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**COMMISSION STAFF WORKING DOCUMENT**

**Country Report Cyprus 2019  
Including an In-Depth Review on the prevention and correction of macroeconomic  
imbalances**

*Accompanying the document*

**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN  
PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN  
CENTRAL BANK AND THE EUROGROUP**

**2019 European Semester: Assessment of progress on structural reforms, prevention and  
correction of macroeconomic imbalances, and results of in-depth reviews under  
Regulation (EU) No 1176/2011**

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## EXECUTIVE SUMMARY

**Cyprus' robust economic recovery has created favourable conditions to correct excessive macroeconomic imbalances and carry out key structural reforms to sustain growth in the long term.** Cyprus continues to have significant macroeconomic imbalances in several areas, namely high stocks of private, public and external debt and non-performing loans. The economy is growing rapidly, creating the right conditions to repay the debt. The economic upswing is also an opportunity to reform key areas, such as the business environment, the public sector, the justice system, education and the labour market to attract investments that increase productivity, diversify the economy and help to sustain robust and inclusive growth in the long term.<sup>(1)</sup>

**Economic growth has continued to be solid and the labour market has markedly improved. However, the long-term sustainability of Cyprus' growth model is a key challenge.** Strong growth in 2018, projected at 3.8 %, was supported by both domestic and external demand. The economy is expected to continue growing by around 3.3 % in 2019. Employment is rising and unemployment rate fell to 8.4 % in the third quarter of 2018, nearly half of its peak during the crisis. Inflation remains low. Despite this positive picture, growth remains concentrated in only a few sectors of the economy. This, together with the previously mentioned imbalances, makes the Cypriot economy vulnerable, particularly to the external environment.

**Cyprus' public finances improved significantly in recent years.** The general government headline balance turned from a deficit of 5.1% of GDP in 2013 to a surplus of 1.8% in 2017, supported by

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<sup>(1)</sup> This report assesses Cyprus' economy in light of the European Commission's Annual Growth Survey published on 21 November 2018. In the survey, the Commission calls on EU Member States to implement reforms to make the European economy more productive, resilient and inclusive. In so doing, Member States should focus their efforts on the three elements of the virtuous triangle of economic policy — delivering high-quality investment, focusing reforms efforts on productivity growth, inclusiveness and institutional quality and ensuring macroeconomic stability and sound public finance. At the same time, the Commission published the Alert Mechanism Report (AMR) that initiated the eighth round of the macroeconomic imbalance procedure. The AMR found that Cyprus warranted an in-depth review, which is presented in this report.

favourable macroeconomic conditions and fiscal consolidation. The headline balance is expected to remain in surplus in the medium term. However, there are risks to the fiscal outlook.

**Investment in environment, energy, digitalisation, workers' skills and innovation is crucial for increasing productivity and making Cyprus' growth model less vulnerable to the external environment.** Investment has recently recovered, but it remains concentrated in less productive sectors. Cyprus needs to significantly improve its waste management system and the circular economy. It can also make much better use of its renewable energy sources— particularly solar— and address current energy inefficiencies. Investing in the digital economy and in improving workers' digital skills is essential for bolstering productivity. To ensure that growth benefits all of society, more investment is needed in vocational education and training, adult learning, childcare and health. In addition, more investment in research and development (R&D) would increase the currently low innovative capacity of the economy. Annex D identifies key priorities for support by the European Regional Development Fund, the European Social Fund Plus and the Cohesion Fund for 2021-2027 in Cyprus, building on the analysis of investment needs and challenges outlined in this report.

**Overall, Cyprus has made some progress in addressing the 2018 country-specific recommendations.**

It has made substantial progress:

- on non-performing loans, as work on implementing a comprehensive strategy, including adopting strengthened legal frameworks on insolvency, foreclosure and the sale of loans, has advanced.

It has made some progress:

- on access to finance for small and medium-sized enterprises, as financial instruments supported by EU funds are expected to be launched soon; and
- on health, as work for the first phase of the National Health System implementation have

advanced, e.g. the reform of the outpatient services has begun.

Cyprus has made limited progress:

- in reforming the public sector, as key legislation for the public administration, the local government and the governance of State-owned enterprises has been delayed;
- on privatisation, as only a few privatisation projects are under way and progressing slowly;
- in the justice system, as the specialisation of courts is only at an initial stage and, although some efforts are being made to revise the civil procedures and introduce e-justice, progress is slow;
- in setting up a reliable system to issue and transfer immovable property (e.g. buildings and land) rights, as there is still a large backlog in cases of buyers who paid the full amount for a property and have yet to receive their legal ownership documents. The reform of the local government, which could simplify the procedures, has not yet been adopted;
- in strengthening the effectiveness of the public employment services and increasing outreach to young people who are not in jobs, education or training, as the effectiveness of the public employment services is still weak, despite the increase in staff, the evaluation of the active labour market policies is still pending and implementation of the action plan to get young people into employment, education or training is slow; and
- on education, as a concrete proposal to improve the evaluation system of teachers has not yet been announced.

Cyprus has made no progress:

- in integrating and strengthening the supervision of insurance companies and pension funds, as relevant laws are still being prepared; and
- in reducing burdensome procedures for strategic investors, as the relevant legislation is still to be adopted.

Cyprus has made some progress in reaching its national targets under the Europe 2020 strategy. It met its target for research and development (R&D) spending. However, the energy consumption has increased alongside the economic recovery and the proportion of renewable energy in the total energy mix has only moderately improved. In the absence of additional measures, this affects Cyprus' capacity to reach its greenhouse gas emissions and renewable energy targets and improve its energy efficiency. Cyprus exceeded its targets on higher education attainment and on reducing early school leaving. It also made some progress on increasing the employment rate. However, although there was some improvement in reducing poverty and social exclusion, the target seems to be beyond reach.

**Cyprus faces several challenges with regard to a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights.**

The proportion of young people who are not in employment, education or training remains high. Within this group, the proportion that has completed post-secondary education (almost one in three) is higher than the rest of the EU. Outreach measures and prompt tailor-made assistance for young people are limited, as confirmed by the low number of young people in relevant employment and training schemes. The incidence of early school leaving is rising. The level of the gross domestic household income is still low compared to that of 2008.

The main findings of the in-depth review contained in this report and the related policy challenges are as follows:

- **Cyprus has taken major steps to reduce non-performing loans, but using all the effective tools available would ensure further progress.** Non-performing loans decreased markedly in 2018 mainly due to the sale and wind down of the Cyprus Cooperative Bank, which moved a significant portfolio of bad assets from the banking system to a separate public entity. In addition, the authorities improved the insolvency and foreclosure frameworks and the sale of loans law, and adopted a securitisation of loans law. Implementing the laws decisively is therefore the next step. The ESTIA scheme, designed to address non-performing loans, collateralised by primary residences, is to be implemented in

2019. The scheme has raised concerns about moral hazard and fairness. The prompt use of all available tools together with an efficient judicial system might mitigate some of these risks, and ultimately strengthen the payment culture. The scheme's medium and long-term effects remain to be seen.

- **The banking sector returned to profitability in the first half of 2018, but the high stock of non-performing loans and low interest margins continue to weigh on banks' performance.** Banks hold large stocks of non-performing loans, even after significant disposals. Net interest margins continue to decline, while the operating cost-to-income ratio almost doubled in the first half of 2018.
- **Private sector debt remains very high, though it is decreasing.** Private debt-to-GDP is going down, but it remains among the highest in the EU. The decrease in 2018 was due to the strong GDP expansion, inflation, cash repayments, write-offs of non-performing loans and debt-to-assets swaps. The improved legal frameworks for insolvency and foreclosure and the ESTIA scheme should help to reduce the private sector debt.
- **Public debt is set to increase in 2018 due to the public support measures for the sale of the Cyprus Cooperative Bank, but to steadily decline after that.** Due to the government's support in the sale and orderly winding down of the Cyprus Cooperative Bank, public debt is estimated to reach 105 % of GDP in 2018, partly reversing the decrease of 2017. Public debt is projected to steadily decline in 2019-2020, due to the expected continuation of strong performance in public finances. However, according to the Commission's latest fiscal sustainability analysis, risks remain. In particular, public debt is among the highest in the EU, making Cyprus vulnerable to potential financial or economic shocks. These risks are somewhat mitigated by the fairly contained medium-term financing needs, while the country has recently regained investment grade rating for Cyprus' debt.
- **The net international investment position remains very negative.** It decreased in 2018, but remains largely negative at 105.5 % of GDP in the third quarter of 2018. Excluding the external debt of special purpose entities, the negative net international investment position is much smaller. In the third quarter it stood at -30.4 % of GDP, compared to the benchmark of -35 % of GDP. This nevertheless highlights Cyprus' dependency on foreign financing sources and its vulnerability to shifts in international financial market sentiment. The current account deficit is large and warrants monitoring.
- **Potential growth is expected to increase somewhat over the medium term supported by recovering investment.** The projected expansion of the labour force and increased investment are expected to raise growth potential. However, focus on investment in construction and ship registration, difficulty to access finance domestically and the shortcomings in the business environment could hamper long-term growth and productivity.
- **Persisting inefficiencies in the justice system weaken the enforcement of claims.** Outdated civil procedure rules, lengthy court proceedings and weak enforcement of claims impede the business environment and deter banks from using the available legal tools to reduce non-performing loans and ultimately strengthen the payment culture in the country. A comprehensive reform of the judicial system is under way. It focuses on the most urgent issues, namely the specialisation and digitalisation of courts, the clearance of the large backlog and the lifelong training of judges.
- **The housing market continues its recovery supported by foreign demand.** Residential property prices increased for the third year in a row, albeit moderately, and housing sales continued to increase significantly, supported by the residence and citizenship by investment schemes. The recovery in the housing market could reduce private debt, but the existing inefficiencies in the system of issuing and transferring title deeds complicates foreclosure procedures and deters the liquidation of collaterals.

A number of other key economic issues analysed in this report point to particular challenges to the Cypriot economy, namely:

- **Employment is rising and unemployment is falling, but much more can be done to support labour and social recovery.** There is significant scope for bringing public employment services in line with best EU practices. They could for example: (i) strengthen their outreach; (ii) improve their administrative efficiency and personalised guidance and (iii) improve participation in active labour market policies, focusing on vulnerable groups in particular.
- **Reforms in the education and health sectors are under way, but challenges remain.** In education, the relatively high public spending is not reflected in observed outcomes. Progress on crucial education reforms such as improving teachers' appointments and evaluation is uneven. Skills mismatches and poor educational achievements continue to restrict potential growth and relatively few people participate in adult learning and vocational education and training. Putting in place the universal national health insurance system is an opportunity to increase efficiency by reforming public hospitals, developing e-health and focusing more on health promotion.
- **Weaknesses remain in enforcing environmental and climate regulations.** The country's weak environmental performance is a major concern. Waste and water management is inefficient and the transition towards a circular economy has barely begun. Cyprus is also lagging behind on renewable energy generation and it is still heavily dependent on fossil fuels.
- **Cyprus' tax rules appear to be used in aggressive tax planning structures, but some steps are being taken to limit such practices.** Some elements that may facilitate tax planning include the absence of withholding taxes on interests, royalties and dividends, the corporate tax residence rules, or the residence and citizenship by investment schemes. However, Cyprus has taken steps to amend aspects of its tax system to curb aggressive tax planning, in

particular by implementing European and internationally agreed initiatives.

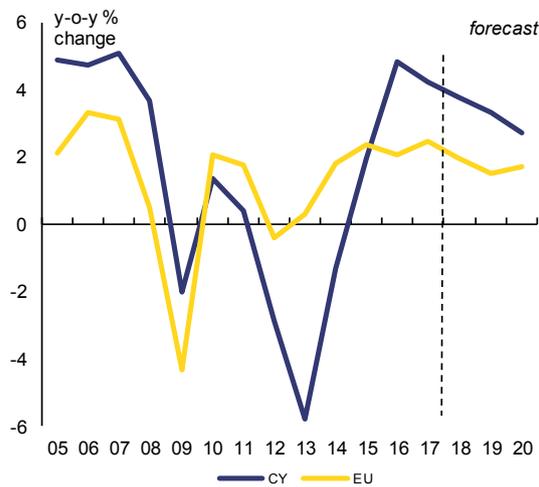
- **Inefficiencies in the public sector are harming the business environment.** Although planned reforms to modernise and improve the efficiency of the public administration have not yet started, efforts are being made to expand e-government services. The governance framework for State-owned enterprises is still not equipped to improve their performance. This may lead to build-up of public contingent liabilities and hinder investment in key utilities such as telecoms and energy. Cyprus needs to significantly simplify the procedures for obtaining permits for strategic investments. The local government reform that could improve services for local residents has not yet started. Corruption is perceived as a problem by both businesses and citizens and the pace of anti-corruption reforms is slow. The independence of prosecution and the capacity of law enforcement to carry out corruption investigations remain weak.

# 1. ECONOMIC SITUATION AND OUTLOOK

## GDP growth

**Cyprus continues to enjoy strong cyclical growth as it rebounds from the sharp contraction experienced during the crisis.** After 2 years of remarkable growth, the Cypriot economy continued to expand solidly in 2018. Real GDP over the first three quarters of the year grew at around 4 % on annual terms, one of the strongest growth rates in the euro area. In 2018, it is expected to have surpassed pre-crisis peak level (see Graph 1.1).

Graph 1.1: Real GDP growth in Cyprus and the EU



Source: European Commission

**Growth is increasingly driven by investment and private demand.** In 2016-2017, investment was the main contributor to growth, funded by hefty inflows of foreign capital. These flows financed tourism infrastructure, residential construction <sup>(2)</sup> and investments by special purpose entities (SPEs) <sup>(3)</sup>, including registration

- <sup>(2)</sup> The latter was particularly supported by the residence and citizenship by investment schemes with its mandatory acquisition of high value residence.
- <sup>(3)</sup> Legal entities registered and tax resident in Cyprus with few employees and/or no production, which are controlled by non-resident entities. These are widely used to register ships in Cyprus. As shipping activities usually take place offshore, shipping companies have an interest in structuring these activities through special purpose entities in favourable tax regimes such as Cyprus. Shipping-related transactions introduce bias in Cyprus' economic statistics by significantly affecting investment, imports and exports statistics. They have, however, only limited impact on the GDP through the leasing services provided by ship-owning entities whose economic owners are residents of Cyprus.

of ships in Cyprus. In 2018, consumption increasingly became a major driver for growth. Upbeat sentiment and rapidly improving situation in the labour market encouraged private consumption, which is expected to continue to perform strongly. Public consumption has also risen, partly due to the increase in wages and hiring by the government.

**Net exports weigh negatively on growth.** Net exports were a drag on economy in 2017, as rising exports were nevertheless outweighed by imports. In early 2018, exports have markedly risen, temporarily reversing the trend, but this strong performance was heavily influenced by the sizeable ship de-registration (which statistically increased the exports of goods). Apart from this one-off improvement, the net exports are expected to further weaken. The tourism sector, which has been the main driver of rising service sector exports in recent years, now faces headwinds: stronger competition from neighbouring countries (where safety concerns are abating) and the lower purchasing power of tourists visiting Cyprus (predominantly British and Russian) as a result of their currency depreciations. In parallel, imports are projected to rise in line with the increasing domestic demand.

**Growth is expected to remain strong and above potential in the short to medium term.** It is projected to reach 3.8 % in 2018 and then slow to 3.3 % in 2019 and to 2.7 % in 2020. This implies that growth is set to remain above the potential throughout this period, as the latest estimates project Cyprus' potential growth at around 2 %.

**Cyprus' key challenges mostly relate the long-term sustainability of its growth model.** The country's fast growth over recent years appears to have been largely determined by the performance of tourism-linked sectors, the revival of the construction sector and the sectors linked to the setting and servicing of foreign companies under the special purpose entities' regime. Tourism, amid increasing competition and certain market

For more information on SPEs and their impact on statistics and the real economy see European Commission, 2018a.

saturation<sup>(4)</sup>, is expected to consolidate gains and plateau. The new tourism strategy is in place and will influence the future growth of the sector. The construction sector prospects are very good in the short term, but its heavy reliance on foreign funding increases vulnerabilities. Potential changes in the international corporate tax framework could challenge Cyprus' role as a business service hub.

### Inflation

**Inflation remains very low.** Following a 0.7 % rise in the Harmonised Indices of Consumer Prices (HICP) indicator in 2017, inflation stayed equally low in 2018 at 0.8 %, although there was a substantial variation throughout the year, ranging from deflation in the first quarter to nearly 2 % inflation in the last quarter. Oil prices, transmitted with a lag to energy prices, and the unprocessed food prices accounted for this volatility. Core inflation in Cyprus continued to fluctuate around zero, as falling prices in non-energy industrial goods were partly offset by the modest increase in the price of services. Inflation is expected to remain very low in 2019, at 0.7 %, due to the dampening effect of oil prices but increase moderately in 2020 on the back of households' higher disposable incomes.

### Housing market

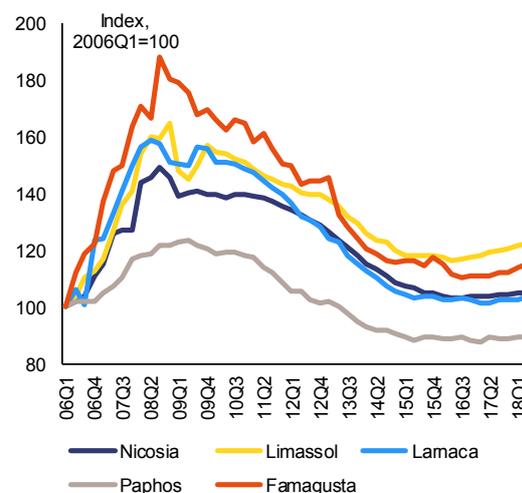
**The residential real estate market continues to recover.** Residential property prices moderately increased for the third year in a row (see Graph 1.2). In 2018, they rose by 1.6 % annually, according to the latest available data of the Central Bank (2018Q2). In terms of valuation, European Commission house-price valuation methods do not point to significant undervaluation (the overall valuation gap is estimated at -4.6 percentage points).<sup>(5)</sup> Housing sales continued to expand at double-digit growth rates.

<sup>(4)</sup> Tourist inflows hit accommodation capacity ceilings in peak months, while heavy competition of airlines led to the bankruptcy of Cobalt Air in 2018.

<sup>(5)</sup> The analysis of price valuations is based on an average of three metrics: (i) affordability gap (price-to-income deviation with respect to its long-term average); (ii) dividend gap (price-to-rent deviation from its long-term average); and (iii) estimates of deviations of house prices from equilibrium values justified by housing demand and supply fundamentals. See Philipponnet and Turrini (2017). In the case of Cyprus, besides the short sample, the

**The housing market recovery is largely driven by the inflow of foreign funds.** An increasing number of acquisitions is made by foreigners: they bought nearly half (48 %) of all property sold in 2018. The mandatory acquisition of personal immovable property under the residence and citizenship by investment schemes has been one of the key drivers of the real estate market recovery, adding to the traditional foreign demand for second homes in a holiday destination. It also contributed to the regional differences in price trends: real estate prices in Limassol, where the foreign, predominantly Russian, community is concentrated, rose much more strongly than elsewhere. Meanwhile, house purchases by Cypriots continue to be restricted by limited bank lending. Therefore, despite the improving economic situation for Cypriot households, locals bought fewer properties than in the previous year.

Graph 1.2: Residences price developments by region



Source: Central Bank of Cyprus

**The supply of real estate is accommodating the higher demand.** Construction has steadily increased since mid-2016 as evidenced by the number of new properties. Construction is reportedly shifting towards the luxury segment to adapt to the changing demand and to enable construction companies to benefit from funding from pre-sales. This pre-sale funding is still the major source of funding, as bank credit continues to be extremely limited. The real estate supply may also increase if properties acquired to obtain

analysis has the caveat that it does not take into account foreign demand.

citizenships are put up for sale. <sup>(6)</sup> Furthermore, the sale of non-performing loans by Cypriot banks to specialised managers (see Section 4.2.1) may result in the more rapid sale of the underlying collateral, releasing a large stock of real estate to the market.

### Labour market

**The labour market conditions continue to improve thanks to robust economic growth.** Employment is expected to grow by 3.8 % in 2018, almost among all sectors, following a similar strong increase 3.9 % in 2017. Unemployment rate continued to fall, reaching 8.4 % in 2018Q3, but it is still slightly above the EU average (6.8 %). Youth unemployment also remains higher than the EU average. In addition, the proportion of young people not in education, employment or training is among the highest in the EU. The proportion of underemployed part-time workers remains relatively high, which points to a persisting labour market slack (see Graph 1.3). <sup>(7)</sup> On labour market developments see Section 4.3.

**Despite of improving labour market conditions, disposable household income remains below the pre-crisis level.** The long period of wage restraint, which has supported employment growth and competitiveness gains since 2013, is expected to ease as renegotiated collective agreements in key sectors, including the public sector, provide for a gradual increase in wages and a partial adjustment to the price indexation. However, these increases are expected to be only moderate as labour market slack continues and job creation is mainly concentrated in labour intensive, low-paying sectors such as construction and tourism. In 2018, nominal compensation per employees is expected to have increased by around 1.5 % remaining below the rate consistent with economic fundamentals. <sup>(8)</sup> Real wage growth is expected to remain broadly stable and below real GDP growth

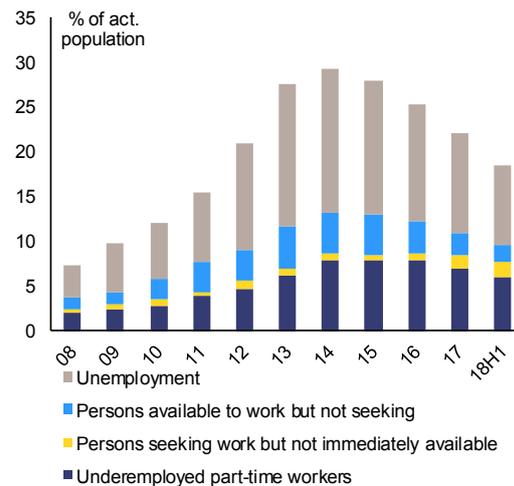
<sup>(6)</sup> The scheme requires holding the acquired residence for at least three years.

