition. Also, even though Cyprus adopted a horizontal law for the transposition of the Services Directive in July 2010, there are concerns regarding the completeness and thoroughness of the transposition as many

obstacles to establishment and free provision of services persist in sector-specific legislation, where no amendments have been made. In addition, the availability of electronic procedures through the Point of Single Contract is not yet ensured. Boosting effective competition and setting prices that reflect social costs levels (through internalisation charges) would improve the sustainability and efficiency of services. Cost efficiency and equity concerns could be addressed with the establishment of a water-management plan and a price-setting scheme.

ANNEX

Table I. Macro economic indicators

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012
Core indicators							
GDP growth rate	4,8	3,5	4,2	-1,7	1,0	1,5	2,4
Output gap 1	-1,2	0,9	0,9	-1,1	-1,7	-1,5	-0,5
HICP (annual % change)	2,3	3,1	2,7	0,2	2,6	3,4	2,3
Domestic demand (annual % change) 2	4,5	4,5	6,4	-6,9	2,2	0,8	1,6
Unemployment rate (% of labour force) 3	3,2	4,2	4,4	5,3	6,5	6,3	5,6
Gross fixed capital formation (% of GDP)	18,6	17,7	21,2	20,6	18,4	17,3	16,6
Gross national saving (% of GDP)	18,6	14,5	11,3	9,4	9,1	9,2	9,3
General Government (% of GDP)							
Net lending (+) or net borrowing (-)	-3,5	-3,9	0,2	-6,0	-5,3	-5,1	-4,9
Gross debt	46,6	60,9	60,1	58,0	60,8	62,3	64,3
Net financial assets	-36,3	-36,7	-34,3	-33,8	n.a	n.a	n.a
Total revenue	31,9	36,1	42,3	39,8	41,3	41,0	41,0
Total expenditure	35,4	40,0	42,1	45,8	46,6	46,1	45,9
<i>of which: Interest</i>	2,6	3,3	3,1	2,5	2,2	2,4	2,4
Corporations (% of GDP)							
Net lending (+) or net borrowing (-)	3,1	-0,4	-6,8	0,3	n.a	n.a	n.a
Net financial assets; non-financial corporations	n.a	n.a	-116,0	-148,0	n.a	n.a	n.a
Net financial assets; financial corporations	n.a	n.a	5,3	54,9	n.a	n.a	n.a
Gross capital formation	9,0	7,7	8,6	4,0	n.a	n.a	n.a
Gross operating surplus	27,4	25,1	21,4	21,3	n.a	n.a	n.a
Households and NPISH (% of GDP)							
Net lending (+) or net borrowing (-)	-0,8	0,8	-3,6	-1,8	n.a	n.a	n.a
Net financial assets	n.a	n.a	167,1	141,0	n.a	n.a	n.a
Gross wages and salaries	39,3	38,8	38,0	39,6	n.a	n.a	n.a
Net property income	6,0	5,3	5,4	5,7	n.a	n.a	n.a
Current transfers received	17,2	20,4	22,8	24,8	n.a	n.a	n.a
Gross saving	6,7	7,7	6,3	6,8	n.a	n.a	n.a
Rest of the world (% of GDP)							
Net lending (+) or net borrowing (-)	-1,2	-3,4	-10,3	-7,6	-9,4	-7,9	-7,1
Net financial assets	n.a	n.a	-20,5	-11,3	n.a	n.a	n.a
Net exports of goods and services	-0,8	-0,5	-5,8	-5,3	-6,4	-5,7	-5,0
Net primary income from the rest of the world	-0,9	-4,4	-5,3	-1,8	-2,6	-2,5	-2,4
Net capital transactions	0,0	0,3	0,2	0,4	-0,1	0,2	0,1
Tradable sector	44,4	41,2	36,0	33,4	33,4	n.a	n.a
Non tradable sector	48,2	50,2	53,2	56,5	56,8	n.a	n.a
<i>of which: Building and construction sector</i>	7,3	6,7	7,8	7,4	6,5	n.a	n.a
Real effective exchange rate (index, 2000=100)	106,6	107,8	116,3	116,8	116,1	118,7	119,7
Terms of trade goods and services (index, 2000=100)	99,4	100,6	102,1	102,0	101,9	101,9	102,1
Market performance of exports (index, 2000=100)	110,2	96,4	86,9	88,2	84,7	87,6	89,4
Notes:							
1 The output gap constitutes the gap between the actual and potential gross domestic product at 2000 market prices.							
2 The indicator on domestic demand includes stocks.							
3 Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.							
Source:							
<i>Commission services' spring 2011 forecast</i>							