<sup>(7)</sup> Labour market slack is a measure of labour underutilisation. It includes persons available to work but not seeking work; those seeking work but not immediately available; and all involuntary part-time employed

<sup>(8)</sup> This is a benchmark for wage growth consistent with internal labour market conditions. It is calculated as the wage growth predicted on the basis of changes in labour productivity, prices and the unemployment rate (see Arpaia and Kiss, 2015).

in the near future limiting the increase in real disposable household income, which in 2017 was at 84.6 % of the pre-crisis level. On the upcoming increases in social contributions see Section 4.1.

Graph 1.3: **Labour underutilisation (% of the active population, 15-74)**



(1) The level of labour underutilisation includes persons available to work but not seeking work; those seeking work but not immediately available; and all involuntary part-time employed

Source: Eurostat

### Social developments

**Poverty and inequality continues to decrease according to indicators, almost reaching the pre-crisis levels.** The percentage of people at risk-of-poverty or social exclusion declined further to 25.2 % in 2017 (though this is somewhat above the EU average), compared to 27.7 % in 2016. It was mainly due to a steep decline in severe material deprivation and in the proportion of individuals living in very low work intensity households. In 2017, the richest 20 % of the population had an income 4.6 times higher than that of the poorest 20 %, which was below the EU average gap. The guaranteed minimum income scheme has contributed to the observed decline in poverty and income inequality (see also Sections 4.1.3 and 4.3.2). However, according to the latest available data (2014), overall wealth inequality in Cyprus is still among the highest in the euro area <sup>(9)</sup> and

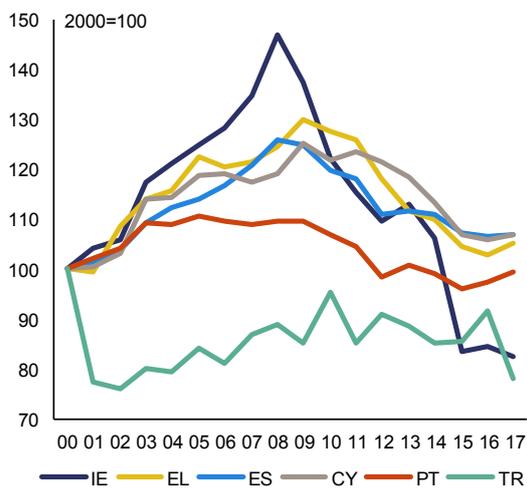
<sup>(9)</sup> As measured by Gini coefficient of net wealth, i.e. assets minus liabilities. The Gini coefficient is a summary statistic of inequality. The closer the Gini is to 1, the more unequal is the distribution of income or wealth. If there is no inequality in a society, the indicator is equal to 0. If all

wealth is disproportionately concentrated in the wealthiest 10 % of households (European Commission, 2018a, Sections 1 and 4.1.3). The recent recovery in economic growth has nonetheless been relatively non-inclusive, as the real gross disposable income of households per capita is still well below 2008 levels. Inequality of opportunity also remains relatively high in Cyprus compared to the EU average (see Section 4.3).

### Competitiveness

**The real effective exchange rate started to appreciate, reducing cost competitiveness.** After strong depreciation during the crisis years (see Graph 1.4), the rate is on an upswing. As the euro appreciated against major currencies in 2017, its adjustment has come to a halt and it increased by 1.6 % in 2018. Cyprus is particularly vulnerable to the exchange fluctuations of the UK pound and the Russian rouble, due to trade and investment links. Turkey, which competes with Cyprus for tourists, experienced sharp lira depreciation in 2018, gaining substantial advantage over Cyprus from a cost perspective.

Graph 1.4: Real effective exchange rates



Source: European Commission

**Labour productivity<sup>(10)</sup> and unit labour cost have recovered only moderately since the crisis.** As from 2014, labour productivity began to moderately increase. However, it has decreased

national income or wealth is earned by one person alone, the Gini coefficient is equal to 1.

<sup>(10)</sup> Measured as real GDP per occupied person.

between the last quarter of 2017 and the first half of 2018 (see Section 4.4.1). Unit labour costs started to increase from mid-2017, but the increase was relatively modest and followed a long downward adjustment. In 2019, an increase in social security contributions may increase unit labour costs.

### External position

**Cyprus' current account deficit is large, although a large part of it is associated with the activities of the special purpose entities.** The current account deficit widened to 8.4 % of GDP in 2017. Activities of special purpose entities accounted for -5.2 % of GDP<sup>(11)</sup> (see Graph 1.5). In the first half of 2018, the headline current account deficit contracted for the special purpose entities' component (de-registration of ships), while the part not related to the special purpose entities recorded a deficit of slightly more than 3 % of GDP. The combination of robust domestic demand and the government's efforts to attract shipping activity suggests that the current account deficit is set to widen further. The overall current account deficit is larger than the one required to stabilise the net international investment position over 10 years (estimated at -4.5 % of GDP), and larger than the current account 'norm'<sup>(12)</sup> explained by fundamentals (estimated at -1.6 % of GDP), whilst noting that the current account balance in Cyprus has never been in positive territory.

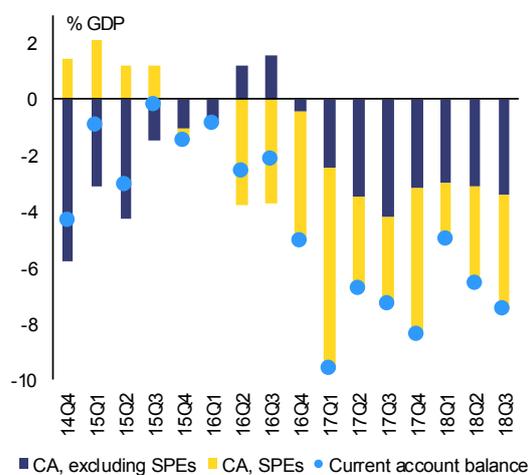
**The net international investment position remains very negative but is slowly narrowing.** Nearly two thirds of the negative net international investment position is attributable to the presence of special purpose entities (see Graph 1.6). As of 2018Q3, the special purpose entities' share was -75.1 % of GDP, compared to the total net international investment position of -105.5 % of GDP. This slightly mitigates the risks of the very negative overall net international investment

<sup>(11)</sup> It must be noted that here and in subsequent references to ratios related to special purpose entities throughout the report only the numerator has been adjusted, while the GDP has not been adjusted for the presence of special purpose entities.

<sup>(12)</sup> The current account 'norm' benchmark is derived from regressions capturing the main fundamental determinants of the saving-investment balance (e.g. demographics, resources), as well as policy factors and global financial conditions. See also European Commission, 2017a.

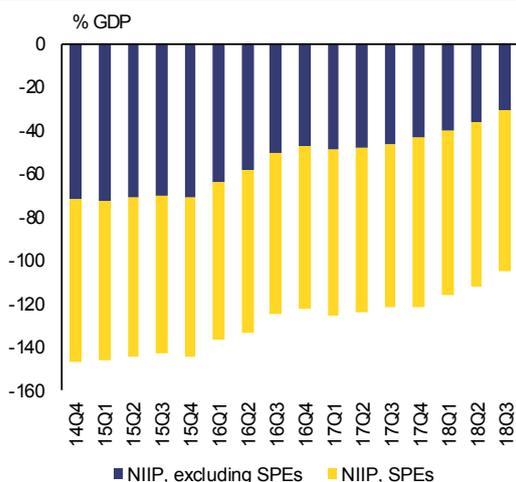
position, as links of the special purpose entities to the real economy are perceived to be limited. Since 2014, sectors not related to special purpose entities led the correction of the net international investment position, which is a positive sign. In the first three quarters of 2018, the negative net international investment position contracted significantly, by 16 percentage points.

Graph 1.5: **Current account developments by special purpose entities status**



Source: Central Bank of Cyprus

Graph 1.6: **Developments of the net international investment position**



Source: Central Bank of Cyprus

## Financial sector

**Although banks have ample liquidity, they face profitability and asset quality challenges.**

Following losses in 2017, profitability turned positive in the first half of 2018. However, poor quality assets and low interest margins continue to weaken banks' performance. The non-performing loans stock and ratio declined significantly in 2018 compared to the past, but Cyprus continues to have one of the highest non-performing loans ratio in the euro area. Cyprus Cooperative Bank's exit from the banking market was the sector's key development in 2018 (see Section 4.2).

**New lending from the domestic financial sector to the real economy remains very limited in light of still very high debt stocks.** Therefore, the private sector has to rely more on internal resources and external funding. According to data from the Central Bank of Cyprus, the gross volume of new loans to domestic residents reached EUR1.4 billion in the first half of 2018, similar to the amount provided in the first 6 months of 2017. The new loans were mostly channelled towards non-financial corporations, in sectors where debt stocks and non-performing loans are still very high. Household indebtedness continues to be high despite ongoing deleveraging, while net credit flows to the household sector remain negative.

## Public finances

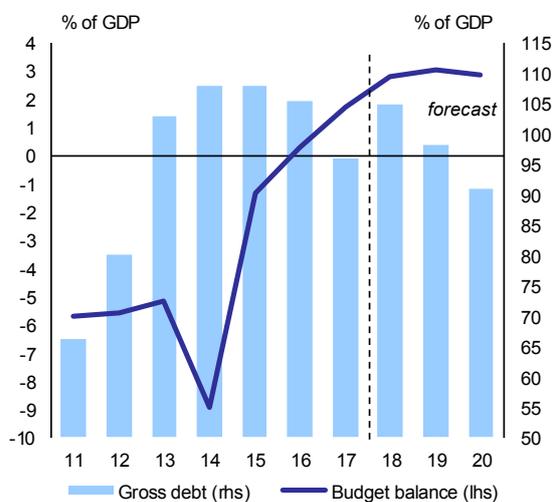
**Public finances improved significantly over the last years, supported by a favourable macroeconomic outlook and consolidation of government spending.** Since the start of the economic adjustment programme in 2013, Cyprus' fiscal position has improved markedly (see Graph 1.7). The general government headline balance moved from a deficit of 5.1 % of GDP in 2013 to a surplus of 1.8 % of GDP in 2017. This improvement was the result of both budgetary consolidation implemented during the programme years and favourable macroeconomic conditions. The sizeable improvement in the government headline balance was the main reason behind Cyprus reducing public debt by 2017.

**The budget balance is expected to remain in surplus in the medium term.** The Commission 2018 autumn forecast projects that the general government surplus will increase to 2.5-3.0 % of GDP in 2018-2020. Buoyant tax revenue growth underpinned by strong underlying economic growth and an improved labour market is expected to continue to outpace expenditure growth. This

forecast excludes the potential deficit-increasing (one-off) impact on the general government balance in 2018 from the banking support measures related to the Cyprus Cooperative Bank (see Section 4.1.2). The structural balance is expected to maintain a surplus of above 1 % of GDP in 2018-2020 (above the medium-term budgetary objective of 0 % of GDP), although it is expected to decrease from 2019 onwards as the positive output gap widens.

asset-management company legacy (see Box 4.2.1). The transaction represents a level-shift upwards in Cyprus' public debt. However, public debt is projected to significantly decrease again to 98.4 % in 2019 and to 91 % in 2020 (the latter is about 13 percentage points above the projected EU average). The decrease reflects the projected continued strong fiscal performance and a favourable contribution of the interest rate-growth rate differential (see Section 4.1.1 and Annex B for an analysis of debt sustainability).

Graph 1.7: **General government budget balance and gross debt**



Source: European Commission

**There are risks to the fiscal outlook.** Fiscal risks are mainly due to: (i) the potential realisation of explicit contingent liabilities regarding the measures related to the sale of the Cyprus Cooperative Bank; (ii) increasing spending pressures; and (iii) the sustainability of the strong tax revenue performance as presented in Section 4.1.

**Due to the government's support in the Cyprus Cooperative Bank sale, public debt is projected to increase from 96.1 % of GDP in 2017 to 105 % in 2018, but to steadily decline after that.** The increase in 2018 is mainly due to the issuance of a series of government bonds in April and July 2018, to facilitate the sale of the State-owned Cyprus Cooperative Bank (see Section 4.2.1). The net proceeds from the bond issuances, which totalled EUR 3.5 billion (17 % of GDP) after the addition of some cash, were deposited with the Cyprus Cooperative Bank and have been kept in its

Table 1.1: Key economic and financial indicators – Cyprus

	2004-07	2008-12	2013-15	2016	2017	forecast		
						2018	2019	2020
Real GDP (y-o-y)	4.9	0.1	-1.8	4.8	4.2	3.8	3.3	2.7
Potential growth (y-o-y)	3.8	2.2	-1.5	0.8	1.8	2.1	2.2	2.2
Private consumption (y-o-y)	6.2	0.5	-0.8	4.5	4.1	.	.	.
Public consumption (y-o-y)	2.7	2.2	-4.3	-0.8	3.1	.	.	.
Gross fixed capital formation (y-o-y)	10.0	-8.6	-8.4	41.8	26.8	.	.	.
Exports of goods and services (y-o-y)	3.5	0.4	3.8	4.6	6.0	.	.	.
Imports of goods and services (y-o-y)	5.9	-1.0	2.5	6.6	12.2	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	6.5	-1.2	-2.5	8.4	8.0	.	.	.
Inventories (y-o-y)	-0.2	0.4	0.1	-2.3	0.3	.	.	.
Net exports (y-o-y)	-1.4	0.5	0.6	-1.3	-4.1	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	1.4	0.9	-1.0	0.6	0.9	0.9	0.7	0.6
Capital accumulation (y-o-y)	2.1	1.5	0.0	0.6	1.2	1.3	1.4	1.5
Total factor productivity (y-o-y)	0.3	-0.2	-0.4	-0.4	-0.2	-0.1	0.0	0.1
Output gap	4.6	-0.2	-7.6	-1.8	0.5	2.3	3.5	4.3
Unemployment rate	4.6	7.0	15.7	13.0	11.1	8.2	6.3	4.8
GDP deflator (y-o-y)	3.0	2.1	-1.3	-0.6	1.5	2.1	1.3	1.7
Harmonised index of consumer prices (HICP, y-o-y)	2.1	2.7	-0.5	-1.2	0.7	0.8	0.7	1.2
Nominal compensation per employee (y-o-y)	3.7	2.7	-3.4	-1.1	0.7	1.5	2.2	2.2
Labour productivity (real, person employed, y-o-y)	1.4	-0.1	0.4	0.2	0.4	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2.3	2.8	-3.8	-1.4	0.4	1.5	1.5	1.6
Real unit labour costs (y-o-y)	-0.7	0.7	-2.5	-0.8	-1.2	-0.6	0.2	-0.1
Real effective exchange rate (ULC, y-o-y)	0.7	0.7	-4.1	-1.8	1.0	1.8	-1.2	-0.4
Real effective exchange rate (HICP, y-o-y)	-0.1	-0.4	-2.1	-0.1	0.2	1.5	-1.8	-0.9
Savings rate of households (net saving as percentage of net disposable income)	4.5	0.3	-11.8	-10.6	-10.2	.	.	.
Private credit flow, consolidated (% of GDP)	23.7	17.5	-3.2	9.7	8.7	.	.	.
Private sector debt, consolidated (% of GDP)	259.7	311.3	348.6	337.8	316.3	.	.	.
of which household debt, consolidated (% of GDP)	87.2	116.3	128.5	118.8	107.5	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	172.5	195.0	220.2	218.9	208.8	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	.	8.9	35.8	33.8	28.9	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-11.7	0.5	10.1	2.5	-1.1	0.2	0.1	0.7
Corporations, gross operating surplus (% of GDP)	23.8	20.3	21.9	21.3	20.7	20.4	20.1	20.5
Households, net lending (+) or net borrowing (-) (% of GDP)	-5.6	-5.0	-7.6	-7.7	-8.5	-11.2	-12.4	-13.1
Deflated house price index (y-o-y)	6.8	-4.7	-1.6	1.7	1.3	.	.	.
Residential investment (% of GDP)	10.9	8.2	4.1	4.9	5.7	.	.	.
Current account balance (% of GDP), balance of payments	0.0*	-8.9	-3.6	-5.1	-8.4	-8.2	-9.3	-9.5
Trade balance (% of GDP), balance of payments	0.0*	-6.0	1.6	-0.6	-3.5	.	.	.
Terms of trade of goods and services (y-o-y)	-0.5	-0.1	-0.4	0.7	1.4	1.6	0.0	0.3
Capital account balance (% of GDP)	.	0.3	0.8	0.2	0.5	.	.	.
Net international investment position (% of GDP)	0.0*	-109.9	-143.6	-123.0	-121.5	.	.	.
NIIP excluding non-defaultable instruments (% of GDP) (1)	.	-84.2	-118.2	-110.8	-95.1	.	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	.	578.3	508.3	476.2	431.2	.	.	.
Export performance vs. advanced countries (% change over 5 years)	-13.5	-8.7	-13.2	-5.7	2.1	.	.	.
Export market share, goods and services (y-o-y)	.	.	0.6	6.0	-0.8	.	.	.
Net FDI flows (% of GDP)	0.0*	1.7	12.6	-9.8	-23.2	.	.	.
General government balance (% of GDP)	-0.9	-4.1	-5.1	0.3	1.8	2.8	3.0	2.9
Structural budget balance (% of GDP)	.	.	1.9	1.3	1.5	1.7	1.3	0.8
General government gross debt (% of GDP)	60.4	60.6	106.4	105.5	96.1	105.0	98.4	91.0
Tax-to-GDP ratio (%) (3)	32.2	32.4	32.7	32.8	33.9	34.9	35.2	35.0
Tax rate for a single person earning the average wage (%)	.	.	.	.	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	.	.	.	.	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares

(2) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

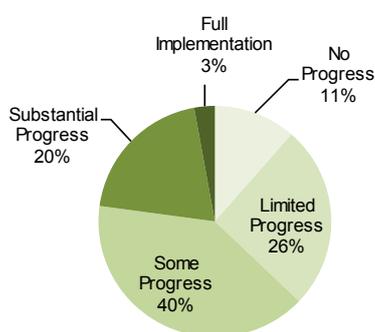
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation

**Source:** Eurostat and ECB as of 31-1-2019, where available; European Commission for forecast figures (Winter forecast 2019 for real GDP and HICP, Autumn forecast 2018 otherwise)

## 2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Since the start of the European Semester in 2011, 63 % of all country-specific recommendations addressed to Cyprus have recorded at least ‘some progress’.<sup>(13)</sup> 37 % of these country-specific recommendations recorded ‘limited’ or ‘no progress’ (see Graph 2.1). Full implementation and substantial progress have been achieved in a wide range of reforms, in particular fiscal and financial ones supported by the 2013-2016 European Union-International Monetary Fund economic adjustment programme. These reforms address most of the country-specific recommendations made in 2011 and 2012. As regards the country-specific recommendations made after the programme’s completion, these mostly cover persisting challenges, which are also reflected in the 2018 country-specific recommendations.

Graph 2.1: Cyprus - Level of implementation today of 2011-2018 country-specific recommendations



\* The overall assessment of the country-specific recommendations related to fiscal policy excludes compliance with the Stability and Growth Pact  
 \*\* 2011-2012 annual assessment: Different CSR assessment categories  
 \*\*\* The multiannual CSR assessment looks at the implementation until 2019 Country Report since the CSRs were first adopted.  
**Source:** European Commission

**Public financial management and the budgetary framework** were significantly strengthened with the adoption and implementation of the Financial Responsibility and Budget Framework Law, which have helped in ensuring transparency and sustainability of the public finances. The **pension**

<sup>(13)</sup> For the assessment of other reforms implemented in the past, see Section 4.

**system** was reformed to ensure its long-term sustainability.

The country-specific recommendations on **social benefits** and the high ‘at-risk-of-poverty’ rate among the elderly were addressed by introducing the guaranteed minimum income, which allows for more efficient and targeted social benefits.

The **financial sector** underwent significant reforms, notably through the harmonisation and integration of the supervision of banks and cooperative credit institutions. New insolvency and foreclosure frameworks were adopted, which were further strengthened in 2018.

Sector-specific obstacles to the establishment and **free provision of services** have been mostly removed.

Some measures were introduced to promote **renewable energy** production and diversify the energy mix as recommended. However, energy production is still heavily dependent on fossil fuels.

Measures to improve the **labour market** situation have been put in place through a reform of wage indexation, active labour market policies to reduce unemployment, notably among young people, long-term unemployed and receivers of guaranteed minimum income and policies to upgrade worker’s skills. Some measures were also undertaken to improve the attractiveness of the vocational education system.

The longstanding recommendation regarding the reform of the **national healthcare system** has made progress in 2017 with the adoption of the necessary legislative framework. However, implementation is still pending.

Cyprus has made so far some<sup>(14)</sup> progress in addressing the 2018 country-specific recommendations (see Table 2.1). Reforms related to the efficiency of the public administration, the local government and the State-

<sup>(14)</sup> Information on progress and action taken to address the policy advice in each subpart of a country-specific recommendation is presented in the overview table (see Annex A).

owned enterprises have begun, but very slowly. Although some measures to improve the efficiency of the judicial system were announced or introduced, the implementation of the comprehensive reform needs to be stepped up and in particular measures related to the handling of financial disputes. A reliable and efficient system to issue and transfer immovable property rights is still pending and progress is slow. A comprehensive strategy is being implemented to help accelerate the reduction of non-performing loans, including the strengthening of the insolvency and foreclosure frameworks, but its overall effect will be assessed over time. The action plan for growth is gradually being implementing, focussing on improving the business environment, in line with the euro area recommendation 1, and access to finance for small and medium-sized enterprises. Improving the performance of the State-owned enterprises and implementing the planned privatisation projects has proved challenging to progress. The capacity of the public employment services was strengthened, but with regards to its effectiveness, announced measures are still pending. The outreach efforts for young people not in employment, education or training have recorded only limited progress. The education reform is progressing unevenly and without concrete results on the evaluation of teachers. Finally, some measures were adopted and implemented for the first phase of the healthcare reform and in an effort to prepare the ground for full implementation of the National Health System in 2020, as planned.

Table 2.1: Assessment of the 2018 country-specific recommendations implementation

2018 CSRs to Cyprus	Overall assessment of progress with the 2018 CSRs: Some progress
<p><b>CSR1:</b> <i>Adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration and the governance of State-owned entities and local governments. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Limited progress</b> regarding the laws to modernise the functioning of the public administration.</li> <li>• <b>Limited progress</b> on the law for the improvement of the governance of the State-owned enterprises.</li> <li>• <b>Limited progress</b> on the reform of the local governments.</li> </ul>
<p><b>CSR2:</b> <i>Step up efforts to improve the efficiency of the judicial system by revising civil procedures, increasing the specialisation of courts and setting up a fully operational e-justice system. Take measures to fully operationalise the insolvency and foreclosure frameworks and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. (MIP Relevant)</i></p>	<p><b>Some progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Limited progress</b> on the revision of the civil procedures, on increasing the specialisation of courts and on introducing e-justice.</li> <li>• <b>Substantial progress</b> on improving the operationalisation of the insolvency and foreclosure frameworks.</li> <li>• <b>Limited progress</b> on ensuring reliable and swift systems for issuing and transferring of title deeds.</li> </ul>
<p><b>CSR3:</b> <i>Accelerate the reduction of non-performing loans by implementing a comprehensive strategy, including legislative amendments allowing for the effective enforcement of claims and facilitating the sale of loans. Integrate and strengthen the supervision of insurance companies and pension funds. (MIP Relevant)</i></p>	<p><b>Substantial progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Substantial progress</b> on implementing a comprehensive strategy, including legislative amendments for more effective enforcement of claims and facilitating the sale of loans.</li> <li>• <b>No progress</b> on the integration and strengthening of the supervision of insurance companies and pension funds.</li> </ul>
<p><b>CSR4:</b> <i>Prioritise the implementation of key elements of the action plan for growth, in particular fast-tracking strategic investments, and take additional measures to improve access to finance for small and medium-sized enterprises. Improve the performance of State-owned enterprises including by resuming the implementation of privatisation projects. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>No progress</b> regarding the fast-track strategic investments.</li> <li>• <b>Some progress</b> on access to finance for small and medium-sized enterprises.</li> <li>• <b>Limited progress</b> on improving the performance of State-owned enterprises and the implementation of privatisation projects.</li> </ul>
<p><b>CSR5:</b> <i>Complete reforms aimed at increasing the capacity and effectiveness of the public employment services and reinforce outreach and activation support for young people who are not in employment education or training. Complete the reform of the education and training system, including teacher evaluation and actions to increase the capacity of vocational education and training. Take measures to ensure that the National Health System becomes fully functional in 2020, as planned. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Limited progress</b> on completing the reforms on the effectiveness of the public employment services and on reinforcing the outreach and activation support for young people not in employment, education or training.</li> <li>• <b>Limited progress</b> on completing the reform of the education and training system, including teachers' evaluation and actions to increase the capacity of vocational education and training.</li> <li>• <b>Some progress</b> on taking measures to ensure that the National Health System becomes fully functional in 2020, as planned.</li> </ul>

Source: European Commission

**Box 2.1: Technical support by the Structural Reform Support Service in Cyprus**

The Commission can provide tailor-made technical support upon a Member State's request via the Structural Reform Support Programme to help Member States implement growth-sustaining reforms to address challenges identified in the European Semester process or other national reforms.

**The Cypriot authorities have benefitted from support from the Commission in the area of judiciary reform**, in particular to review the functioning of the Court system and the Attorney General's Office, and to prepare for the introduction of an electronic system in Courts. The Commission is also supporting the Supreme Court in modernising the rules of civil procedures, designing training programmes and establishing criteria for the selection and promotion of judges, and assessing the feasibility of introducing a digital audio recording system in Courts.

**Cyprus is also drawing on technical support for its reform of the public administration.** This includes the design of a workforce planning system to align the government's human resources management with the country's strategic priorities, as well as a functional review of the operations in the Cypriot public administration. Support is also provided to the authorities to improve web presence of the government and to consolidate the information technology infrastructure in the Ministry of Labour.

**The Cypriot authorities are working with the Commission to improve the regulatory framework for insolvency** and restructuring practitioners in the areas of licensing, remuneration, training, monitoring, supervision and discipline. A project was also launched to improve the efficiency and effectiveness of the operations of the Insolvency Service. In the area of access to finance, support is provided to improve the management of financial instruments

**In the area of growth and business environment, the Commission has assisted the authorities in strengthening the administrative capacity for public investment management and public private partnerships.** Technical support was also provided to increase participation to EU competitive programmes, and to produce the first annual Competitiveness Report for Cyprus. In the area of energy, the authorities have received support to help develop renewable energy and energy efficiency, draft the integrated National Energy and Climate Plan, as well as training and expertise on a range of topics related to the internal energy market.

**In the area of health, Cyprus has benefitted from technical support for the design, financing and management of the National Health Insurance System**, business continuity and disaster recovery in the Health Insurance Organisation, implementation of the EU General Data Protection Regulation, identification of a negotiation strategy with healthcare providers, and capacity planning in the healthcare sector.

**In the area of education, the Commission provided technical support to assess the feasibility of introducing a student loan scheme in Cyprus**, as well as for the reorganisation of school boards, and the development of a reform of the special education system with the aim of making it more inclusive.

**In the area of public finances, Cyprus received technical support to finalise a capacity-building exercise of a value-for-money review**, and for the preparation of reviews of State-owned enterprises. The Commission also assisted the authorities for the implementation of international public sector accounting standards. In addition, the Cyprus Tax Department received support to prepare the procurement of a new integrated tax administration system. A new project has recently started to support change management for the implementation phase of this new system.

**Box 2.2: EU funds and programmes contribute to addressing structural challenges and to fostering growth and competitiveness in Cyprus**

**Cyprus is a beneficiary of European Structural and Investment Funds (ESI Funds).** Cyprus achieved the best execution rate of European Regional Development Fund funds (46 %) and European Social Funds funds (50 %) for 2018. In addition, Cyprus improved in the execution of the Cohesion Fund, and achieved the second highest rate in the EU (33.3 %). Financial allocation from European Structural and Investment Funds aimed to support Cyprus in facing development and social challenges, amounts to approximately EUR 917 million in the current Multiannual Financial Framework for 2014-2020, equivalent to around 0.7 % of GDP annually and 26 % of all public investment per year on average. As of the end of 2018, an estimated EUR 730 million (around 80 % of the total) was already allocated to specific projects, among which EUR 36.3 million to critical interventions for youth through the Youth Employment Initiative. In addition, EUR 54.8 million was allocated to strategic EU TEN-Transport projects through the dedicated EU funding instrument, the Connecting Europe Facility. Furthermore, numerous Cypriot research institutions, innovative firms and individual researchers benefited from other EU funding instruments, notably Horizon 2020 which provided EUR 134.2 million.

**EU funding has helped address policy challenges and implement country-specific recommendations.**

The European funding has paved the way for some 1 700 enterprises to be supported, achieving so the creation of some 1 320 full time equivalent new direct jobs. 80 innovative enterprises are also supported in introducing new products to the market and 2 800 people are trained to meet labour market needs. By the end of the period, it is expected that public support in research and innovation will leverage some additional EUR 12 million of private investments and. Investments are also scheduled for additional 13 600 people equivalent to benefit from modern waste water treatment. Thanks to the European Social Fund, additional 4 800 people, including unemployed, long-term unemployed, and 1 800 people below 29 years of age will have been supported in their integration to the labour market. With the support from the EU funds, some 2 100 households will be able to improve their energy performance and the energy consumption of public buildings will annually reduce by 3 million kWh and some 1 100 people from jobless households will be integrated to the labour market or will be better skilled to do so. Over 100 000 sqm of open spaces will be created or rehabilitated for the improvement of urban mobility as well as 32 000 sqm of open spaces will be created or rehabilitated in urban areas and 1 300 people from disadvantaged groups will be supported with a view to promoting equal opportunities and active participation.

Out of the EU financing, EUR 40 million is to be delivered via financial instruments to support small and medium-sized enterprises and projects in the fields of energy efficiency and renewable energy sources both for the public and private sector (households and enterprises) i.e. twice the amount delivered in the 2007-2013 period.

Cyprus' total financing under the European Fund for Strategic Investments (EFSI) amounts to EUR 45 million and is set to trigger EUR 81 million in additional private and public investments. The country ranks 27<sup>th</sup> as to the overall volume of approved operations as a share of GDP. In the Infrastructure and Innovation window, 1 project was approved and financed by the European Investment Bank with the European Fund for Strategic Investments backing for approximately EUR 35 million, set to trigger EUR 53 million in total investment. The small and medium-sized enterprises component, instead, saw 2 approved agreements with intermediary banks financed by the European Investment Fund with the European Funds for Strategic Investments backing of EUR 10 million, set to trigger around EUR 28 million in investments with some 125 small and medium-sized enterprises and mid-cap companies expected to benefit from improved access to finance.

More information at: <https://cohesiondata.ec.europa.eu/countries/CY>

### 3. SUMMARY OF THE MAIN FINDINGS FROM THE MIP IN-DEPTH REVIEW

#### Introduction

**The 2019 Alert Mechanism Report concluded that a new in-depth review should be undertaken for Cyprus to assess the persistence or unwinding of the imbalances (European Commission, 2018c).** In winter 2018, Cyprus was identified as having excessive macroeconomic imbalances. The imbalances identified related in particular to the high share of non-performing loans (NPLs) in total loans and the significant stock of private, public, and external debt. This is in a context of high, even though declining, unemployment and weak potential growth. This section summarises the findings of the analyses in the context of the macroeconomic imbalance procedure in-depth review that is contained in various parts of this report. <sup>(15)</sup>

#### Imbalances and their gravity

**The non-performing loans (NPL) ratio in the banking sector declined significantly in 2018 but it remains one of the highest in the EU.** The NPL ratio dropped to 45 % of total loans in mid-2018, and it is expected to fall significantly further by the end of 2018 to approximately 37 % of total loans. The large decrease was due to the removal of the Cyprus Cooperative Bank's sizeable NPLs portfolio from the banking system in September 2018, when the bank surrendered its banking licence. Another key development that contributed to the downward trend was the Bank of Cyprus' sale of a large volume of NPLs (EUR 2.7 billion) to an international private equity firm, Apollo Global, although this transaction is pending approval from the Single Supervisory Mechanism (see Section 4.2.1).

**Private sector debt is on a downward path, though it remains well above the fundamental and prudential benchmarks.** The private debt-to-GDP ratio decreased from 337.8 % in 2016 to 316.3 % in 2017 and then to below 300 % in mid-2018. This reduction is mainly driven by the strong GDP expansion, pick-up in inflation, cash

repayments, NPL write-offs and debt-to-assets swaps. Non-financial corporations debt is inflated by the foreign debt of special purpose entities. However, even when excluding the special purpose entities, the corporate debt is very high. In 2017, the overall stock of debt of non-financial corporations remained stable compared to the previous year, whereas the household sector stock of debt declined more significantly. New lending, while limited, is largely channelled towards non-financial corporations, to business sectors such as wholesale and retail trade, accommodation and food service activities, construction and real estate activities. These sectors already account for a large share of the banks' loan portfolio, and have a high incidence of non-performing loans. The household sector does not have positive net credit flows. Both the corporate and household sector remain overly indebted and thus, vulnerable to economic shocks. Everything else constant, the deleveraging process is bound to slow down once growth starts to converge towards potential (see Section 4.2.2).

**Following an increase in 2018, public debt exceeds now 100 % of GDP, making Cyprus vulnerable to economic shocks.** Due to the government's support in the sale of the Cyprus Cooperative Bank (see Section 4.2.1), public debt is projected to increase to 105 % of GDP in 2018, partly reversing the sharp decrease in 2017. High public debt makes Cyprus vulnerable to financial or economic shocks, namely a potential sharp increase in interest rates. However, the recently regained investment grade rating for Cyprus' debt and relatively contained — despite the one-off increase due to the sale of the Cyprus Cooperative Bank — medium-term financing needs mitigate refinancing risks. Given also the fact that the large proportion of long-term low-interest debt was provided by external creditors during the economic adjustment programme, Cyprus' debt servicing costs are relatively low for its level of debt (see Section 4.1.1).

**The country's net international investment position remains a source of vulnerability,** as at -105.5 % of GDP in 2018Q3 it was one of the most negative in the EU and well beyond the estimated prudential and fundamental thresholds,

<sup>(15)</sup> Analyses relevant for the in-depth review of excessive government debt can be found in Section 4.1.1 and Annex B; financial sector imbalances and private indebtedness are discussed in Section 4.2.

of -54 % and -43 %, respectively<sup>(16)</sup>. The risk is moderated thanks to the larger part (75.1 % of GDP) of the negative position being accounted for by the non-financial special purpose entities registered in Cyprus, which appear to have limited links to the real economy. The net international investment position excluding the share of the special purpose entities was much smaller (-30.4 % of GDP) and within the benchmark.

**The current-account deficit is high, while sustained current account surpluses are necessary to bring the net international investment position to safer levels.** Amid strong cyclical upswing, the current account remains deeply negative. In 2017, the current account was -8.4 % of GDP, and it remained in high deficit in 2018, at -7.5 % of GDP as of Q3. Activities of the special purpose entities, notably ship registration and de-registration, have a major impact on current account. Excluding special purpose entities, the current account in 2017 and 2018 (as of Q3) was at around -3 % of GDP. However, this is still below the current account 'norm'<sup>(17)</sup> implied by fundamentals (-1.6 %). Moreover, Cyprus would need a current account balance of close to zero and a trade balance of close to 5 % to reduce its net international investment position to its threshold of -35 % of GDP over the next 20 years (without accounting for the presence of special purpose entities).

**The strong increase in job creation has substantially improved the country's labour market conditions.** Most indicators improved considerably as unemployment is expected to drop to 8.2 % in 2018. Long-term and youth unemployment also decreased significantly, reducing the gravity of the problem (see Sections 1 and 4.3.1).

<sup>(16)</sup> The country-specific NIIP level explained by fundamentals represents the NIIP that would result if a country had run its current account 'norm' since 1995. It derives from cumulated current account 'norms', which in turn represent the impact of fundamentals on the current account. See Turrini and Zeugner, 2018.

<sup>(17)</sup> The current account 'norm' benchmark is derived from regressions capturing the main fundamental determinants of the saving-investment balance (e.g. demographics, resources), as well as policy factors and global financial conditions. See also Coutinho et al., 2018.

**Potential growth is expected to increase somewhat over the medium term, helping to slowly unwind the accumulated stock imbalances.** Recovering investment, the return of discouraged workers to the labour force and lower unemployment are expected to increase growth potential. Potential growth is estimated at around 2 % in 2017-2021 but is expected to decline thereafter. The concentration of investment into construction and ship registration does not favour long-term growth and productivity (see Sections 1 and 4.4).

### Evolution, prospects and policy responses

**The Cypriot authorities devised and started implementing a three-pillar policy strategy to reduce non-performing loans (NPLs).** The strategy comprised of: (i) a legislative package, including amendments to the foreclosure and insolvency frameworks and to the sale of loans law, and the adoption of a securitisation law; (ii) the sale of the Cyprus Cooperative Bank, which struggled with a high volume of NPLs, putting its residual entity into a wind down mode; and (iii) the setting-up of a temporary State support scheme (ESTIA) for addressing the NPLs collateralised by primary residences, the most challenging part of NPLs. Under the first pillar — strengthening of the legal and regulatory framework — the legal amendments aim to remove some impediments to NPLs resolution. The second pillar was implemented in September 2018, when the Cyprus Cooperative Bank surrendered its banking licence. Therefore, its impact on NPLs materialized already, with a big portion of bad loans having been carved out of the banking sector. Under the last pillar, the design of the ESTIA scheme was finalised in early November 2018 and is expected to be implemented in the first part of 2019 (see Section 4.2.1). The planned reform of the judicial system aims to strengthen contract enforcement and ultimately improve the country's payment culture (see Section 4.4.3). In addition, the performance of the ESTIA scheme greatly depends on the judicial system's efficiency in enforcing foreclosure procedures to re-defaulters and non-eligible borrowers.

**Private sector deleveraging may accelerate in the light of the legal changes to the foreclosure and insolvency frameworks and due to the ESTIA scheme.** Both households and non-

financial corporations' debt ratios are on a declining path. Valuation effects and GDP growth contributed greatly to the deleveraging of both sectors in the first part of 2018 (see Section 4.2.2). The strengthened foreclosure framework could further facilitate the reduction of private debt by foreclosing on assets pledged as collateral, while the amended insolvency framework could increase debt-workouts. In addition, the ESTIA scheme, which provides very attractive terms (including debt reductions) to defaulted borrowers, may also decrease private indebtedness, provided that the foreclosure procedure is implemented effectively upon re-default to contain moral hazard. Currently, the slow progress in setting up a reliable system for transferring and issuing property rights complicates foreclosure procedures and deters the liquidation of collateral.

**Public debt is projected to fall steadily in 2019-2020, underpinned by the expected continuation of strong fiscal performance.** Based on a 'no-policy-change' assumption, Cyprus' public debt is projected to drop by an average of 7 percentage points in 2019 and 2020. This is mainly due to projected high structural primary surpluses, at an average of 3.3 % of GDP, although lower than achieved in 2016-2018. However, downside risks to fiscal sustainability are significant (see Section 4.1.1 and Annex B).

**Cyprus' net international investment position narrowed but still remains deeply negative.** The net international position improved from -121.5 % of GDP at the end of 2017 to -105.5 % in Q3 2018. The more pronounced contraction in 2018 was mainly due to the reduction of liabilities in two categories: currency and deposits, and debt instruments. Meanwhile, increasing equity and investment fund shares contributed to widening of the net international investment position. The further adjustment is expected to be limited, as the current account is forecast to remain in substantial deficit in 2018 and 2019. This is against an estimated annual surplus of 3.1 % of GDP necessary to bring the net international investment position to its estimated prudential level of -54 % over a 10-year period. The structure of external liabilities over recent years shows a shift from loans and other investments to foreign direct investment. The foreign direct investment in Cyprus, however, mostly involves the financial transactions of holding companies and ship

registrations, as opposed to green field investments. The net external debt to GDP meanwhile contracted from 144.3 % at the end of 2017 to 103.0 % in Q3 of 2018, according to the Cyprus Central Bank's data.

**Recent policy measures aimed at improving the business environment should contribute to improving competitiveness.** This was mainly in the area of administrative simplification, e-governance and entrepreneurship. Measures have also been taken to attract foreign investors and improve competitiveness by addressing issues related to internationalisation of small and medium-sized enterprises, improving workers' skills and strengthening innovation. The planned measures to reform the justice system and improve the efficiency of courts are expected to further improve the business environment in the long-term.

**Labour productivity decreased slightly in 2016-2017 but is set to improve as of 2018.** The weak performance in 2016 and 2017 is mostly cyclical, due to the high rate of job creation in labour intensive sectors such as tourism-related services and construction. The forecasted recovery as of 2018 is based on expectations for a less strong and more broad-based increase in employment. Weak total factor productivity over a prolonged period of time has also driven labour productivity down. Strong investment in productivity-enhancing areas and continued upskilling of the labour force are essential to raise productivity in the long-term (see Section 1 and 4.4).

**Labour market outcomes continue to improve rapidly with unemployment forecast to drop to 6.3 % by 2019.** Unemployment dropped from 11.1 % in 2017 to a provisionally estimated 8.2 % in 2018, supported by strong employment growth. This positive trend is expected to continue though at a slower pace. The activity rate also improved and long-term unemployment decreased substantially. As labour market indicators improve, there is no evidence yet of wage overheating, as a large part of the employment growth is skewed to low-wage sectors and labour market slack is still in place.

Action is being taken to improve the efficiency of the public employment services and promote active labour market policies (see Section 4.3.1)

### Overall assessment

**Stock imbalances remain high, mainly in terms of non-performing loans, private, public and external debt.** Despite the recent improvement, Cyprus' vulnerabilities, which are mostly because of long-lasting stock-imbalances, continue to be significant. The government, private and external debt ratios are still high. The large, albeit decreasing, level of non-performing loans (NPLs) and weak profitability highlight vulnerabilities in the banking sector. Adjustment issues in the labour market have largely been resolved, as reflected by the strong employment growth and the fall in unemployment. Remaining risks in this area are mostly linked to the low labour productivity, which remains a major weakness of the Cypriot economy.