Table II. Comparison of macro comparisons and forecasts

	2010		2011		2012		2013	2014
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.0	0.9	1.5	1.5	2.4	2.5	2.7	3.0
Private consumption (% change)	0.8	-1.5	1.4	0.5	2.2	2.3	2.3	2.3
Gross fixed capital formation (% change)	-7.9	-5.5	-3.9	-0.5	-0.8	2.0	2.5	3.0
Exports of goods and services (% change)	0.6	2.2	4.1	2.6	4.3	3.5	4.5	4.6
Imports of goods and services (% change)	3.1	0.7	2.2	1.8	2.5	2.0	2.5	2.5
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	-1.0	-2.0	0.8	0.1	1.7	1.9	2.0	2.1
- Change in inventories	3.2	2.4	0.0	1.1	0.0	0.0	0.0	0.0
- Net exports	-1.2	0.6	0.7	0.2	0.6	0.5	0.7	0.8
Output gap ¹	-1.7	-2.1	-1.5	-2.2	-0.5	-1.5	-0.6	0.6
Employment (% change)	-0.3	0.5	0.2	0.5	0.8	0.8	1.0	1.0
Unemployment rate (%)	6.5	6.2	6.3	6.0	5.6	5.8	5.5	5.3
Labour productivity (% change)	1.3	0.4	1.3	1.0	1.5	1.7	1.7	2.0
HICP inflation (%)	2.6	2.6	3.4	3.4	2.3	2.1	2.3	2.5
GDP deflator (% change)	2.0	2.0	3.1	3.7	2.1	2.1	2.4	2.6
Comp. of employees (per head, % change)	2.8	2.3	3.8	3.2	3.2	2.3	2.3	2.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-9.4	-7.8	-7.9	-7.3	-7.1	-6.8	-6.0	-5.2
<u>Note:</u>								
¹ In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.								
<u>Source:</u>								
Commission services' spring 2011 forecasts (COM); Stability programme (SP).								

Table III. Composition of budgetary adjustment

(% of GDP)	2010	2011		2012		2013	2014	Change: 2010-2014
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	41.3	41.0	42.1	41.0	41.8	41.4	41.3	0.0
<i>of which:</i>								
- Taxes on production and imports	15.3	15.7	16.2	15.7	16.1	16.0	15.8	0.5
- Current taxes on income, wealth, etc.	11.1	11.1	11.5	11.1	11.5	11.3	11.4	0.3
- Social contributions	9.6	9.5	9.6	9.5	9.6	9.6	9.6	0.0
- Other (residual)	5.4	4.7	4.8	4.7	4.5	4.5	4.5	-0.9
Expenditure	46.6	46.1	46.1	45.9	44.4	43.4	42.9	-3.7
<i>of which:</i>								
- Primary expenditure	44.4	43.7	43.7	43.5	41.8	40.7	40.3	-4.1
<i>of which:</i>								
Compensation of employees	15.4	16.0	15.0	15.9	14.5	14.0	13.9	-1.5
Intermediate consumption	5.2	4.9	4.9	4.9	4.8	4.6	4.5	-0.7
Social payments	14.8	15.1	14.8	15.0	14.9	14.8	14.7	-0.2
Subsidies	0.2	0.3	0.4	0.3	0.3	0.2	0.1	-0.1
Gross fixed capital formation	3.6	3.5	3.6	3.5	3.6	3.5	3.5	-0.2
Other (residual)	5.1	3.9	5.0	3.9	3.7	3.5	3.6	-1.5
- Interest expenditure	2.2	2.4	2.4	2.4	2.5	2.6	2.6	0.4
General government balance (GGB)	-5.3	-5.1	-4.0	-4.9	-2.6	-2.0	-1.6	3.7
Primary balance	-3.1	-2.7	-1.6	-2.5	0.0	0.6	1.0	4.1
One-off and other temporary measures	0.4	0.1	0.1	0.1	0.1	0.0	0.0	-0.4
GGB excl. one-offs	-5.7	-5.2	-4.1	-5.0	-2.7	-2.0	-1.6	4.1
Output gap ²	-1.7	-1.5	-2.2	-0.5	-1.5	-0.6	0.6	2.3
Cyclically-adjusted balance ²	-4.6	-4.5	-3.2	-4.7	-2.0	-1.8	-1.9	2.8
Structural balance³	-5.1	-4.6	-3.3	-4.8	-2.1	-1.8	-1.9	3.2
<i>Change in structural balance</i>		<i>0.5</i>	<i>1.8</i>	<i>-0.2</i>	<i>1.2</i>	<i>0.3</i>	<i>-0.1</i>	
Structural primary balance ³	-2.9	-2.1	-0.9	-2.4	0.4	0.9	0.8	3.6
<i>Change in structural primary balance</i>		<i>0.7</i>	<i>2.0</i>	<i>-0.3</i>	<i>1.3</i>	<i>0.4</i>	<i>-0.1</i>	
Notes:								
¹ On a no-policy-change basis.								
² Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.								
³ Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
Source:								
<i>Stability programme (SP); Commission services' spring 2011 forecasts (COM); Commission services' calculations</i>								