**The composition of risks has shifted over the past year and some imbalances have been reduced while others have increased.** In terms of flows, many imbalances are decreasing, helped by the cyclical upswing. This is particularly the case for employment conditions, which have improved significantly, with unemployment rate now at an eight year low. The deleveraging in the private sector is also progressing, mostly because of strong GDP growth, non-performing loans write-offs, cash repayments and debt-to-assets swaps. Non-performing loans have been reduced significantly, as a large volume was carved out of the banking sector upon market exit of the Cyprus Cooperative Bank. However, this also led to a substantial increase in public debt in 2018, though this is expected to start decreasing again in 2019.

**Implementing effectively the policy measures in place and addressing any remaining inefficiencies are essential for further reducing the imbalances.** Some progress has been made on implementing the measures that address macroeconomic imbalances, particularly the high stock of non-performing loans (see also Sections 2, 4.1 and 4.2 and Annex A). However, reform commitments are still pending in several areas, for example the justice system reform (notably the handling of non-performing loans in the courts and the improvement of contract enforcement) and setting-up a reliable system for issuing and transferring title deeds. The running of the Insolvency Service and the information on borrowers still need to be improved. Continued

fiscal discipline is also crucial for public debt reduction.

Table 3.1: **Macroeconomic imbalance procedure assessment matrix - Cyprus**

	Gravity of the challenge	Evolution and prospects	Policy response
<i>Imbalances (unsustainable trends, vulnerabilities and associated risks)</i>			
<b>Financial Sector</b>	<p>At 45 % of the total loan stock in June 2018**, non-performing loans (NPLs) in the Cypriot banking sector remain among the highest in the EU.</p> <p>Banks are not yet able to generate profits in a sustainable manner to ensure adequate capitalisation.</p> <p>There is a large proportion of collateralised loans, a large share of which is not performing (and around half of NPLs are in terminated accounts, for which banks deem no viable restructuring solution).</p>	<p>The NPL ratio decline has been steeper in 2018 than in the last years. The sales of loans that started in 2018, together with the Cyprus Cooperative Bank sale and wind down, were the key factors behind the decline. However, both households and non-financial corporations sectors remain with very high NPL ratios (at around 50 % and 38 % respectively, in mid-2018). Capacity to build up further capital buffers is still hampered by low profitability and high NPL risks. The flow of credit to the economy is still limited. The high level of collateralised lending poses challenges regarding the perception of credit risk. However, the provisioning levels improved significantly. Provisioning requirements have been enhanced, so that provisions caught up with the euro area average in 2017.</p>	<p>A three pillar policy strategy is being implanted to reduce NPLs (legal package Cyprus Cooperative bank's sale and ESTIA)</p> <p>The revision of the rules of civil procedure and the law of civil procedures, as well as measures to improve the court administration and functioning, are expected to increase the efficiency in handling of NPL cases and improve contract enforcement and ultimately the payment culture.</p>
<b>Private debt</b>	<p>Private debt in Cyprus stood at 292 % of GDP in Q3 2018, still among the highest level in the EU.</p> <p>For non-financial corporations, debt remains high even when excluding the debt of special purpose entities. Household sector debt-overhang reflects high stocks of mortgage and consumption loans. Both households and non-financial corporations are vulnerable to shocks due to their still high debt exposures.</p> <p>A large proportion of debt stocks is non-performing mainly due to poor contract enforcement. This harms financial stability and increases vulnerability of the overall economy.</p>	<p>Deleveraging of the private sector continues at a slow pace. The household debt-to-GDP ratio declined from 119 % in 2016 to 108 % in 2017, and further to 97 % in Q3 2018, while in the case of non-financial corporations the ratio has declined from 219 % in 2016 to 209 % in 2017 and further to 195 % in Q3 2018.</p> <p>GDP growth is a key contributor to reducing the debt-to-GDP ratio (denominator effect), thus a deteriorated growth environment will slow down the decline in private indebtedness. Loans write-offs, repayments and debt-to-asset swaps contributed to lowering the debt stock of both households and non-financial corporations. New lending, albeit limited, is largely channelled towards non-financial corporations, in sectors where debt stocks and NPLs are still very high. The net credit flows to the household sector remain negative. Debt-to-asset swaps may not be a sustainable strategy in the long term as banks become vulnerable to real estate assets. The use of the insolvency tools continued to be limited, partly due to deficiencies in the Insolvency Service.</p>	<p>The revisions to insolvency and foreclosure frameworks may accelerate private debt reduction.</p> <p>Furthermore, the ESTIA scheme may also reduce private indebtedness if borrowers restart servicing their loans. Prompt use of the foreclosure tools upon redefault under the scheme may help deter strategic default.</p> <p>Progress in improving the protection of property rights and enabling liquidation of collaterals is limited. A comprehensive reform of the current system of transferring and issuing property rights is still lacking.</p>
<b>Public debt</b>	<p>The Government debt-to-GDP ratio was very high at 109.2 % at the end of October 2018, exposing the country to changes in financial or economic conditions.</p>	<p>After declining significantly in 2017, the debt-to-GDP ratio has increased again in 2018 (due to one-off transactions with the Cyprus Cooperative Bank). It is projected to continue strongly declining again starting from 2019.</p> <p>After 6 years, in autumn 2018, Cyprus' government bond rating returned to investment grade (by three of the four major rating agencies).</p>	<p>The policy measures to reduce NPLs have a temporary negative impact on public debt, notably in 2018. Explicit contingent liabilities have also increased significantly (stemming from government counter-guarantees to the Cyprus Cooperative Bank buyer, Hellenic Bank, in the form of the asset protection schemes). However, they have reduced risks from the banking sector, boosted investor confidence and helped to upgrade the sovereign rating of Cyprus to investment grade, in turn reducing the cost of refinancing for the government.</p>

(Continued on the next page)

Table (continued)

<b>External position</b>	Cyprus net international investment position remained still very high, at -105.5 % of GDP in Q32018, exposing it to adverse shocks or shifts in market sentiment. The net external debt to GDP remained also large, at 103.0 % in Q3 of 2018. Current account deficit was very large, at 8.4 % of GDP in 2017 and 7.5 % of GDP in Q3 2018 (based on 4 quarter rolling sum). Considerable share of these external liabilities was incurred by the special purpose entities, thus external risks could be less pronounced than what headline figures suggest. The real effective exchange rate depreciated by 5.9 % over three years, beyond the macroeconomic imbalance procedure threshold of -5 %, reflecting subdued domestic inflation.	The net international investment position and the net external debt to GDP have substantially contracted over the three quarters of 2018, also helped by high nominal growth.  Domestic savings are low due to negative savings of households. This is driving a wedge between savings and investment, in favour of foreign investment.  Amid strong economic rebound, current account deficit widened sharply in recent years. Strong domestic demand that drives imports up and intensifying competition in tourism exports are factors that are set to lead to persistently large current account deficits in the near future.  Inflation has turned positive since 2017 and is reverting the trend for depreciation in the real effective exchange rate.	Exports of tourism services have been stimulated by structural reforms aimed at further extending the season and improving tourism quality. Less has been done in other areas.  With cost competitiveness fading away, stronger productivity gains and contained wage inflation become of key importance.
<i>Adjustment issues</i>			
<b>Potential growth</b>	Potential growth remains low, estimated at around 2% in 2017-2021, while inflation is also low.	Potential growth in the past was constrained by low investment and stagnant productivity growth. Investment has increased over the last two years but due to its nature, no major impact on potential growth is expected. Productivity growth remains stagnant.	An action plan for growth is gradually being implemented aiming to improve the business environment and help develop key sectors of the economy. Though, progress in implementation of key elements is lacking.  Progress in implementing privatisation projects to attract investment, increase competition and reduce prices in network industries is slow.
<b>Unemployment</b>	Unemployment was still high in 2017, at 11.1%. The 3-year average was 13.0%, above the macroeconomic imbalance procedure threshold. Youth and long-term unemployment were also high but no longer exceeding the threshold.  The activity rate, which has fallen by 0.4 percentage points over 3 year period, has breached the macroeconomic imbalance procedure threshold.	Unemployment continued to markedly fall in 2018 (8.4 % in 2018Q3). This trend is expected to continue in the coming years supported by strong growth. Youth unemployment keeps falling (18.7 % in 2018Q3) and long-term unemployment is now below the EU average. Activity rate also improved.  The level of young people not in employment, education or training is still high. While participation in vocational and education training remains low.	The capacity of the public employment services was strengthened, however in term of effectiveness, more efforts are needed. The impact of the active labour market policies is still to be evaluated.  An action plan to outreach young people not in employment, education or training is still at initial stage.  Measures are being taken to enhance vocational education and training and the quality of higher education, but the implementation is slow.
<b>Conclusions from IDR analysis</b>			
<ul style="list-style-type: none"> <li>• Cyprus is characterised by large stock imbalances, in the form of the high external and internal debt, both private and public, in combination with very high level of NPLs in the banking system. This exposes a country to adverse shocks and shifts in market sentiment, which would have harmful implications for the real economy.</li> <li>• Some stock imbalances – notably the very large stock of household and corporate debt, NPLs and net international investment position - are declining, but fairly slowly, on the back of strong economic growth and in the case of NPLs facilitated by policy measures. Current account deficit has widened and is expected to remain large driven by solid domestic demand, not helping to reduce imbalances. Unemployment keeps falling and is expected to continue contracting amid strong economic growth.</li> <li>• An NPL reduction strategy was prepared and started to be implemented in 2018. Some effects materialised already in 2018, as a large volume of NPLs was carved out of the banking sector upon Cyprus Cooperative Bank's market exit. However, the strategy's overall impact is to be seen over time. Furthermore, extra efforts are needed in order to improve the following: (i) available information on borrowers, (ii) the efficiency of the Insolvency Service, (iii) the handling of NPLs in Courts and contract enforcement, and (vi) the system of issuing and transfer of title deeds. Ensuring fiscal discipline is also crucial for public debt reduction. Measures are still needed to foster efficiency and competition in network industries and to further improve labour market conditions.</li> </ul>			

\* The first column summarises "gravity" issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the "evolution and prospects" of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment issue. The final three paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.

\*\* Per European Central Bank data; it includes only exposures to non-financial corporations and households.

**Source:** European Commission

## 4. REFORM PRIORITIES

### 4.1. PUBLIC FINANCES AND TAXATION

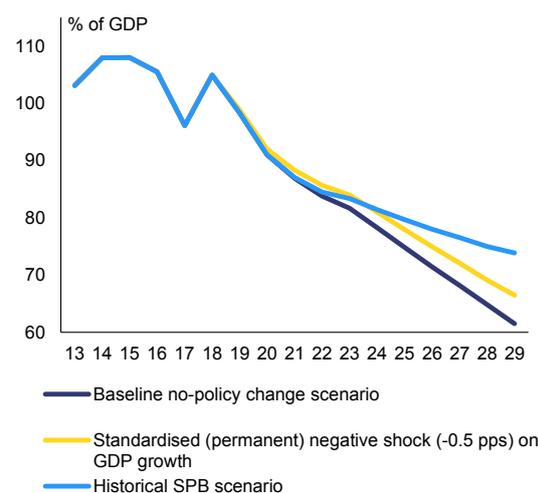
#### 4.1.1. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS\* (18)

**The short-term fiscal sustainability is a cause for concern due to potential spill-overs from macroeconomic, financial and competitiveness imbalances, recently exacerbated by increased government debt.** The indicator-based analysis (19) signals risks of fiscal stress in the short term (within 1 year), based on the most recent data and the Commission's autumn 2018 forecast (see Annex B). As in the past, the high value of the indicator is driven by short-term risks on the financial-competitiveness side, this time in the context of a sharp increase in government debt in 2018 due to one-off banking support measures. In particular, the financial-competitiveness sub-index points to short-term vulnerabilities notably due to the negative net savings of households, the large negative net international investment position and the high private sector debt, a significant fraction of which is short-term. However, the S0 indicator value for Cyprus has just reached its critical threshold, as some other fiscal variables are positively oriented in the country. This is particularly the case for the large primary surplus, which should enable a significant reduction of government debt in 2019.

**However, financial markets' perceptions of Cyprus' sovereign risk have improved recently.** The short-term risks to fiscal sustainability are somewhat mitigated by the recent upgrade of the rating of Cyprus bonds to 'investment grade' by three major rating agencies and a significant increase in the cash buffer (covering all financing needs until the third quarter of 2019). Despite fluctuations in the sovereign yield spread in 2018 mainly due to the sale of the Cyprus Cooperative Bank and external events, 10-year sovereign yield

spread in relation to the German 10-year 'bund' was contained recently, at 2.0 % in January 2019.

Graph 4.1.1: Government debt projections



Source: European Commission (Fiscal Sustainability Report 2018)

**Given its initial high government debt stock, Cyprus faces medium fiscal sustainability risks in the medium term.** Debt sustainability analysis shows that, under normal economic conditions with no fiscal policy change (baseline scenario), the general government debt-to-GDP ratio would fall to around 62 % by 2029, still slightly above the critical 60 % threshold (see Graph 4.1.1). The projected significant decrease of 29.5 percentage points between 2020 and 2029 would be driven by the continued strong fiscal performance assumed under the no fiscal policy change scenario (with a structural primary balance unchanged at 2.9 % of GDP (20)) and be supported by favourable snowball effects (interest rate-growth rate differential) and decreasing ageing costs over most of the next decade. The medium risk assessment is confirmed by alternative and stress test scenarios, including stochastic projections (21). The S1 sustainability indicator, which measures sustainability risks until

(18) An asterisk indicates that the analysis in the section contributes to the in-depth review under the macroeconomic imbalances procedure (see Section 3 for a summary of main findings).

(19) Short-term fiscal stress is measured by the S0 indicator, an early-detection indicator designed on the basis of past crises to highlight short-term fiscal risks stemming from the financial-competitiveness or the fiscal side of the economy (European Commission, 2019a).

(20) This implies a relatively high structural primary balance by European standards. Over 1980-2018, in only 17% of the cases, EU countries were able to reach a structural primary balance value greater than 2.9% of GDP.

(21) Stochastic projections account for uncertainty surrounding the baseline projections in a more detailed manner than deterministic projections.

2033, indicates a low medium-term risk (European Commission, 2019a).

**Cyprus' long-term fiscal sustainability risk is also assessed as medium.** The analysis of the sustainability gap indicator S2 points to limited risk (see Annex B). With a value of -0.9 percentage points of GDP, it indicates that under the baseline scenario the debt-to-GDP ratio would stabilise over the long term given an assumed continuation of the structural primary surplus. This result is due to the favourable initial budgetary position, which more than offsets the projected rise in ageing costs in the long run, mainly driven by pension expenditure<sup>(22)</sup>. The debt sustainability analysis discussed above, points to medium risk in the long term, due to vulnerabilities linked to the high debt burden.

**Contingent risks remain in the banking sector, notably in the short term, mainly due to a high ratio of non-performing loans.** According to the Commission's systemic model of banking originated losses (SYMBOL), Cyprus is the Member State most exposed to short-term fiscal risks in a severe stress scenario of a repeat of the recent financial crisis. On the basis of the current level of non-performing loans and conservative loss assumptions, a recapitalisation of Cyprus' banks by public funds to 10.5 % of their risk-weighted assets could increase sovereign debt by 3.1 % to 17.5 % of GDP depending on the scenario<sup>(23)</sup> in the short term (2019 Q1). Contingent risks are considered more significant in the short term, since safety nets in the form of increasing capital requirements, bail-in and national and supranational resolution funds are still being put in place. However, the country's exposure to implicit contingent liability risks from the banking sector is expected to decrease to below 0.5 % of GDP by 2029, given that the safety nets

<sup>(22)</sup> According to the 2018 Ageing Report, public pension expenditure would rise from 10.2% of GDP in 2016 to 12.4% in 2070. Total age-related spending is projected to increase by 1 percentage points of GDP over the same period.

<sup>(23)</sup> The lowest exposure results from the reference scenario, whereby only the subset of banks considered to be systemic will go into resolution and be recapitalised. As a novelty compared to the Country Report Cyprus 2018, two additional alternative scenarios considering all banks go into resolution are performed. Under the worst-case scenario, all banks are assumed to go into resolution and be recapitalised and recovery rates for non-performing loans are set at 20% of World Bank reported levels.

will have been fully phased in and assuming that the effect of non-performing loans will become negligible in the long term<sup>(24)</sup> (European Commission, 2019a).

**The nature of contingent risks from the banking sector changed after the sale of the publicly-owned Cyprus Cooperative Bank.** On the one hand, the sale and wind-down of the Cyprus Cooperative Bank — the second largest bank in the country and burdened by a high portfolio of non-performing loans — reduced the implicit contingent liabilities in relation to the banking sector. On the other hand, to facilitate the sale of the bank, the State adopted public support measures at a high cost to public finances (see Section 1 and Section 4.1.2). Amongst others, the State's exposure to explicit contingent liabilities, in the form of government guarantees, increased. This was mainly due to the creation of asset protection schemes agreed as part of the sale of the Cyprus Cooperative Bank.

**The sovereign wealth fund could improve the long-term sustainability of public finances, but the legislative proposal is still pending adoption by the House of Representatives.** The draft sovereign wealth fund law sets out the conditions for collecting, managing and using future resources from hydrocarbon exploitation and stipulates that the government will be able to use part of the revenue to reduce government debt. The House of Representatives is still discussing some proposed amendments to the bill. Adoption of the legislation would contribute to ensuring the sustainable use of revenue from the exploitation of hydrocarbon reserves and in turn to improving the outlook for public debt sustainability.

#### 4.1.2. FISCAL FRAMEWORK AND POLICY CHALLENGES\*

##### Fiscal framework

**A rigorous implementation of the budgetary framework is essential to contain risks of fiscal relaxation.** Currently, the focus is on implementing the secondary legislation of the

<sup>(24)</sup> The SYMBOL long-term scenario does not attempt to include the effects of the November 2016 banking package, which is still under negotiation (final stages of trilogues).

Fiscal Responsibility and Budget System Law rigorously, in particular not exceeding the expenditure ceilings set in the medium-term budget framework. Furthermore, in March 2018, the government approved a decision accompanying the Fiscal Responsibility and Budgetary Framework Law to fully transpose the Budgetary Frameworks Directive (EU 2011/85). The adopted changes clarified the responsibilities for assessing the macroeconomic and budgetary forecasts so as to improve the transparency of public finances. In particular, in its semi-annual reports the Fiscal Council is requested to compare the official macro-fiscal projections with the Commission's most recent forecasts, while the Ministry of Finance is responsible for explaining any significant differences between these projections. The Fiscal Council's mandate on the ex-post evaluation of the accuracy of the government's macro-fiscal forecasts is set to cover at least four consecutive years.

### Policy challenges

**Public expenditure has accelerated since 2017.** At 37.5 % of GDP in 2017, total public spending in Cyprus is below the EU average of 46.6 %. However, public primary expenditure (i.e. excluding interest) growth in Cyprus was higher than the nominal potential growth in 2017 (at around 4.9 % vs 3.3 %). This growth rate in public spending was due to both increased current expenditure and public investment. While the pace of public expenditure has accelerated recently, it has been outpaced by buoyant tax revenue growth underpinned by strong underlying economic growth. A prudent fiscal policy would avoid risks associated with using the additional temporary revenue generated by tax buoyancy effects to finance increases in long-term expenditure.

**With the positive macroeconomic outlook, deficit-increasing measures have been adopted recently.** Public employees' salaries are projected to gradually increase further in 2018-2023 thanks to the government's measure to reverse wage cuts implemented since the crisis. This measure is expected to increase the overall public wage bill, but to remain below nominal GDP growth, as set by the collective agreement on public wage indexation between the government and the unions. The collective agreement, which was set to expire at the end of 2018, will continue to be in

effect in the absence of any amendments. Furthermore, a recent Court decision deeming the pensions cuts in the public sector implemented since the crisis to be unconstitutional is likely to have an additional fiscal impact.<sup>(25)</sup> The government's support measure for low-income pensioners as part of a social dividend payout and a voluntary retirement scheme for employees of the Cyprus Tourism Organisation as of January 2019<sup>(26)</sup> are also expected to increase public expenditure. Capital transfers are expected to rise as a result of the introduction of the ESTIA scheme, which involves State support for loan repayment of eligible borrowers with non-performing loans backed by primary residences (see Section 4.2.1).

### Despite the measures adopted, pressure to further increase public spending is mounting.

The ongoing discussions between the government and the unions to create a provident fund for public sector employees recruited after October 2011 and on contracts of indefinite duration might create additional incremental fiscal costs. Furthermore, the agreement in principle between the government and other political parties on introducing a State support scheme for borrowers who have their primary residence as collateral and are servicing their loans, with criteria similar to the ESTIA scheme, would also weigh negatively on the budget balance.

**The potential fiscal impact of the healthcare reform remains uncertain, in particular the public hospitals reform might create additional budgetary pressures.** The national health insurance system has been designed to have a balanced budget in the long term, thanks to the legislated contributions to the system and the expected improved efficiency of public healthcare providers.<sup>(27)</sup> However, as mentioned in Section

<sup>(25)</sup> The decision implies that the pension cuts will have to be fully reinstated in 2019, instead of gradually reversed over several years as envisaged in the government's measure mentioned above. The fiscal impact is estimated at around 0.1% of GDP in 2019.