Table IV. Debt dynamics

(% of GDP)	average 2005-09	2010	2011		2012		2013	2014
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	59.7	60.8	62.3	61.6	64.3	62.0	61.3	60.1
Change in the ratio	-2.4	2.8	1.5	0.7	2.0	0.3	-0.6	-1.3
<i>Contributions²:</i>								
1. Primary balance	-2.0	3.1	2.7	1.6	2.5	0.0	-0.6	-1.0
2. “Snow-ball” effect	-0.6	0.5	-0.2	-0.6	-0.3	-0.1	-0.4	-0.7
<i>Of which:</i>								
Interest expenditure	3.0	2.2	2.4	2.4	2.4	2.5	2.6	2.6
Growth effect	-1.9	-0.6	-0.9	-0.9	-1.4	-1.5	-1.6	-1.7
Inflation effect	-1.8	-1.1	-1.8	-2.1	-1.2	-1.2	-1.4	-1.5
3. Stock-flow adjustment	0.2	-0.8	-0.9	-0.3	-0.3	0.5	0.4	0.4
<i>Of which:</i>								
Cash/accruals diff.	0.1	0.0		0.0		0.0	0.0	0.0
Acc. financial assets	0.1	-0.7		0.5		0.5	0.5	0.5
<i>Privatisation</i>	0.0	0.0		0.0		0.0	0.0	0.0
Val. effect & residual	0.1	0.0		0.0		0.0	0.0	0.0

Notes:

¹End of period.

²The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other

Source:

Stability programme (SP); Commission services' spring 2011 forecasts (COM); Commission services' calculations

Table V. Long-term sustainability

Cyprus	Baseline scenario (2010)			Programme scenario		
	S1	S2		S1	S2	
Value	8.5	11.9		4.6	8.2	
<i>of which:</i>						
Initial budgetary position (IBP)	3.4	3.8		-0.2	0.1	
Debt requirement in 2060 (DR)	0.2	-		0.0	-	
Long-term change in the primary balance (LTC)	4.9	8.1		4.9	8.1	
	2010	2015	2020	2010	2015	2020
Debt as % of GDP	60.9	74.4	88.8	60.9	60.1	56.8

Note: The 'baseline' scenario (2010) depicts the sustainability gap under the assumption that the 2010 budgetary position remains unchanged over the medium-term (until the end of the period covered by the programme). The 'programme' scenario depicts the sustainability gap under the assumption that the budgetary plans of the programme are fully implemented.