<sup>(26)</sup> In January 2019, the Cyprus Tourism Organisation became the Deputy Ministry of Tourism.

<sup>(27)</sup> The national health insurance system will be mainly financed by contributions to the system and co-payments on certain services. Contributions will be collected as of March 2019 for the first phase of the system (outpatient care) at the following rates: 1.70 % for employees and pensioners, 1.85 % for employers, 1.65 % for the State and 2.55 % for the self-employed. As of March 2020

4.3.2, the law on the new Organisation of public hospitals stipulates that the State will subsidise any potential deficit of public healthcare providers in the first 5 years of the operation of the system (as of June 2019). In the meantime, public healthcare providers are expected to gradually adjust their labour and cost structure to raise their productivity, improve the quality of services and maintain a certain amount of demand for public healthcare service. The governance capacity of public hospitals needs to be carefully monitored to ensure the future sustainability of the system.

**Some uncertainty remains on the overall fiscal impact of the banking support measures related to the sale of the Cyprus Cooperative Bank.** The impact of these measures on the general government balance in 2018 will be reported in the April 2019 Excessive Deficit Procedure notification and subject to further verification by Eurostat. The general government accounts for the third quarter of 2018 were recently published, including the fiscal impact of these measures, in agreement with Eurostat.<sup>(28)</sup> The potential realisation of explicit contingent liabilities regarding the measures related to the sale of the Cyprus Cooperative Bank is a risk to the fiscal outlook.

**The State's exposure to explicit contingent liabilities has increased, mainly due to the measures related to the sale of the Cyprus Cooperative Bank.** Unlike implicit contingent liabilities<sup>(29)</sup> (see Section 4.1.1), explicit contingent liabilities are government obligations as recognised by a law or a contract. According to Eurostat, government guarantees in 2017 amounted to around 8.7 % of GDP (EUR 1.7

billion). Most of these liabilities concerned State-owned enterprises, including the sewerage boards<sup>(30)</sup>, private corporations, local authorities and retail exposures. Cyprus' government guarantees further increased in 2018 due to the government's contingent obligations in relation to financial institutions, particularly the establishment of asset protection schemes related to the sale of the Cyprus Cooperative Bank (see Box 4.2.1). According to the authorities (Ministry of Finance of Cyprus, 2018, p. 36), government guarantees are projected to increase to 22.5 % of GDP in 2018, of which 13.4 % are related to the financial sector.

**An improved corporate governance of State-owned enterprises and further progress on privatisation projects would reduce the State's exposure to contingent liabilities from public companies.** The draft law on the governance of State-owned enterprises is at standstill since its submission to the House of Representatives in 2015. This law would improve the corporate governance of State-owned enterprises and ensure that they are monitored more effectively. Progress on individual privatisation projects has been limited (see Section 4.4.3). Further progress on the privatisation projects could reduce the State's exposure to contingent liabilities from public companies (including implicit ones, which are difficult to quantify) and attract further foreign investment in Cyprus.

#### 4.1.3. TAXATION\*

**Tax revenues increased significantly in 2017, although uncertainties remain about whether the increase can be sustained.** In terms of GDP, indirect tax revenue in Cyprus was well above the EU average in 2017 (15.9 % vs 13.5 %), while revenue from direct taxes and social contributions (9.4 % and 8.7 %, respectively) continue to remain below the EU average (13.4 % and 12.2 %, respectively). Total tax revenues stood at 34 % of GDP in 2017, below the EU average of 39 %. In nominal terms, tax revenues increased by 9.3 % in 2017 compared to the year before. This was the

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contributions will be adjusted upward for the full implementation of the system (outpatient and inpatient care) to the following rates: 2.65 %, 2.90 %, 4.70 % and 4.00 %, respectively.

<sup>(28)</sup> On 21 January 2019, the Statistical Service of Cyprus published a press release with the revised figures for the general government quarterly accounts for the third quarter of 2018. It announced that the two new entities which resulted from the sale process of parts of the assets and liabilities of the Cyprus Cooperative Bank have been classified within the general government sector. The fiscal impact of the banking support measures related to the sale of the Cyprus Cooperative Bank in the revised fiscal accounts for the third quarter of 2018 is estimated at EUR 1.5 billion.

<sup>(29)</sup> Implicit contingent liabilities represent moral obligations of governments, although not legally binding, reflecting public and interest group pressures.

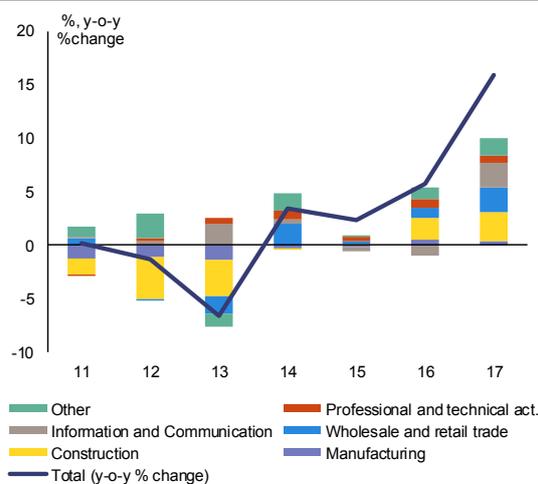
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<sup>(30)</sup> The Excessive Deficit Procedure notification of October 2018 refers to the capital transfers to sewerage boards for an approximate amount of EUR 15 million both in 2015 and 2017.

result of sizeable increases in all tax revenue categories and in particular thanks to an increase in value-added tax revenues (by 11.3 %) and a strong increase in corporate tax revenues (by 6.1 %). However, it is unclear whether the strong tax revenue performance from value-added tax and corporate income tax can be sustained.

**Corporate tax revenue may pose sustainability risks, since it is prone to volatility.** In particular, this volatility might stem from possible relocation decisions by (large) companies benefiting from Cyprus' tax jurisdiction, for instance if changes in the international corporate tax framework would cut out incentives for aggressive tax planning. To safeguard fiscal sustainability, it is important that temporary or volatile revenues are not used to fund additional current spending.

Graph 4.1.2: Value-added tax revenue growth and its main sector contributors



(1) The sectors presented in the graph do not include all economic categories. Therefore, value-added tax revenue from these sectors does not add up to the value-added tax total (gross) revenue.

Source: Ministry of Finance

**The recent significant increase of value-added tax revenues might weaken in the future, as it is largely due to the current positive economic cycle and the strong construction activity.** While most sectors increased their contributions to value-added tax revenues in 2017, a few sectors stood out (see Graph 4.1.2). Half of the total value-added tax revenues in 2017 stem from the following four sectors: (i) wholesale and retail trade; (ii) construction; (iii) professional activities; and (iv) information and communication. The construction

sector significantly increased its value-added tax collection for the second consecutive year, as a result of the strong construction activity. Tax revenue might not continue to increase at the same rate in the future due to changes in the economic cycle and a projected slowdown in construction activity.

**Cyprus' tax structure remains more growth- and environment-friendly than that of the EU on average.** As mentioned in the 2018 Country Report for Cyprus (European Commission, 2018a, Section 4.1.3), the tax burden on labour is low, while consumption and environmental tax revenues are high, in line with euro area recommendation 3. In the medium term, the tax burden on labour is expected to remain below the EU average, despite the legislated rises in social contributions in relation to the pension system in 2019 (European Commission, 2017a) and the introduction of compulsory health insurance contributions to finance the recently adopted national health insurance system in 2019 and 2020 (see Section 4.1.2). Consumption and environmental tax revenues in terms of GDP are also expected to remain above the EU averages<sup>(31)</sup>, in spite of some policy measures envisaged on environment-related taxation. Moreover, as in other EU countries, Cyprus' corporate tax system favours debt over equity financing (i.e. is subject to the 'debt bias'). This debt bias may lead to excessive leverage and make companies more vulnerable to economic shocks. However, such bias is lower in Cyprus compared to the EU average<sup>(32)</sup>. Although the effective corporate income tax rate is below the EU average (13 % vs 20 % in 2017), the tax on capital revenue in Cyprus is similar to the EU average (8.6 % of GDP in 2016) mainly due to relatively high corporate income tax revenue<sup>(33)</sup>.

<sup>(31)</sup> The environmental tax revenues in terms of GDP data needs to be interpreted with caution. E.g. an increase in tax revenue may arise when the underlying tax base increases, but the corresponding tax rates remain constant.

<sup>(32)</sup> Following the introduction of notional interest deduction on equity, in 2015, Cyprus' cost of capital at corporate level stood at 6.3 % for new equity (below the EU average) and 4.9 % for debt (above the EU average). The difference between the cost of capital between equity financed (new equity) and debt-financed investments amounted to 1.4 % in Cyprus (0.7 percentage points below the EU average).

<sup>(33)</sup> All other capital tax revenue components, i.e. capital tax revenue from income of households, self-employed and capital stock are significantly lower in Cyprus compared to

**There is further scope for redesigning in a socially fair manner the structure of environmental taxation to improve climate and environmental policy in Cyprus.** This is particularly true in view of the challenges Cyprus is likely to face in meeting its greenhouse gas emissions targets in 2020 and 2030 (see Section 4.4.1). The recently approved measure to reduce the excise duties on fuel as of mid-December 2018 as part of a social dividend pay-out will make meeting the greenhouse gas emissions targets even more difficult. Yet, its impact is estimated by the authorities to be relatively limited (at 0.2 % of GDP). Alternative tax measures could further improve cost-efficiency of climate and environmental policy in Cyprus. To that end, the government plans a revision of the vehicle taxation through changes to road tax and abolition of vehicle excise duties, which are based on CO2 emissions (Ministry of Finance of Cyprus, 2018, pp. 10-11). While the overall fiscal impact of the reform is expected to be very limited, with potential revenue losses of 0.03 % of GDP, it is aimed at promoting the introduction of environmentally-friendly (i.e. low-emission) vehicles. Removing environmentally harmful tax expenditures such as the exemption of excise duties on fossil fuels for power generation could also facilitate meeting the relevant targets, notably for primary energy consumption.

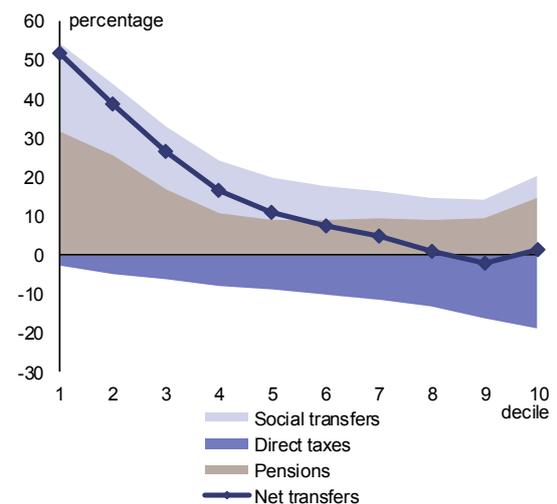
**The redistributive power of the Cypriot tax and benefit system has more than offset the post-crisis rise in income inequality in 2015-2016.** In 2004-2012, Cyprus' income inequality after taxes and benefits was at around the EU average level, even though the redistributive power of the tax and benefit system was among the lowest in the EU.<sup>(34)</sup> Since the 2012-2013 crisis, income inequality has increased somewhat in Cyprus. In 2015-2016, income inequality after taxes and benefits decreased significantly thanks to the higher impact of taxes and the improved government redistribution policy with respect to social benefits. The latter could be related to the

the EU average. Tax on property revenue is very low and well below the EU average (1.1 % of GDP vs 2.6 % in 2017).

<sup>(34)</sup> In 2004-2012, Cyprus' income inequality before taxes and benefits (i.e. market income) was among the lowest in the EU, as measured by Gini coefficient.

introduction of guaranteed minimum income <sup>(35)</sup> (see Section 4.3.2).

Graph 4.1.3: **Main receivers from and contributors to government redistribution by decile (average 2005-2016)**



**Source:** European Commission Joint Research Centre, based on EU-SILC data

**The large progressivity of taxes and the current social pension scheme have helped to reduce income inequality in Cyprus.** Public pensions contribute to reducing income inequality in Cyprus thanks to its social pension scheme.<sup>(36)</sup> However, public pensions in general are not primarily aimed at income redistribution, but to lifetime social contributions. Aside from public pensions, both social transfers and taxes play a significant role in reducing income inequality in Cyprus. In 2016, the tax effect on income inequality stood at 8 % (above the EU average of 7.4 %) and the benefit effect stood at 12.1 % (below the EU average of 15 %) as measured by Gini. The relatively high tax effect is due to the progressivity of taxes, in particular for the personal income tax (European Commission, 2018a, Section 4.1.3). As shown in Graph 4.1.3, the tax and benefit system in Cyprus supports income redistribution to the low-income households, as net transfers <sup>(37)</sup> are positive for low- and middle-income (i.e. they are net

<sup>(35)</sup> According to the latest data available (2016), the government distribution effect on income inequality as measured by Gini coefficient increased by around 44 % as compared to 2014.

<sup>(36)</sup> The social pension scheme provides social benefits for residents with no or low old age pension income.

<sup>(37)</sup> Net transfers are the sum of social transfers net of direct taxes per disposable income of a given income decile.

receivers) and close to zero for high-income households.

**The high levels of inward and outward foreign direct investment, in addition to the high levels of dividend and interest payments as a percentage of GDP,<sup>(38)</sup> may indicate that Cyprus' tax rules are used by companies and individuals that engage in aggressive tax planning.** Possible risk areas involving aggressive tax planning include the absence of withholding taxes,<sup>(39)</sup> the design of the Cyprus tax residence rules and the residence and citizenship by investment schemes. Due to the absence of withholding taxes, the outbound payment of dividends, interest, and royalties from Cyprus-based companies to non-EU jurisdictions may lead to double non-taxation if these payments are not taxed in the recipient jurisdiction. Another risk is that the proceeds of contributions to foreign companies are recognised as capital, despite no shares being issued in return (a practice known as 'non-returnable capital contributions'). In 2018, Cyprus tightened the conditions to recognise non-returnable capital contributions, but the effects of this on aggressive tax planning remain to be seen<sup>(40)</sup>. Furthermore, the Cyprus tax residence rules are based on the management and control test, so that a company may be incorporated in Cyprus but not be tax-resident there. This has the potential to create a mismatch that could also be exploited for tax planning purposes. Aggressive tax planning can also occur in combination with the avoidance of social security contributions and the facilitation of undeclared work through artificial intermediaries in Cyprus (European Platform Undeclared Work, 2017). Also, in 2015 Cyprus introduced a Notional Interest Deduction scheme, which needs to be closely monitored to ensure that it is not misused for aggressive tax planning and harmful tax competition. Finally, the 'Citizenship' and 'Residence by investment' schemes operated by Cyprus (Citizenship by Investment: Scheme for Naturalisation of Investors in Cyprus by Exception and Residence by Investment Scheme, also known as 'golden visas') give access to a low personal tax rate on income from foreign financial assets and do not require an

individual to spend a significant amount of time in the jurisdiction offering the scheme. Although individuals are subject to tax on a worldwide basis, non-domiciled taxpayers are exempt from tax on dividends and interest. These measures can create the potential for misuse when used as tools to hide assets held abroad from reporting and have been listed by the OECD as having a potentially high risk for being misused to circumvent the automatic exchange of financial account information by facilitating the concealment of the real jurisdictions of residence, effectively avoiding taxation.

**Cyprus is acting to curb aggressive tax planning through the implementation of European and internationally agreed initiatives.** In line with the rest of the EU, Cyprus has to transpose into national law the two EU Directives on Anti-Tax Avoidance. Member States are expected to complete this transposition by the end of 2018 and 2019.<sup>(41)</sup> The Notional Interest Deduction scheme is currently under examination by the Code of Conduct on Business Taxation of the Council. Furthermore, Cyprus has signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, and expects to complete its ratification by the second half of 2019. Cyprus has chosen to apply it to the vast majority of its treaty partners, but has put numerous reservations, not forming part of the minimum standard. The latter significantly limits the effectiveness of implementation of the multilateral convention in Cyprus. A circular issued by the Cyprus Tax Authority amending the rules on the tax treatment of financing companies from 1 July 2017 provides additional guidance on substance and transfer pricing requirements in line with OECD guidelines. The Cyprus Tax Authority is also reviewing the wider transfer pricing legal framework with a view to updating it in mid-2019. The effectiveness of these new measures in limiting the scope for aggressive tax planning and their impact on the corporate income tax revenue in the medium term deserves to be assessed.

<sup>(38)</sup> See European Commission, 2018a, pp. 27-28.

<sup>(39)</sup> There is a withholding tax on royalties if the intellectual property rights are used locally. See ZEW, 2016.

<sup>(40)</sup> Interpretative Circular EE 25- Income Tax of 3 September 2018.

<sup>(41)</sup> These entail rules for interest limitation, controlled foreign companies, and general anti-tax avoidance (to take effect as from 2019); exit taxation (from 2020); and hybrid mismatch (from 2020-2022). See European Commission, 2016a and 2017b.

## 4.2. FINANCIAL SECTOR\*

### 4.2.1. BANKING SECTOR DEVELOPMENTS \*

**One of the key developments in the Cypriot banking sector in 2018 was the market exit of the Cyprus Cooperative Bank.** After struggling with reducing a significant non-performing loans (NPL) portfolio and very weak governance, the second largest bank in the country was ultimately sold to Hellenic Bank. It took over almost the entire performing loan portfolio, all government bonds and all customer deposits. The Cyprus Cooperative Bank surrendered its banking licence on 3 September 2018 and left behind an asset-management company — which took over the bank's NPL portfolio (EUR 5.7 billion). The Cyprus Cooperative Bank sale and wind-down resulted in a consolidation of the banking sector. It reduced uncertainty in the market, helped stop deposit outflows, and reduced the stock of NPLs in the banking sector (by shifting it to the publicly owned asset management company). More details on the bank sale and its timeline, its asset-management company legacy and the impact on the public finances are presented in Box 4.2.1.

**Following the acquisition of the Cyprus Cooperative Bank, Hellenic Bank is expected to improve its performance.** Hellenic Bank became the second largest bank in Cyprus after the transaction. As a result of the better portfolio mix, the bank expects its NPL ratio to decline significantly and its NPL coverage ratio to increase. The bank's profitability is also expected to increase significantly, driven by the high interest income from the government bonds. However, integrating a bank that is approximately twice as large in terms of gross loans and deposits, also poses challenges. The integration involves major organisational and managerial challenges and restructuring costs. In addition, in January 2019, Hellenic Bank announced the share capital increase through (i) rights issue of up to EUR 100 million and (ii) a private placement of EUR 50 million and the listing on the Cyprus Stock Exchange of the rights issued.

**The banking sector returned to profitability in the first half of 2018, but poor asset quality and low interest margins continue to push banks' performance down.** The sector's aggregate pre-tax profit was EUR 196 million as of September 2018, up from a net loss of EUR 535 million a year ago, but the high stock of NPLs still weighs heavily on bank profitability and the overall stability of the banking sector, even after the disposals of bad assets. Net interest margins continue to decline, while the operating cost-to-income ratio almost doubled in the first half of 2018, partly due to the servicing arrangements with specialised NPL management companies that several banks have entered into to accelerate their NPL reduction. Provisioning costs (excluding adjustments related to the International Financial Reporting Standards 9 (IFRS 9-related)) declined in the first half of 2018, bringing the banking sector back into profitability, with a return-to-equity of 8.6 % as of September 2018.

**Capital levels have declined slightly,** driven largely by the IFRS 9 related adjustments. <sup>(42)</sup> In particular, despite transitional IFRS 9 application, the Common Equity Tier 1 ratio dropped to 14.1 % in September 2018, down from 15.0 % a year ago. Although the capital ratios are higher than the EU averages, Cypriot banks have to maintain higher capital ratios than the minimum levels, as required by their supervisors, to absorb potential shocks associated with a weak asset quality.

**Risk provisioning continued to improve.** Following supervisory actions in 2017 and the entry into force of the IFRS 9 standards in January 2018, provisioning coverage ratios increased from 46.7 % of gross non-performing loans in June 2017 to 52.3 % in September 2018, staying above the EU average of 45.7 %.

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<sup>(42)</sup> All major Cypriot banks have elected to apply the IFRS 9 transitional arrangements for regulatory capital purposes in line with Commission Regulation (EU) 2016/2067, resulting in increases of 5 % in 2018, 15 % in 2019, 30 % in 2020, 50 % in 2021, 75 % in 2022 and full recognition thereon.

**Box 4.2.1: The Cyprus Cooperative Bank exit from the banking sector**

**The sale of the State-owned Cyprus Cooperative Bank to Hellenic Bank allowed the bank to make an orderly market exit.** The Cypriot authorities initiated a restructuring process of the Cyprus Cooperative Bank in February 2014. Over the following years the bank struggled with large volumes of non-performing exposures (i.e. a non-performing loan (NPL) ratio close to 60 % in the beginning of 2018) and ultimately it was not able to return to viability. In early 2018, the bank faced sizeable deposit outflows linked to souring public opinion and doubts over a successful restructuring. To ease these pressures, on 19 March 2018 the Cypriot authorities initiated the bank's sale by launching a formal bidding process for a full or partial sale of the bank. To strengthen its balance sheet and thus support the sale, on 3 April 2018 the government made a deposit injection of around EUR 2.5 billion, funded by newly issued government bonds (EUR 2.35 billion) and a small cash addition from the cash buffers (EUR 0.15 billion). The bidding process ended in June with Hellenic Bank emerging as the winning bidder. The European Commission, under the State Aid rules, endorsed the sale agreement on 19 June, approving the public support measures to facilitate the orderly liquidation of the Cyprus Cooperative Bank under the national law. A business transfer agreement between Hellenic Bank and the Cyprus Cooperative Bank was signed on 25 June. As part of the deal, the Cypriot government increased its deposit injection in Cyprus Cooperative Bank from EUR 2.5 billion to EUR 3.5 billion in July 2018. To fund this cash infusion, the government issued a new round of bonds worth EUR 3.2 billion (the proceeds of which redeemed the bonds of 3 April 2018), and provided an additional cash amount of EUR 0.3 billion. The new bonds were placed on the asset side of the balance sheet to match the deposit. In addition to the deposit injection, the Cypriot Republic counter-guaranteed the asset protection schemes provided by the Cyprus Cooperative Bank to Hellenic Bank as part of the sale<sup>(1)</sup>. The closing of the sale transaction took place on 3 September 2018, when the bank surrendered its banking licence. Under the terms of the deal, Hellenic Bank took over the sound part of the Cyprus Cooperative Bank<sup>(2)</sup>.