Figure. Medium term debt projection

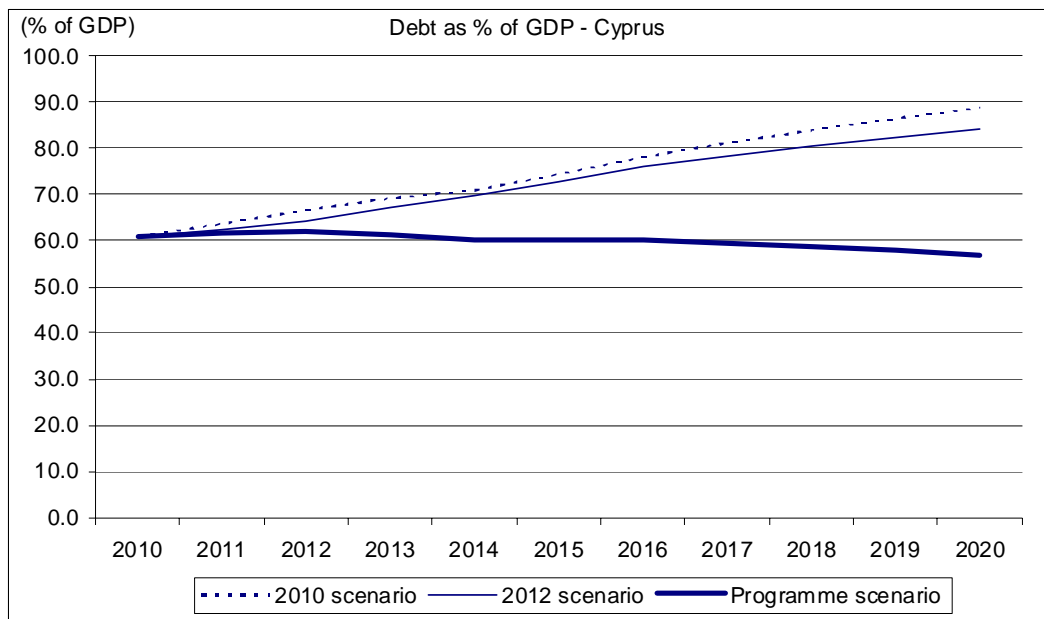


Table VI. Financial sector indicators

	2006	2007	2008	2009	2010
Total assets of the banking sector (% of GDP)	469.1	541.4	587.3	806.3	822.9
Share of assets of the five largest banks (% of total assets)	63.9	64.9	63.8	65.0	...
Foreign ownership of banking system (% of total assets)	29.4	31.5	38.1	37.2	...
Financial soundness indicators:					
- non-performing loans (% of total loans) ¹⁾	3.6	4.5	4.8
- capital adequacy ratio (%) ²⁾	11.0	12.1	11.8
- profitability - return on equity (%) ³⁾	14.5	14.0	3.6
Private credit growth (annual % change)	7.8	16.0	29.4	17.9	7.9
Residential property prices (y-o-y % change) ⁴⁾	-6.4	21.7	16.7	-3.9	-3.7
Exposure to countries receiving/repaying official financial assistance (% of GDP) ⁵⁾
Private debt (% of GDP)	186.3	212.6	259.6	286.3	294.5
Gross external debt (% of GDP)					
- Public	...	...	...	...	...
- Private	...	...	...	...	...
Long term interest rates spread versus Bund (basis points)*	37.2	25.8	61.6	137.8	185.7
Credit default swap spreads for sovereign securities (5-year)*	...	...	...	...	...
Notes:					
¹⁾ Latest available in 2010Q1.					
²⁾ The capital adequacy ratio is defined as total capital divided by risk weighed assets.					
³⁾ Net income to equity ratio.					
⁴⁾ Latest available in 2010Q2.					
⁵⁾ Covered countries are IE, EL, PT, RO, LV and HU.					
* Measured in basis points.					
Source:					
<i>Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission services (long-term interest rates), World Bank (gross external debt), Eurostat (residential property prices) and ECB (all other indicators).</i>					