**Cyprus Asset Management Company is Cyprus Cooperative Bank's legacy.** The bank's residual entity is a State-owned asset management company which has under its perimeter the bulk of Cyprus Cooperative Bank's NPLs (EUR 5.7 billion) together with the State deposit<sup>(3)</sup>. According to the Commission's State Aid decision, the Cyprus Asset Management Company's sole activity is to manage its assets such that it maximises recovery and repays the State. Its organisation and its governance still need to be defined<sup>(4)</sup>. Furthermore, it is not clear whether Altamira, which was Cyprus Cooperative Bank's debt servicer since 2017, will continue to service the asset management company.

**The state support measures for the Cyprus Cooperative Bank sale and wind-down were costly for the public purse.** The aid measures undertaken by the Cypriot authorities increased the country's public debt (projected at 105 % of GDP for the end of 2018) and increased the government's exposure to explicit contingent liabilities (namely asset protection schemes). The support measures are also expected to weigh on the budget balance in 2018, depending on the statistical treatment by Cystat and Eurostat, which is still to be determined.

<sup>(1)</sup> The assets under the asset protection schemes amount to approximately EUR 2.8 billion gross book value. In particular, in gross book value terms, they cover around EUR 2.1 billion of the performing loans transferred to Hellenic Bank and the entire NPL portfolio worth approximately EUR 0.7 billion. Under the set-up of the asset protection schemes, the Cypriot government would provide compensation for 90 % of the approved credit risk losses while Hellenic Bank would be exposed to 10 %. The duration of the asset protection schemes will be 10 to 12 years, depending on the loans. For more details on the schemes, see European Commission, 2018d.

<sup>(2)</sup> Hellenic Bank took over most of Cyprus Cooperative Bank's performing assets, all government bonds and all customer deposits. For more details on figures see European Commission, 2018b.

<sup>(3)</sup> The NPL portfolio is subject to revaluation.

<sup>(4)</sup> The Post-Programme Surveillance Report Cyprus, Autumn 2018 (European Commission, 2018b) presents a comparison of the Cyprus Asset Management Company with selected asset management companies.

**The stock and ratio of non-performing loans (NPL) declined significantly in 2018 but remain high.** The NPL ratio went down to 44.7 % in June 2018 <sup>(43)</sup> and is estimated to decline further to approximately 37 % by the end of the year. Although lower compared to previous years, the ratio is still very high (see Table 4.2.1). The stock of non-performing loans for non-financial corporations contracted the most, having fallen by almost one third in the first half of 2018. In particular, by end of September 2018 the NPL ratio of non-financial corporations stood at 36.8 %, whereas for households it was 38 %. The NPL ratio therefore remains well above the EU average of around 4.0 %.

**The sale of loans made by Hellenic Bank and Bank of Cyprus were the key contributors of the steady decrease in non-performing loans (NPLs) in the first half of the year.** Hellenic Bank's sale of NPLs, a portfolio worth EUR 140 million, to Norway's B2Kapital was the first loan sale in Cyprus <sup>(44)</sup>. The offload of NPLs by Bank of Cyprus was much more significant. The bank agreed with Apollo Global Management on a portfolio worth EUR 2.7 billion of NPLs (*Helix* portfolio). The completion of the transaction remains subject to regulatory approval, most notably on the significant risk transfer recognition by the Single Supervisory Mechanism. Nevertheless, the sale has already been accounted for in the NPL metrics pro-forma <sup>(45)</sup>. The portfolio mainly comprised terminated loans (loans, which the bank considers to have no negotiation possibilities). It remains to be seen how the credit acquiring company manages these loans. In particular, whether it will offer additional restructuring and to what extent it will make use of the newly revamped foreclosure framework. These issues will likely determine whether Cypriot NPLs, particularly terminated loans, will continue to be targeted by investors in the future.

**In the second half of 2018 around one third of non-performing loans (NPLs) were carved out of the banking sector.** With Cyprus Cooperative Bank surrendering its banking licence in September 2018, EUR 5.7 billion NPLs were transferred to the publicly owned wind-down entity of the bank (i.e. a State-owned asset management company). Even though they are out of the banking system, the NPLs from the asset-management company will continue to weigh on the economy as the private sector remains heavily indebted. To maximise recoveries from the bad assets, recuperate the public funds placed in this entity, and ultimately help reduce private indebtedness, it is essential that the Cypriot asset management company is managed successfully. An independent governance structure, proper management, full transparency and appropriate supervision, as outlined in the Commission Decision of 19. 06. 2018 (European Commission, 2018e), are essential ingredients for an effective State-owned asset-management company. The organisation of the Cypriot asset management company and its governance should be fully set out during 2019.

**The House of Representatives approved a series of legal proposals to remove impediments to non-performing loans' (NPLs) resolution.** At the beginning of July 2018, the Cypriot authorities adopted a legislative package that included, among others, amendments to the following acts: the Personal Insolvency Law, the Companies Law, the Insolvency Practitioners' Regulations, the Bankruptcy Law, the Sale of Loans Law and the Immovable Property (Transfer and Mortgage) Law. The Securitisation Law was also approved by the country's parliament as part of the package.

**The changes to both insolvency and foreclosure legislation include clarifications on the scope of application.** In particular, for various insolvency mechanisms (such as debt relief orders or personal repayment plans), the eligibility criteria were broadened and the general government's liabilities were also included, abolishing its preferential treatment. The maximum protection period for non-viable debtors was limited to 12 months. Furthermore, the rules to determine the remunerations of insolvency practitioners within the Insolvency Practitioners' Regulations have been amended to provide more incentives. The foreclosure legislation was amended to allow for a

<sup>(43)</sup> This figure is the private sector NPL ratio which consists only of exposures to non-financial corporations and households, excluding loans to financial institutions and the government sector. It is computed based on ECB data.

<sup>(44)</sup> The NPLs portfolio sale was agreed in January 2018 and took place in June 2018.

<sup>(45)</sup> Should Bank of Cyprus fail to obtain the Single Supervisory Mechanism's approval on this portfolio the published NPLs figures would need to be revised upwards.

broader and smoother application of foreclosure of collateral. The scope of application of the new procedure was clarified, ensuring that old Court decisions are covered as well. The notification requirements were amended to allow for alternative means of delivery, if delivery by registered post is not feasible. The law also allows for electronic auctioning of properties, while the system for e-auctions is being set up. Importantly, under the amended framework the time needed for foreclosure is shortened as the bank may buy the property 6 months after the first unsuccessful auction (within a period of 4 months), whereas before it was 1 year. Furthermore, the right of borrowers to seek a suspension of enforcement, foreclosure or bankruptcy has been limited in time and scope. The impact of the legal changes remains to be seen over time.

**Making use of the amended insolvency and foreclosure frameworks and increasing the efficiency of the judicial processes are essential for strengthening the payment discipline.** Now is the time to fully make use of these frameworks in order to serve their function as credible tools to enhance payment discipline and resolve unviable debts. To this end, improving the efficiency of the judicial proceedings, especially as regards the resolution of NPLs remain essential. Therefore, the ongoing judicial reform is of critical importance and needs to be stepped up (see Section 4.4.3).

**The authorities also announced a temporary subsidy scheme (ESTIA), which aims to deal with the non-performing loans (NPLs) collateralised by primary residences.** During the second half of 2018, the authorities made public their plans regarding ESTIA — a burden-sharing scheme between the banking institutions and the State. Under this scheme, the banks offer debt relief, while the government provides subsidies to eligible borrowers with NPLs backed by primary residences, which has proven to be the most difficult portfolio to recover value from. The borrower's outstanding loan is restructured to ensure that the repayment obligation does not exceed the market value of the main residence. Furthermore, the State pays subsidies to lower the debt servicing costs, including both principal payment and interest charges, by one third. In case of a re-default of the borrower, the foreclosure process is to be commenced and the liquidation proceeds will be shared on equal footing between the bank and the government, to ensure that past subsidies are retrieved. The original ESTIA proposal, which was approved by the Council of Ministers in July 2018, raised a number of concerns (mainly related to its broad eligibility criteria) from different stakeholders, including the European Commission. The authorities therefore revised the terms of the ESTIA scheme in November 2018, notably by tightening the eligibility criteria. <sup>(46)</sup> Narrowing the criteria helped to some extent to address fairness and moral hazard issues, however some concerns remain. Therefore, the scheme's implementation

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<sup>(46)</sup> For more details on ESTIA and key concerns raised see European Commission, 2018b.

Table 4.2.1: Financial soundness indicators for domestic and foreign banks

(%)	2010	2011	2012	2013	2014	2015	2016	2017	2018q1	2018q2
Non-performing loan ratio (1)	-	-	-	-	38.6	36.3	35.4	30.7	30.8	28.1
of NFCs and households (2)	-	-	-	-	54.6	55.1	54.8	50.4	49.3	44.7
of NFCs	-	-	-	-	57.2	55.3	55.0	48.3	46.4	37.5
of households	-	-	-	-	52.1	55.0	54.7	52.4	52.0	50.7
Coverage ratio	48.1	52.6	46.7	31.0	31.7	37.2	41.3	46.3	47.9	47.0
Loan to deposit ratio (3)	103.9	112.6	119.3	152.3	152.1	152.0	120.5	110.4	106.4	100.8
Tier 1 ratio	10.9	7.4	6.3	12.3	14.6	16.0	16.4	15.4	14.7	14.7
CET 1 ratio	-	-	-	-	14.2	15.6	15.9	14.9	14.1	14.2
Return on equity (4)	8.2	-75.6	-100.8	-37.9	-7.1	-7.7	1.7	-11.5	9.8	3.9
Return on assets (4)	0.6	-3.6	-3.6	-2.9	-0.6	-0.6	-0.3	-1.0	0.9	0.3

(1) The aggregate NPL ratio covers all loans and advances. For Cyprus, this ratio may be misleading due to the large exposures (nearly a quarter of gross loans) of domestic and foreign banks to central banks and other financial institutions. More representative is the private sector NPL ratio below.

(2) This is the private sector NPL ratio comprising only of exposures to non-financial corporations and households.

(3) Loans and deposits exclude government and monetary financial institutions as counterparties.

(4) For comparability annualized values are presented.

Source: ECB

will need to be closely monitored. ESTIA is to be implemented from March 2019.

#### 4.2.2. PRIVATE INDEBTEDNESS \*

**The private sector is still highly indebted, despite ongoing deleveraging.** After reaching the peak in 2015, the private debt-to-GDP ratio is on a declining path (see Graph 4.2.1).<sup>(47)</sup> In September 2018, private debt was 291.3 % of GDP, down from 316.3 % of GDP at end of 2017.<sup>(48)</sup> While falling below the 300 % threshold is a positive development, much more deleveraging is needed as the debt-to-GDP ratios for both households and non-financial corporations are well above the fundamental and prudential benchmarks<sup>(49)</sup>. At the end of 2017, the household debt ratio stood at 107.5 % of GDP, above the fundamental and prudential benchmarks estimated at 100 % and 41 % of GDP, respectively. In the corporate sector, the consolidated debt ratio was 208.8 % of GDP at

the end of 2017, exceeding the fundamental and prudential thresholds of 169 % and 69 % of GDP, respectively.

**Excluding the debt of the special purpose entities from the debt metrics reduces the debt overhang of non-financial corporations, however Cypriot indebtedness still remains well above sound levels.** The debt-to-GDP ratio of non-financial corporations is heavily influenced by non-financial special purpose entities, which are mainly ship-owning entities. The special purpose entities are perceived to have limited links to the real economy, they own real assets (ships) and their debt is overwhelmingly funded by foreign banks or other non-resident entities.<sup>(50)</sup> While such set-up of special purpose entities reduces the risks to the domestic economy, their debt inflates the corporate sector indebtedness overall (see Graph 4.2.2). At the end of 2017, the foreign debt of special purpose entities was 76.5 % of GDP. When excluding the special purpose entities foreign debt, the non-financial corporations debt ratio is reduced from 208.8 % to 132.3 % of GDP for the end of 2017. This debt ratio is still above the prudential benchmark and also above the fundamental benchmark adjusted for special purpose entities (90.8 % of GDP).

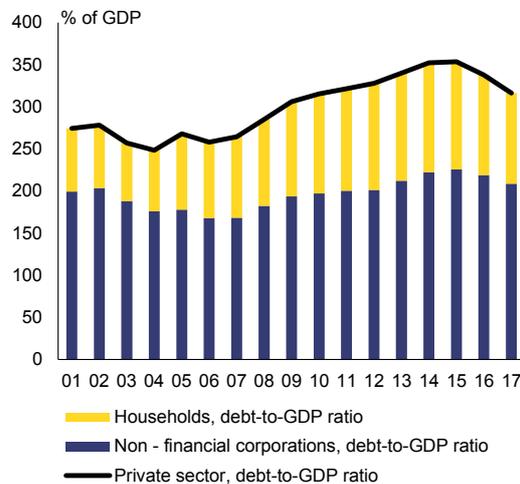
<sup>(47)</sup> Private sector debt refers to the non-financial private sector, thus including, households and non-financial corporations.

<sup>(48)</sup> The September 2018 debt figure refers to non-consolidated data.

<sup>(49)</sup> Fundamental-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodologies are described in European Commission (2017c) and updates to the methodology have been subsequently proposed in European Commission (2018f).

<sup>(50)</sup> References to special purpose entities in this section refer to non-financial ones. For more details on special purpose entities, see European Commission, 2018a.

Graph 4.2.1: Private sector indebtedness



Source: European Commission

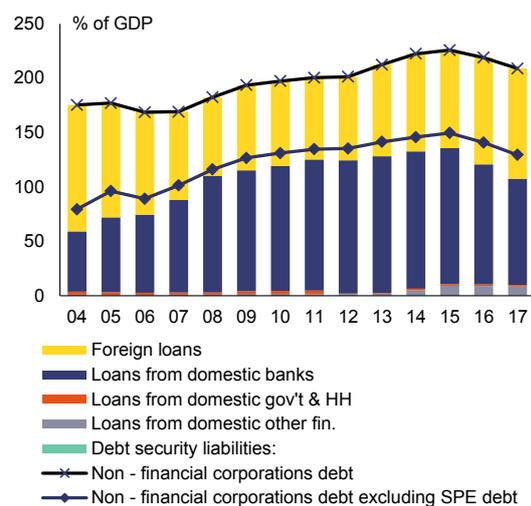
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The corporate sector's stock of liabilities (excluding special purpose entities) comprises mainly domestic bank loans channelled to few business sectors. The non-financial corporations debt decomposition (see Graph 4.2.2) shows an

<sup>(51)</sup> References to special purpose entities in this section refer to non-financial ones. For more details on special purpose entities, see European Commission, 2018a.

almost equal split between foreign and domestic liabilities in 2017. Foreign debt is mostly associated with special purpose entities, while domestic debt is mostly in the form of bank loans. Central Bank of Cyprus data on bank loans by business sectors shows that bank loans are concentrated in few sectors. In particular, in June 2018, a large proportion of the stock of bank loans made to the non-financial corporations sector was reported to be in construction (20 % of total loans), real estate activities (20 % of total loans), wholesale and retail trade (21 % of total loans), and accommodation and food services (12 % of total loans) (see Graph 4.2.3). <sup>(52)</sup>

Graph 4.2.2: Non-financial corporations debt decomposition



Source: Eurostat, ECB, Central Bank of Cyprus

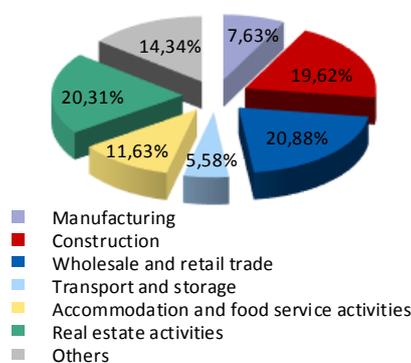
Reducing private indebtedness is challenging in the context of high volumes of non-performing loans (NPLs) and negative savings rates. In the corporate sector almost 40 % of the total bank loans were non-performing in June 2018. In particular, the over-indebted business sectors mentioned above struggled with high NPL ratios: construction (54 %), real estate activities (25 %), wholesale and retail trade (46 %), and accommodation and food services (19 %). <sup>(53)</sup> In the household sector, the debt-overhang is due to the high stock levels of mortgage loans and consumption loans. For households, issues related

<sup>(52)</sup> The figures are computed using Central Bank of Cyprus data on all banks on a consolidated basis. Total loans refer to total bank loans and advances excluding loans and advances to central banks and credit institutions.

<sup>(53)</sup> Based on Central Bank of Cyprus June 2018 data.

to non-performing loans are even more pronounced than for non-financial corporations as the NPL ratio was above 50 % in June 2018. Furthermore, difficulties in reducing debt are compounded by negative savings rates (-3.1 % in 2017). To cover their debt service, households need to increase their savings, as also indicated by debt sustainability indicators.

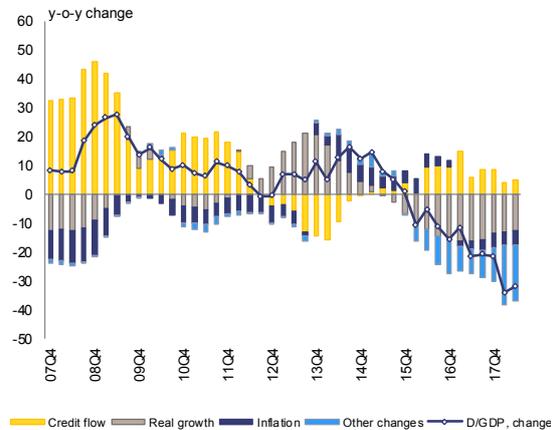
Graph 4.2.3: Bank loans to non-financial corporations by sector



Source: Central Bank of Cyprus

**Despite challenges, the private sector continued deleveraging in 2018 helped by the strong GDP growth, write-offs of non-performing loans, cash repayments and debt-to-asset swaps.** Both households and non-financial corporations debt ratios are on a declining path since the 2015 peak. Overall, total private debt-to-GDP ratio declined by 32 percentage points of GDP in the second quarter of 2018 (y-o-y change). This reduction is attributed to the real GDP growth – which explains 40 % of the drop, to the pick-up in inflation and to valuation effects – which explain the remainder of the decline (see Graph 4.2.4). The valuation effects include loans write-offs, cash repayments and debt-to-asset swaps, which drive the actual reductions in debt volumes. For non-financial corporations, progress in reducing the debt stock is slower as new lending, albeit limited is mostly channelled towards them (more than 60 % of the total gross new loans made in the first half of 2018). The net credit flows to the household sector remain negative.

Graph 4.2.4: Changes in private debt-to-GDP ratio



Source: ECB, Eurostat

**Some acceleration in the debt reductions may be expected in light of the strengthened insolvency and foreclosure frameworks, and ESTIA.** The amended insolvency framework may increase borrowers' participation in the insolvency processes and thus, facilitate debt-workouts. The strengthened foreclosure framework could make the process more efficient, facilitating the reduction of private debt by foreclosing on assets pledged as collateral. In addition, the ESTIA scheme provides very attractive terms to defaulted borrowers, incentivising them to restart servicing their debts. This will also help contain the increase in debt stocks resulting from capitalised interest on non-performing loans. Furthermore, the debt reduction component of the scheme is expected to translate into negative valuation effects upon implementation, reducing the debt stock. Making use of the foreclosure tools upon re-default under the scheme will help mitigate strategic default. Nevertheless, the scheme's long-term impact and adverse effects remain uncertain.

**Shortcomings of the current system for issuing and transferring title deeds hinder the liquidation of collaterals.** The liquidation of collateralised immovable properties by debtors or banks is deterred in cases where property rights are not defined. This relatively frequent phenomenon in Cyprus complicates foreclosure procedures, prevents deleveraging and poses difficulties with the valuation of collaterals. The backlog of cases pending for issuance or transfer of title deeds remains high and progress is slow. To prevent a build-up of future cases, a bill is being drafted

prohibiting the submission of a property sale contract to the Land Registry if the property has encumbrances.<sup>(54)</sup> Setting up a sustainable and reliable system for issuing and transferring property rights, which ensures that buyers who paid the full price of the property get their titles quickly and without impediments remains essential (European Commission, 2018b).

#### 4.2.3. OTHER FINANCIAL ISSUES \*

**The scope and quality of the financial information available for credit risk assessment has been relatively weak.** The authorities are improving the Credit Registry by broadening the information that is collected and made available, as well as expanding the set of reporting counterparties. The credit registry needs further improvements to be in line with international best practices. The creation of a credit scoring system for individuals is still pending.

#### Supervision of non-bank financial sectors

**The authorities should finalise steps to move to a more risk-based and effective supervision for the non-bank financial system.** Drafting the legal framework on integrating the pension funds and insurance supervisors is still ongoing. An independent supervisory body is planned to be set up as a separate organisation outside of the government. The first draft of the legislation is still being prepared by the Ministry of Finance. At present, there are delays in project completion due to issues related to the status of the staff in the planned new organisation. More generally, there is a need to strengthen the supervisory framework for the capital markets, in view of the relatively sizeable cross-border activities of the non-bank financial services companies and the exponential growth of licensed firms in recent years.

**The failure of Olympic Insurance generated a number of uncertainties.** The Cypriot insurance supervisor suspended Olympic Insurance's licence in May 2018, following the insurer's failure to meet its solvency requirements. A liquidation procedure was initiated in early August 2018. While its presence in Cyprus has been modest, the

insurer had an estimated 9 % market share in the motor third party liability insurance segment in Bulgaria, with up to 200 000 policyholders. As it operated through a branch, Olympic Insurance's unpaid claims in Bulgaria are outside the scope of the insurance guarantee scheme in Bulgaria (and Cyprus). Unless the Bulgarian or Cypriot authorities reach an alternative burden-sharing arrangement, these claims will be paid through the receipts from the liquidation of the insurer's assets, which would likely cover only part of the liabilities.

#### Access to finance for small and medium-sized enterprises

**Access to finance for small and medium-sized enterprises remains challenging.** In the context of limited bank credit supply, which is the most relevant form of financing for small and medium-sized enterprises and very few alternative financing sources, access to finance remains a key concern (according to the SAFE survey, European Commission, 2018g). The absence of alternative sources of finance, such as venture capital, local equity finance and the presence of only one business angel (CyBAN) in the country hinders small and medium-sized enterprises to scale-up<sup>(55)</sup>. Start-ups in particular suffer from the lack of seed capital. The regulatory framework for alternative investment funds is being revised to allow for more flexibility.

**Cypriot businesses rely mostly on grant schemes rather than on market based instruments.** EU and national funds have somewhat improved access to finance for small-medium sized enterprises, but, until now, mainly through grant schemes. A financial instrument providing loans for energy efficiency and renewable energy sources for both small and medium-sized enterprises and public and private buildings is set to be launched in the coming months. Furthermore, an on-going scheme providing loans to small and medium-sized enterprises and companies with medium-size market capitalisation (MidCaps) with favourable terms financed by the European Investment Bank, it has been so far well received. The Advice for Small Business facility is also very well received

<sup>(54)</sup> Encumbrances refer to mortgages or other claims on a property or assets.

<sup>(55)</sup> Cyprus ranks 47<sup>th</sup> out of 54 for Entrepreneurial finance (GEM, 2018a).

and is expected to positively contribute to the competitiveness and the internationalization of the SMEs in the country. By contrast, schemes like the Visa Start-up Programme <sup>(56)</sup> and the tax relief for investments in innovative companies are not yet fully delivering in terms of take-up. In the medium and longer term, businesses would benefit more from financial engineering products i.e. loans, guarantees and equity, or other instruments with higher private leverage, rather than grants.

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<sup>(56)</sup> The Cyprus Visa Start-up Scheme enables non-EU entrepreneurs to establish and/or operate companies with high-growth potential by granting them residence permits.

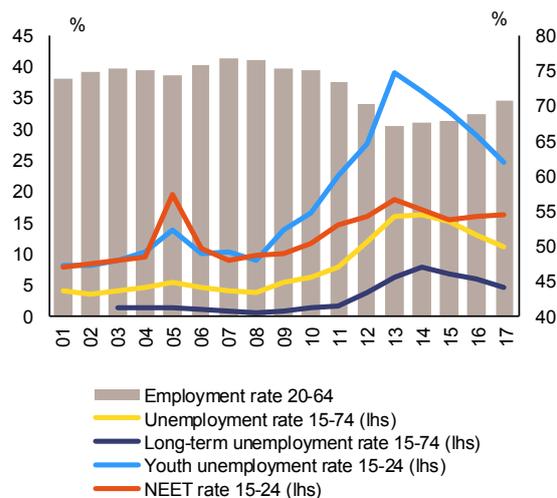
## 4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

### 4.3.1. LABOUR MARKET \*

#### The robust economic performance helped improve the labour market conditions.

Employment increased strongly in 2018, a trend that is expected to continue in the next few years. The drop in the job separation rate combined with an increase in the job finding rate led to a further decline in unemployment. <sup>(57)</sup> Unemployment fell faster than estimated on the basis of economic fundamentals (European Commission, 2018b) to 8.4 % in 2018Q3 from 10.4 % in 2017Q3, but above the EU average 6.8 % and the pre-crisis level, around 4 %. Long-term unemployment fell at 2.5 % in 2018Q3. Youth unemployment fell to 18.7 % in 2018Q3 from 25.2 % in 2017Q3, but remains above the EU average (15.2 %) (see Graph 4.3.1).

Graph 4.3.1: Key labour market developments



Source: Eurostat

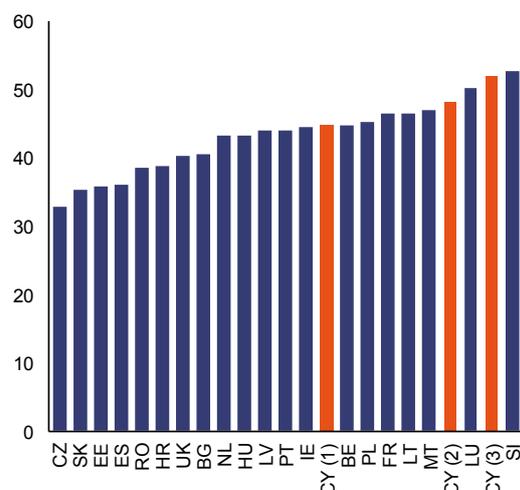
#### High youth unemployment rate combined with a high proportion of young people not in education, employment or training indicate a precarious situation for many young people.

The proportion of young people not in education, employment or training was 11.1 % in 2018Q3, among the highest in the EU. This is probably due to the lack of job opportunities for tertiary graduates, low enrolment in vocational education and training and difficulties and delays in school-to-work transition. Another factor could be undeclared work (see also Box 4.3.1).

<sup>(57)</sup> Respectively, probabilities of losing and finding – if unemployed – employment within a month.

**The minimum wage is in force only for selected sectors.** The minimum wages for nine occupations with low union representation are fixed each year by a governmental decree. Following the economic crisis, the levels of minimum wages have not changed since 2012: EUR 870 per month for shop assistants, clerks, child and personal care workers, EUR 4.90 per hour for guards and EUR 4.55 per hour for cleaners. In 2014, the ratio of the minimum wage over the average wage ranged between 45 % and 52 %, which is relatively high when compared to other EU Member States (see Graph 4.3.2). The percentage of employees earning less than the minimum wage ranged from 7.6 % to 16 %. The possible introduction of a statutory minimum wage warrants careful assessment given the potential impact on work incentives, level of employment and undeclared work.

Graph 4.3.2: Ratio of the monthly minimum wage over the average wage (2014)



(1) The minimum wage is represented by CY(1) for cleaners, by CY(2) for guards and by CY(3) for shops assistants, clerks, child care and personal care workers. The monthly minimum wage for guards and cleaners is calculated based on an average working week of 38 hours.

Source: European Commission

**Social dialogue is performing overall well, but trade union density and collective bargaining coverage are declining.** Between 2005 and 2014, the collective bargaining coverage rate declined from 62.7 % to 47.7 %. Moreover, collective bargaining coverage differs between different types of workers. For example, in 2014, 41 % of full-time employees were covered by a collective agreement (industry or company-level), while this



### Box 4.3.1: Monitoring performance in light of the European Pillar of Social Rights

The European Pillar of Social Rights is designed as a compass for a renewed process of upward convergence towards better working and living conditions in the European Union.<sup>(1)</sup> It sets out twenty essential principles and rights in the areas of equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion.

SOCIAL SCOREBOARD FOR CYPRUS		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	To watch
	Gender employment gap	On average
	Income quintile ratio (S80/S20)	Better than average
	At risk of poverty or social exclusion (in %)	Better than average
Dynamic labour markets and fair working conditions	Youth NEET (% of total population aged 15-24)	Critical situation
	Employment rate (% population aged 20-64)	On average
	Unemployment rate (% population aged 15-74)	Weak but improving
	Long-term unemployment (% population aged 15-74)	Better than average
	GDHI per capita growth	Critical situation
Social protection and inclusion	Net earnings of a full-time worker earning average wage	No data
	Impact of social transfers (other than pensions) on poverty reduction	On average
	Children aged less than 3 years in formal childcare	On average
	Self-reported unmet need for medical care	On average
	Individuals' level of digital skills	Weak but improving

Members States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situation"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average, but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2019, COM (2018)761 final.  
NEET: neither in employment nor in education and training;  
GDHI: gross disposable household income.

Cyprus faces challenges with regard to a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights. The incidence of early school leaving is growing and share of young people who are not in employment, education nor training (NEETs) remains high. The gross domestic household income is still below the 2008 level. On the other hand, the risk of poverty or social exclusion (except for people with disabilities), the income inequality, and the long-term unemployment are below EU averages.

The share of young people not in education, employment or training remained high in 2017. In the age group 15-29 years, almost one third had completed tertiary education and 55 % were men living in semi-urban areas. While the NEET rate for tertiary educated was well above the EU average, it was significantly lower among people with vocational upper secondary and post-secondary non-tertiary education. The estimated share of NEET under 25 registered for the Youth Guarantee was 19 % and 44 % of those registered waited for an offer for more than 4 months. In cooperation with the Ministry of Labour, the Ministry of Education launched a program to reach out to the NEETs and to provide them with individualised guidance.

Progress is being made with regard to the level of digital skills. In 2017, only 50 % of

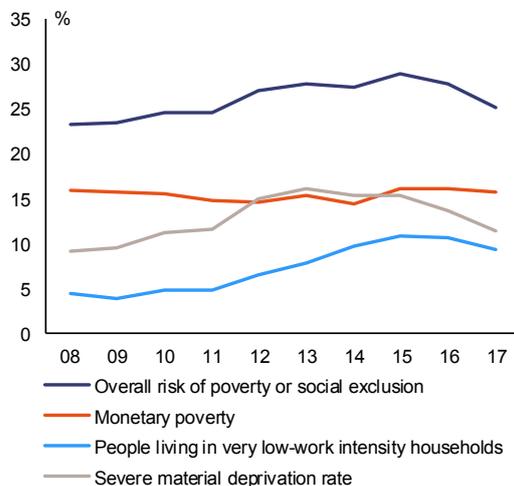
Cypriots possessed at least basic digital skills (as compared with the EU average of 57 %) and the rate of people with advanced ICT skills was among the lowest in the EU. Digital education is promoted in schools through new curricula, participation in European Computer Driving License courses, and competitions in fields such as coding and robotics. Other measures include free workshops for adults and training courses with emphasis on the use of internet and its basic applications.

<sup>(1)</sup> The European Pillar of Social Rights was proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission. [https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles\\_en](https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles_en)

### 4.3.2. SOCIAL POLICIES

**The proportion of people at risk of poverty or social exclusion is high but declining.** The sharp decline in severe material deprivation and in the proportion of people living in low work intensity households were the main drivers of improvement (see Graph 4.3.5). Monetary poverty is slowly falling, thanks to better economic and labour market conditions and the roll-out of the guaranteed minimum income scheme. The proportion of children at risk also recorded a significant drop. However, the gap between the proportion of children of low-skilled parents at risk of poverty or social exclusion and those of high-skilled parents has widened, from 36.9 percentage points in 2011 to 64.1 percentage points in 2017, exceeding the EU average of 53.4 percentage points (2016). The percentage of people with disabilities at risk of poverty or social exclusion is also higher than the EU average (35.7 % vs 29.9 %).

Graph 4.3.5: **The proportion of people at risk of poverty and social exclusion**



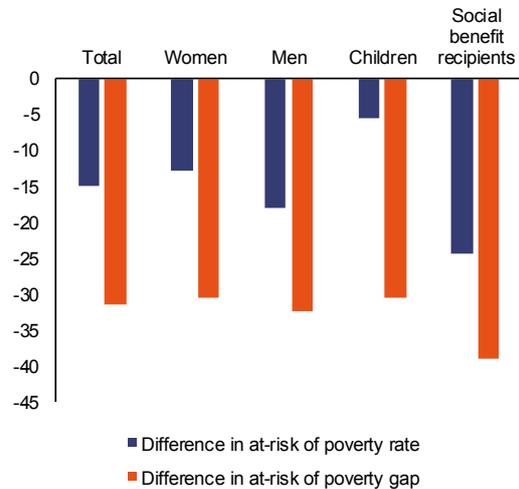
Source: Eurostat

**Pension levels pose the main challenge as regards gender equality.** The women pensioners aged 65 to 74 receive 48.7 % less than men, and the gap widens at ages above 75. This is due to career interruptions, non-standard forms of employment, lower pay and higher life expectancy among women. Meanwhile, the gender employment gap is narrower than the EU average (9.5 vs 11.5 percentage points), but the availability

of childcare remains below the EU average and falls short of the Barcelona target (see Section 4.3.3).

**The guaranteed minimum income scheme appears to be having a significant positive impact on poverty and inequality.** According to the results of a EUROMOD simulation (see Graph 4.3.6), the risk-of-poverty rate in 2018 would be significantly (15 %) higher if the scheme was not in place. The impact on child poverty appears smaller (a 5.5 % decrease). Full implementation of the guaranteed minimum income reform can also bring the poverty gap down by 31 %.<sup>(58)</sup> Since the scheme was introduced, the impact of changes in social exclusion benefits on inequality increased substantially. Based on the simulation, the reform has the potential to reduce the Gini-coefficient by 2.9 % and the income quintile ratio by 9.9 %.

Graph 4.3.6: **Impact of the guaranteed minimum income scheme on the at-risk-of-poverty rate and the relative median at-risk-of-poverty gap in 2018 (% change)**



(1) The impact of the guaranteed minimum income scheme is calculated as the percentage change of each indicator under the full implementation of the guaranteed minimum income scheme and under the implementation of the Public Assistance scheme, which was in place before 2014. The incomes used for the simulations refer to 2015. The poverty line is fixed at 60% of median equivalised disposable income.

Source: European Commission Joint Research Centre, calculations based on the EUROMOD model.

<sup>(58)</sup> The benchmarking exercise in the area of minimum income shows that in 2016 the poverty gap for people aged 18-59 from (quasi-)jobless households was below the EU average. For details, see the European Commission, 2018h.

**The tax, benefit and social protection system has some weak points.** Firstly, it may create disincentives to take up employment, in particular for single households and single parents. In 2018, a beneficiary of the guaranteed income scheme who took up a full-time job at 50 % of the average wage would lose 74 % of new earnings due to higher taxes and lower benefits (70 % for single parent). To keep people on the scheme searching for jobs, requirements changed and those who do not register with the public employment services or refuse to take a job offer are considered ‘voluntary unemployed’ and thus no longer eligible for the benefit. Secondly, the social protection system fails to formally cover the self-employed people for unemployment, accident and occupational injuries (European Commission, 2018i).

**The number of asylum seekers is growing, while measures to integrate them in society are insufficient.** In 2016, 2 840 first-time asylum seekers applied in Cyprus for international protection, marking an increase of 35 % since 2015. This was just 0.2 % of the EU total, but with 3 350 applicants per million inhabitants, Cyprus was among the EU countries with the highest refugee ratio. In 2017, the inflow was bigger, and only in the first 9 months of 2018 there were 4 900 applications. People granted international protection are eligible to receive guaranteed minimum income, but a more comprehensive strategy for their integration in society is lacking.

#### 4.3.3. EDUCATION AND TRAINING

**The relatively high public spending on education is not reflected in observed outcomes.** The Cyprus’ spending on education is high compared to the rest of the EU, as a share of GDP (6 % in 2016, vs the EU average of 4.7 %) and as a share of total government spending (15.6 % vs 10.2 %). However, as shown by the results of the 2015 Programme for International Student Assessment (PISA), the educational outcomes do not match those of other Member States with equal or lower spending levels (Agasisti et al, 2016). The incidence of early school leaving rose by 1 percentage point in 2017, reaching 8.6 % (vs the EU average of 10.6 %). Early school leaving increased among girls from 4.3 % in 2016 to 7.8 % in 2017, while it decreased among boys from 11.4

% to 9.4 % and remained at 18.1 % unchanged among foreign-born students.

**Participation in early childhood education and care is below the EU average and falls short of the Barcelona target.** At 89.7 % in 2016 (EU average 95.3%), participation of 4-6 year-olds in early childhood education and care is unchanged from 2015. It slightly increased for children under 3 (24.8 % vs 20.8 %), yet still fell below the Barcelona target (33 %). Provision of affordable high-quality early childhood education and care for this age group is insufficient resulting in high reliance on informal care (Rentzou, 2018) and impacting Cyprus’ performance work-life balance and support to children.

**Progress in education reform is uneven.** The new teachers’ appointment system is being implemented: 1 869 out of 5 020 participants passed the exam in November 2017 and 60 candidates were offered permanent positions as pre-primary, primary or secondary teachers as the 2018/2019 school year, while 278 candidates were offered temporary positions. The talks between government and unions on reforms of the teachers’ evaluation system and of students’ assessment stalled last summer, but are somewhat progressing since September. A new proposal on teachers’ evaluation by an experts’ committee that aims to improve the quality of school education was submitted to the Minister on the 30<sup>th</sup> of January 2019. To increase the autonomy of schools, teachers’ continuous professional development is becoming school-based. Overall, school autonomy remains limited (World Bank, 2014). Accountability is designed around teachers’ statutory obligations rather than their professional goals like learning achievements or students’ competencies. Evidence suggests that increased school autonomy leads to improved students’ performance, provided that sufficient accountability mechanisms and capacity for autonomy are in place (OECD, 2018a).

**The reform of the secondary technical and vocational education is progressing, yet the proportion of upper secondary students in this type of education remains low (16.7 % vs the EU average of 49.3 % in 2017).** The strong preference of young Cypriots to enter tertiary education and the low attractiveness of the vocational education and training for employers

are considered among the main factors of low participation. To increase the uptake of vocational education and training, the authorities have made efforts to increase the capacity of schools and, in cooperation with industry, to update the curricula, but more investment might be necessary. A comprehensive analysis of the national apprenticeship system started in April 2017 in cooperation with the European Centre for the Development of Vocational Training.

**Higher education attainment further increased, but many graduates still struggle to find suitable jobs.** Tertiary educational attainment reached 55.8 % in 2017, far above the EU average of 39.9 %. The employment rate of recent tertiary graduates is around 20 percentage points higher than that of people with lower qualifications, but significantly lower than the EU average (75.2 % vs 84.9 %). Moreover, the skills mismatch in tertiary education remains one of the highest in the EU (CEDEFOP, 2018). This might be explained by the fact that the most popular areas of study — law, accounting, business administration — do not provide skills that would be most sought after by potential employers. In particular, in 2016 only 9.8 % of students at all levels graduated in science, technology, engineering or mathematics (including 2.4 % in information, communication and technology), compared to 26 % in the EU (European Commission, 2019b).

**Despite the need for upskilling and reskilling, adult participation in lifelong learning remains low, especially among low-skilled.** Adult participation in learning is below the EU average (6.9% vs 10.9% in 2017) and even lower among low-skilled adults (1.0%) and the unemployed (5.7%) who are in most need of upgrading their skills and learning new ones<sup>(59)</sup>. In September 2018, a programme of fast-paced training for practical vocations was initiated, with priority given to the young unemployed (people up to the age of 25). It aims to provide initial training in occupations with high demand and to tackle high unemployment among people between the age of 18 and 25. A comprehensive system to allow individuals to validate qualifications acquired through non-formal and informal learning is being

<sup>(59)</sup> According to the results of the 2018 benchmarking exercise on adult skills and learning. See European Commission, 2018h for details.

prepared and is expected to be full implemented by 2020. Other measures include developing of additional professional standards and strengthening the capacity of post-secondary schools and second-chance schools.

#### 4.3.4. HEALTHCARE

**Health status in Cyprus is overall good.** While the life expectancy at birth is above the EU average (82.3 years vs 81 years in EU), at the age of 65, both life expectancy and healthy life years in Cyprus are below EU average.<sup>(60)</sup> People above 65 years of age have free access to influenza vaccination, but only 32.4 % of them obtained it in 2014. This is well below the EU average and marks a significant decline since 2008 when the respective rate was over 40 %. Smoking rates have not fallen in the way they have in many other countries and obesity is increasing. Overall, Cyprus is lagging in terms of disease prevention and health provision at older ages.

**Health spending and investment in Cyprus continue to be among the lowest in the EU.** In 2017, the total health spending was 6.8 % of GDP, of which only 42.6 % comes from public sources, both rates are among the lowest in the EU. Despite the existence of free services in public healthcare for poorer citizens, 4.6 % of Cypriots report having unmet medical needs due to costs. Meanwhile, direct out-of-pocket healthcare payments are among the highest in the EU. Their share is particularly high for retail pharmaceuticals (73 %, vs the EU average 34 %). Healthcare investment is also much lower than the EU average (0.12 % vs 0.65 % of GDP respectively in 2015).