Table VII. Labour market and social indicators

	2001-2005	2006	2007	2008	2009	2010
Employment rate (% of population aged 20-64)	74.9	75.8	76.8	76.5	75.7	75.3
Employment rate - women (% of female population aged 20-64)	64.3	65.9	67.7	68.2	68.1	68.4
Employment - share of part-time employment	7.3	6.6	6.4	8.0	8.7	9.4
Employment - share of permanent employment	88.1	86.8	86.7	86.1	86.5	86.4
Unemployment rate ¹ (% of labour force)	4.2	4.6	3.9	3.7	5.3	6.5
Long term unemployment rate ² (% of labour force)	0.9	0.8	0.7	0.4	0.3	1.3
Labour productivity per person employed (annual growth in %)	1.5	2.3	1.8	0.8	-0.9	1.9
Hours worked per person employed (annual % change)	0.7	0.9	-0.3	-0.5	-0.8	1.9
Labour productivity per hour worked (annual % change; constant prices)	0.8	1.4	2.1	1.3	-0.1	0.0
Employment protection legislation ³ (Index; 0 = least stringent; 6 = most restrictive)	:	:	:	:	:	:
Compensation per employee (annual % change; constant prices)	0.2	0.0	-1.6	-2.6	3.7	3.8
Notes:						
¹ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.						
² Share of persons in the labour force who are for at least 12 months unemployed (labour force survey).						
³ The employment protection indicators are compiled from 21 items covering three different aspects of employment protection: (i) individual dismissal of workers with regular contracts; (ii) additional costs for collective dismissals; (iii) regulation of temporary contracts. However, it is important to note that employment protection refers to only one dimension of the complex set of factors that influence labour market flexibility. The details of the methodology are explained at the website of the OECD. The latest available employment protection indicators are from 2008.						
<i>Source:</i> <i>Commission services and OECD.</i>						

Table VII. (cont.) Labour market and social indicators

Expenditure on social protection benefits (% of GDP)	2004	2005	2006	2007	2008
Sickness/Health care	4.21	4.52	4.64	4.49	4.44
Invalidity	0.75	0.68	0.71	0.66	0.67
Old age and survivors	8.53	8.41	8.33	8.31	8.20
Family/Children	2.04	2.11	1.94	1.93	2.06
Unemployment	0.98	1.09	1.06	0.86	0.81
Housing and Social exclusion n.e.c.	1.20	1.20	1.33	1.56	1.92
Total	17.7	18.0	18.0	17.8	18.1
of which: Means tested benefits	1.59	1.52	1.61	1.83	2.21
Social inclusion indicators	2005	2006	2007	2008	2009
Risk-of-poverty or exclusion ¹ (% of total population)	25.3	25.4	25.2	22.2	22.2
Risk-of-poverty or exclusion of children (% of people aged 0-17)	22.1	21.3	20.8	18.8	17.6
Risk-of-poverty or exclusion of elderly (% of people aged 65+)	54.2	55.6	55.6	50.7	50.1
At-Risk-of-Poverty rate ² (% of total population)	16.1	15.6	15.5	16.2	16.2
Value of relative poverty threshold (single HH per year) - in PPS	8868	9816	10956	11448	11784
Severe Material Deprivation ³ (% of total population)	12.2	12.6	13.3	8.2	7.9
Share of people living in low work intensity households ⁴ (% of people aged 0-59 not student)	4.4	3.8	3.7	4.1	4.0
In-work at-risk-of poverty rate (% of persons employed)	6.4	7.2	6.3	6.4	6.9
Notes:					
¹ People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).					
² At-risk-of poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.					
³ Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone					
⁴ People living in households with very low work intensity: Share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.					
Sources:					
For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.					

Table VII. Product market performance and policy indicators

Performance indicators	2001-2005	2006	2007	2008	2009	2010
Labour productivity ¹ total economy (annual growth in %)	0.1	2.3	1.9	0.7	-0.9	n.a.
Labour productivity ¹ in manufacturing (annual growth in %)	0.3	-6.0	1.3	1.8	-4.9	n.a.
Labour productivity ¹ in electricity, gas, water (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity ¹ in the construction sector (annual growth in %)	-0.9	2.7	2.6	-0.5	-1.6	n.a.
Patent intensity in manufacturing ² (patents of the EPO divided by gross value added of the sector)	1.0	0.4	0.3	n.a.	n.a.	n.a.
Policy indicators	2001-2005	2006	2007	2008	2009	2010
Enforcing contracts ³ (days)	n.a.	n.a.	n.a.	735	735	735
Time to start a business ³ (days)	n.a.	n.a.	n.a.	8	8	8
R&D expenditure (% of GDP)	0.3	0.4	0.4	0.4	0.5	n.a.
Tertiary educational attainment (% of 30-34 years old population)	38.1	46.1	46.2	47.1	44.7	n.a.
Total public expenditure on education (% of GDP)	6.7	7.0	6.9	n.a.	n.a.	n.a.
	2003	2005	2006	2008	2009	2010
Product market regulation ⁴ , Overall (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Retail (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Product market regulation ⁴ , Network Industries ⁶ (Index; 0=not regulated; 6=most regulated)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Notes:						
¹ Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.						
² Patent data refer to applications designated to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.						
³ The methodologies, including the assumptions, of this indicator is presented in detail at the website http://www.doingbusiness.org/methodology .						
⁴ The methodologies of the Product market regulation indicators are presented in detail at the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html . The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.						
⁶ Aggregate ETCR.						
*figure for 2007.						
Source :						
Commission services, World Bank Doing Business (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).						

Box 2 – Current Account deficit

Cyprus' current account deficit reached a record high of 17.6% of GDP in 2008, moderating to an estimated 9% in 2010. Following a close-to-balance position in the mid-1990s, the current account balance has deteriorated over time. Its evolution shows large disparities between net trade in goods and services. The persistently high deficit in goods trade and the high surplus in services reflect the shift of the Cypriot economy towards the tertiary sector. Nevertheless, the negative trade balance for goods is only partly compensated by the surplus recorded in services trade. The widening of the trade deficit in recent years reflected high import elasticities coupled with the acceleration and the composition of domestic-demand driven GDP growth. It also reflected temporary factors such as rising prices for oil, food and other commodities, on which Cyprus is highly dependent. The current account deficit also reflects a particular country-specific feature related to the statistical treatment of profits of firms with foreign shareholding based in the country, which are accounted as an outflow in the income account and as a foreign direct investment (FDI) inflow in the financial account, when reinvested in the country. As a result, part of the current account deficit is automatically compensated by capital inflows.

From a savings-investment perspective, the increase in the current account deficit essentially reflects a steady worsening of the net financial position of the private sector. On the back of a fall in risk premia and an easing of financial conditions, the private sector saving rate fell sharply. Credit grew at double-digit rates in 2007-08, driven by construction, real estate, renting, and business activities. The deterioration in private sector balances was partially offset by an increase in public sector savings, as government accounts recorded surpluses. Thus, public sector savings played a buffer role in meeting the increasing financial needs of private agents by mitigating crowding-out effects. Nevertheless, the unwinding of the financial market crisis and the burst of the real estate bubble saw a reversal of these trends. Public sector dissavings have been more than compensated by savings from the private sector, leading to a significant correction of the current account imbalance. However, this correction should only partly be considered as structural. The current levels are associated with a period of subdued domestic demand, on the backdrop of tepid consumption and construction investment activity, which has resulted in a sharp fall in imports.

The external financing of the current account deficit includes a variety of instruments, which can be classified into three categories: direct, portfolio and other investments, which are recorded in the financial account. In the case of Cyprus, the financial account has posted significant surpluses, mainly due to positive net FDI inflows and, to a lesser extent, to positive balances in portfolio and other investment. Net FDI inflows, which represent mostly reinvested profits of firms, have covered a substantial part of the current account deficit. In particular, they accounted for more than 100% of the current account deficit between 2000 and 2003 and for 50-75% between 2004 and 2006 and to a lesser extent in more recent years. During the latter years of last decade, inflows were negatively affected by subdued external demand for housing from non-residents in 2008, while outflows resulted from sales by foreigners of their holiday properties in Cyprus. Foreign capital is overwhelmingly concentrated in tradable services, particularly financial services and other business services. Other inflows have also been sizeable, essentially reflecting a significant inflow of non-resident deposits.