**The implementation of the universal national health insurance system is progressing, but challenges remain.** One of the key milestones is the successful rolling out of the information and technology system by June 2019. Health providers should be able to receive continuous support and training to use the information and technology system tool. Several legislations, including the audit system and the definition of beneficiaries are expected to be adopted in the coming months. The authorities need to ensure that an adequate number of health providers will join the system within the

<sup>(60)</sup> Based on three-year averages, see OECD, 2018b.

budgetary limits, including use of non-monetary incentives. Finally, the communication strategy to the health stakeholders has been delayed.

**The public hospitals' reform entails investments in infrastructure, human capital, health technologies and information and technology systems, but also requires better management practices and accountability.** The new organisation of public hospitals has been set up as planned. An important study on the costing of hospitals has been completed and the study on utilisation and satisfaction level of patients is planned to be completed in early 2019. The organization aims to generate economies of scale, better management practices, better public procurement and increase revenues from alternative funding sources i.e. educational and research programmes, partnerships, grants, donations etc. The reform entails further investments in primary and mental care (i.e. renovations, human capital, health technologies, information and technology infrastructure). Moreover, the necessary capacity of health authorities in accessing and managing financing sources remains to be developed.

**Efforts are made to improve the efficiency, planning and integration of the health sector.** The hospitals' occupancy rates decreased between 2000-2016, contrary to the general EU trend. In a number of surgical procedures Cyprus is below other EU countries (OECD, 2018b). Moreover, advanced medical equipment is unevenly distributed between public and private sector and not sufficiently used. A voucher system, allowing patients covered by the public health system to use private services, which is in place since 2015, is meant to alleviate the situation. Improving capacity planning and integrating care remain to be scaled up.

**Cyprus has a shortage of adequately skilled health professionals.** Apart from the relatively low number of nurses compared to doctors in Cyprus, half of the doctors practicing in Cyprus are above 50 years old. This trend indicates further pressures in the medium term. There is a lack of specialised personnel among various specialities. More efforts are needed to improve research opportunities, continuous learning, digital skills for the health personnel and the system's overall attractiveness.

**Developing e-health could lead to considerable efficiency gains.** E-health could promote on-line medical appointments, which currently does not exist in Cyprus. The planned e-prescription will allow medicine consumption to be monitored, but more investment is needed for the public health services to improve communication on disease surveillance and response. The planned electronic record for vaccines will facilitate monitoring of their use. Cyprus is lagging behind other EU countries in terms of laboratory capacities, partly due to the absence of a data processing information and technology system, especially for clinical microbiology laboratories.

**Cyprus lacks specific legislation to regulate formal home and community care.** The projected increase in the number of dependent people in the next decades is much higher than the EU average. Total long-term care spending in Cyprus accounts for only 0.3 % of GDP (against an EU average of 1.6 %), and only 21 % of the dependent population receives long-term care services. The fragmentation of services and lack of coordination hinders access to services. Only a small number of dependants receive care under formal arrangements resulting in high inactivity rate due to informal care. Most of long-term care benefits are in the form of cash, available only to recipients of guaranteed minimum income and individuals with severe disability.

#### 4.3.5. INVESTMENT NEEDS

**Increased investments in outreach and activation, vocational education and training, adult learning, childcare and health are important for improving Cyprus' productivity and long-term inclusive growth.** Skills shortages and mismatches are among the main obstacles to business investment, pointing at the need to invest more in training of unused and under-used labour potential, aligning better education curricula to labour market needs, and investing in matching vocational education infrastructure. Using the full labour potential also requires matching investment in social inclusion, health promotion, the effectiveness of public employment services and the availability of child and long-term care services.

## 4.4. COMPETITIVENESS REFORMS AND INVESTMENT

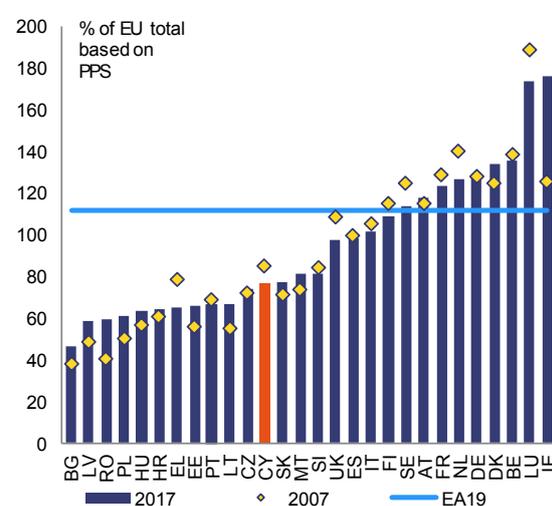
### 4.4.1. PRODUCTIVITY AND INVESTMENT \*

**To support Cyprus’ long-term growth, investments are needed in environment, energy, digitalisation and innovation.** Cyprus faces significant challenges in upgrading its waste and water management and creating a circular economy (see Section 4.4.2). Delays in developing Cyprus’ renewable energy generation potential might further erode the country’s competitiveness given the high and volatile cost of oil imports. Therefore, additional investment in energy efficiency, renewable sources of energy - notably solar – and sustainable urban transport would contribute to the long-term sustainability of growth (see Section 4.4.2). Higher investment in e-governance, e-commerce, e-education and e-health and promoting digital skills would have a positive impact on the country’s business environment and productivity in the long term (see below). Research and development (R&D) spending in Cyprus remains one of the lowest in the EU, hindering the innovation capacity of the research centres and the business sector (see below).

**Growth in labour productivity has been weak hindering Cyprus’ real income convergence.** In the post-crisis period, labour productivity has lagged the euro area one, which has hindered Cyprus’ real income convergence process (see Graph 4.4.1). The increase in labour productivity has been mainly driven by capital deepening, <sup>(61)</sup> while the total factor productivity decreased steadily for almost a decade, weighing on the country’s competitiveness. Major factors, such as low digitalisation, barriers to investment, composition of investment — skewed to construction — and low R&D affect productivity performance. A positive development is that the productivity in key sectors, such tourism-related sectors and information, communication and technology, is strongly rebounding and has exceeded the pre-crisis level. Financial services have also almost caught up, construction and manufacturing are recovering, but are still below the pre-crisis level (see Graph 4.4.2).

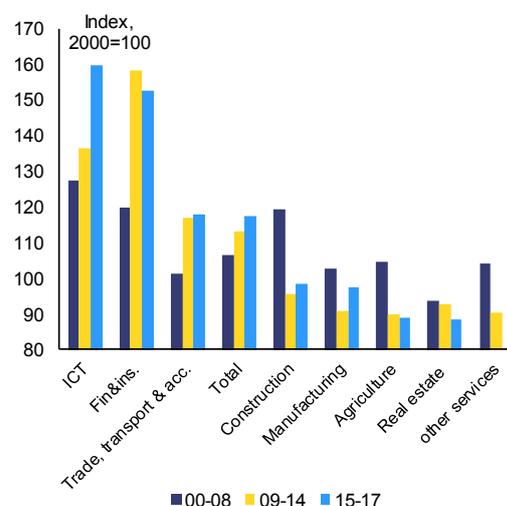
<sup>(61)</sup> Measured by net capital stock at constant prices per persons employed in full time equivalent.

Graph 4.4.1: Labour productivity



(1) Nominal labour productivity per hour worked  
Source: Eurostat

Graph 4.4.2: Labour productivity by sector - period averages



(1) Labour productivity is defined as real gross value added of a given sector over total hours worked in the same sector.  
Source: Eurostat

**Following the 2016 Council Recommendation, Cyprus has appointed the Cyprus Economy and Competitiveness Council as National Productivity Board in June 2018.** National Productivity Boards are objective, neutral and independent institutions that can investigate the productivity challenges, contributing to evidence-based policy making, boosting domestic ownership of structural reforms. The Council has already been consulted in the European Semester exercise.

**Investment in Cyprus was robust, but it continued to be directed to activities less likely to boost productivity.** In 2017, the ratio of investment to GDP — 20.9 % — was in line with euro area average (20.6 %), indicating the strong post-crisis recovery. However, for some time now, investment continues to be concentrated on residential construction and transport equipment (ship registrations) — activities that have very limited capacity to boost productivity. These two activities accounts for more than a half of total investment (see Graph 4.4.3).

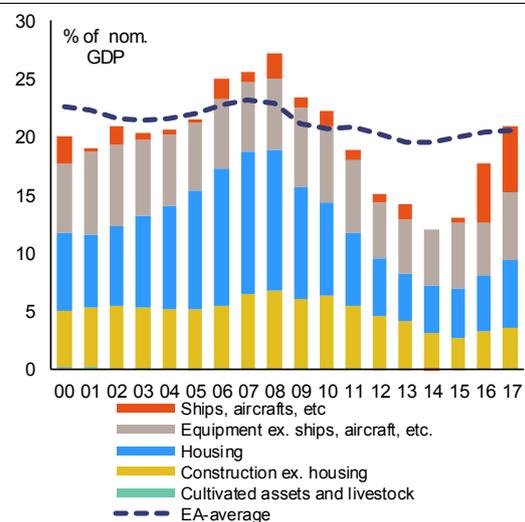
**Only some of the current investments are likely to have a positive impact in the long term.** The non-residential construction investment, specifically tourism infrastructure, may positively affect growth in the medium to long term, possibly furthering the new tourism strategy to attract tourists throughout the year and make Cyprus a ‘premium’ (higher-value) destination. Similarly, construction carried out by Cypriot private and public universities (relatively small in volume), in an effort to establish Cyprus as a regional hub for tertiary education can boost long-term growth potential and help diversify the economy. Cypriot universities also strengthened their marketing efforts to expand their student base and establish links with other reputable universities, reflecting intangible investment, not easily captured by statistics.

**Foreign direct investment is concentrated in financial intermediation and holding companies, ships and real estate.** Cyprus receives substantial flows of foreign direct investment. In 2015-2017 financial intermediation, and in particular holding companies were the main recipients of these flows. Marine transport, reflecting expanding ship registration, was the second largest, followed by real estate in the last few years. In 2017, flows to financial activities accounted for 62.2 % of total foreign direct investment, flows to water transport for 18.6 % and flows to real estate for 10.7 %. However, inflows to the financial intermediation and holding companies must be treated with caution, as outflows from these sectors in some years have also been very large. The largest inflows and outflows over the last few years were mostly from Russia, followed by Luxembourg, the Netherlands, the UK and Germany. In all these cases except Germany foreign direct investment flows were

large on both sides — i.e. inflows and outflows in the same year, which is linked to the activities of holding companies and other financial intermediation.

**In 2017, public investment in Cyprus fully caught up with the EU average.** After its trough of 2.1 % of GDP in 2014, government investment increased to 2.7 % of GDP in 2017 bringing it in line with the EU average. As a share of total government expenditure, public investment in Cyprus outpaced the EU average in 2017, reaching 7.3 % against 6.0 %.

Graph 4.4.3: Investment by category



Source: Cystat, Eurostat

**Public investment with long-term positive growth effects represents only around one third of total public investment in Cyprus, which is below the EU average.** The composition of public investment can be broken down into three categories: (i) expenditure for the long run; (ii) welfare expenditure; and (iii) other expenditure.<sup>(62)</sup> Empirical studies typically find that government expenditure for the long run can increase growth, particularly expenditure on

<sup>(62)</sup> Expenditure for the long run encompasses productive categories of government expenditure, such as education, R&D, environment protection and transport and communication. Welfare expenditure consists of expenditure on social protection and health. Other expenditure comprises the remaining of total expenditure, mainly covering general public services, defence and public order and safety.

education and infrastructure. <sup>(63)</sup> In Cyprus, public investment for the long run accounted for 32% of total public investment in 2016, compared to the EU average of 49%. In particular, the most important public investment projects for the long run were geared towards education and infrastructure.

### Digitalisation

**Cyprus made steady progress in digital economy, but challenges remain.** The country ranks among the last in the EU, though showing improvement in all aspects of the digital economy society Index. Further enhancing digital skills is key in strengthening the digital economy and society. Structured awareness campaigns for the digital agenda might help.

**Action is being taken to expand Cyprus' digital public services (e-government), though supply is still weak.** Progress in improving and broadening Cyprus' digital public services is a priority for the authorities, even though the supply is still slightly below EU average. The number of e-services offered doubled in comparison to 2017. More e-services are planned to be available in 2019. At the same time, training is being offered to people who are not digitally literate to enable them to use digital public services.

**E-Commerce is improving, but is still below the EU average.** Consumer confidence in online shopping (50%) increased by 7 percentage points but remains among the lowest in the EU. By contrary, retailers' confidence in selling online in their own country increased by 6 percentages points and is above the EU average. (European Commission, 2019c)

**Implementing the digital single market strategy is key for ensuring productivity gains in the long term.** Cyprus is committed to advancing the use of new technologies and has signed declarations on artificial intelligence, setting up a

<sup>(63)</sup> When assessing the long-term impact of total public expenditure, other government expenditure categories not classified as investment should also be taken into account. European Commission, 2016b, Section III.3

joint undertaking for high-performing computing, blockchain partnership and artificial intelligence, coordinated by the Commission. Based on a recent study (Baker, 2016), which listed the main obstacles to the growth of e-commerce, the Cypriot authorities are proceeding with two specific actions. These are (i) amending the current legislation for regulating e-commerce to ensure security in online transactions and (ii) creating e-shops and e-platforms in Cyprus through a new grant scheme.

### Research and innovation

**Cyprus has a small but growing research and innovation system, which plays a limited role in economic growth.** The R&D intensity <sup>(64)</sup> in Cyprus stood at 0.56 % of GDP in 2017, higher than its EU 2020 target (0.5 %) — a target that was not deemed to be ambitious enough. Both public and private R&D spending remain well below the EU average. In 2017, public R&D expenditure was around 0.3 % of the GDP, one of the lowest in the EU. Tertiary education and business sector R&D expenditure also lag behind the EU average. The size of the research and innovation system and the available resources are very limited: at around EUR 110 million, which puts the country among the lowest positions in the EU.

**The research output is a point of strength for innovation.** In 2017, about three quarters of the total number of publications were international co-publication (among the highest in the EU) and in 2014 more than 10 % of Cyprus' publications were among the top 10 % worldwide most cited scientific publications (above EU average), (CWTS, 2018). In 2017, 55.9 % of the population aged 30-34 had a tertiary education (among the highest in the EU). The tertiary education sector is considered a driver of economic growth with potential for further expansion in the future (E&Y, 2018), thus contributing to Cyprus' ambition of becoming a regional hub for higher education and research. However, interaction between academia and the business sector is limited.

<sup>(64)</sup> Gross domestic expenditure on R&D as a percentage of GDP.

### Box 4.4.1: Investment challenges and reforms in Cyprus

#### Macroeconomic perspective

Investment in Cyprus has recovered, with investment to GDP ratio at 20.9% in 2017, in line with euro area. However investment continues to be skewed towards non-productive activities such as residential construction and transport equipment (mainly ship registration), accounting for more than a half of total investment. Public investment has fully recovered, however, it remains weak in areas such as R&D and digitalisation. Meanwhile, the overall business environment in Cyprus does not appear to facilitate investment, notably due to difficult access to finance for small and medium-sized enterprises, inefficiencies of the justice system, and cumbersome procedures for obtaining necessary permits. An action plan for growth is being implemented gradually, which mainly aims to create a more dynamic business environment, lighten the administrative burden for firms promote entrepreneurship and reform the justice system.

#### Assessment of barriers to investment and reform priorities:

Public administration/ Business environment	Regulatory/ administrative burden	Some progress	Financial Sector / Taxation	Taxation	Some progress	
	Public administration	CSR		Access to finance	CSR	
	Public procurement /PPPs	Some progress	R&D&I	Coop between academia, research and business	Some progress	
	Judicial system	CSR		Financing of R&D&I	Some progress	
	Labour market/ Education	Insolvency framework	CSR	Sector specific regulation	Business services / Regulated professions	Some progress
		Competition and regulatory framework	Some progress		Retail	Some progress
EPL & framework for labour contracts		Some progress	Construction		Some progress	
Wages & wage setting	Some progress	Digital Economy / Telecommunications	Some progress			
Education, skills, lifelong learning	Some progress	Energy	Some progress			
			Transport		Some progress	

**Legend:**

	No barrier to investment identified		
CSR	Investment barriers that are also subject to a CSR	Some progress	
	No progress	Substantial progress	
	Limited progress	Fully addressed	

#### Main barriers to investment and priority actions underway

1. Finance for firms is mostly dependent on bank lending, which has been only slightly recovering since the crisis (see Section 4.2.3). Capital markets remain underdeveloped and access to alternative financing sources, such as venture capital and equity funding remains limited.
2. The business environment remains weak. Despite the efforts undertaken, the administrative burden is high, in particular for initiating strategic investment (see Section 4.4.3). Inefficiencies in the public sector, inadequate legal enforcement of claims and lengthy court proceedings weaken the business environment and the legal certainty in Cyprus. The digital public services are continuously increasing, however, the overall digital uptake of the firms and e-commerce is low.

**The information and communication technologies and pharma-chemical sectors have the potential to promote transfer knowledge.** Though still in their starting phase, these sectors can generate a demand for research and innovation. An analysis of business R&D composition (RIO, 2017) shows that it is currently concentrated in the information, communication and technology and pharma-chemical sectors, which account for around 80 % of its value in the services and manufacturing sectors respectively.

Export and patent data confirm this analysis. Around 20 % of Cyprus' export (USD 600 million) originates from each of the two sectors (MIT, 2017) and patents awarded between 2009 and 2013 are concentrated in civil engineering, the pharma-chemical sector and information, communication and technology (even if the influence of the patent-box legislation on the patent data is difficult to assess) (KUL, 2018). These sectors are among the priorities of Cyprus' Smart Specialisation Strategy

and several research centres in the country work in these fields.

**Incentives have been put in place to improve knowledge transfer.** In 2018, the law allowing universities to create spin-offs was enacted. In addition, a policy support facility measure to stimulate the utilisation of research laboratories of government-funded organisations by the business community is planned to start in 2019.. The government also plans to set up a single national point, built on the one-stop shop principle, to coordinate all knowledge transfer activities, which are currently split among knowledge transfer offices in universities and research centres, with low capacity.

**Progress in implementing the smart specialisation strategy is key in diversifying the economy.** Although it was adopted in 2015, the implementation of the strategy has been delayed. Most of the projects are expected to start in 2019. In addition, the priority areas of the strategy are broad, rather than focusing on a few well-defined areas reflecting specialisation. An update of the strategy would allow for a more forward-looking identification of the investment needs based on the analysis of remaining bottlenecks and the evaluation results of the current strategy.

#### 4.4.2. THE SERVICES SECTOR AND INTEGRATION OF THE MARKETS

##### Energy and climate

**Further efforts are needed for Cyprus to meet its energy efficiency and renewable energy 2020 targets.** The renewable energy share in Cyprus was 8.9 % in 2017, with the 2020 target being 13%. (CERA, 2018). Residential and commercial buildings constructed with no or low levels of thermal protection, particularly in urban settings are a substantial source of energy inefficiency. Framework conditions for investing in the renewable energy sector have improved and several measures have been introduced, including installations of photovoltaic systems and grant schemes for small and medium-sized enterprises and households. However, Cyprus has not yet taken full advantage of its considerable potential in renewable energy generation notably from solar sources. Measures with the potential to drive the

energy efficiency market up further include: (i) market uptake of the available energy efficiency solutions, (ii) technological innovation; (iii) digitalisation and (iv) training workers in the energy renovation sector.

**Cyprus is expected to miss its greenhouse gas emissions targets in 2020 and 2030 by a large margin, therefore further measures are needed.**

Cyprus is expected to fall short of its 2020 and 2030 targets by 12.5 and 47.4 percentage points respectively, based on the current measures in place. On the positive side, Cyprus has estimated that with additional measures, in areas, such as: (i) transport (e.g. promoting low-emission vehicles and reduction of vehicle use), (ii) waste management (e.g. promoting biogas and exploiting organic waste), (iii) buildings (e.g. replacing old systems and promoting co-generation) and (iv) industry by promoting energy efficiency can help reduce the gap to 17 percentage points and it is of crucial importance to ensure sufficient investments for these measures.

**The planned importation of liquefied natural gas is expected to help diversify Cyprus' energy mix.**

Cyprus has launched the process of importing liquefied natural gas. The necessary infrastructure and the contract to import liquefied natural gas are expected to be concluded by the end of 2020. This might help to diversify Cyprus' energy mix and facilitate compliance with the Industrial Emissions Directive, which applies to plants that use heavy fuel oil to generate electricity i.e. the Electricity Authority of Cyprus.

**There is currently no wholesale and retail energy market in the country.** The sole supplier the Electricity Authority of Cyprus is a State-owned enterprise that operates as a de facto monopoly. There are only few renewable generators, which signed power purchase agreements with the Electricity Authority of Cyprus for the whole production. Therefore, although the consumers are legally entitled to choose their supplier, in practice the lack of alternative suppliers means that they are unable to do so. Steps are being taken to open up the electricity market in Cyprus, but progress has been slow.

**The planned EuroAsia interconnector would end Cyprus' energy isolation.** When constructed, the EuroAsia interconnector will connect Cyprus with Israel, Crete and Attica. A feasibility study is currently under way. A feasibility study is also under way for the EastMed pipeline, which will allow any natural gas extracted in Cyprus' exclusive economic zone to be transported to Crete and continental Greece.

**In its final National Energy and Climate Plan to be adopted by 31 December 2019 in line with the Regulation on the Governance of the Energy Union and Climate Action** <sup>(65)</sup>, Cyprus will provide an overview of its investment needs until 2030 for the different dimensions of the Energy Union, including renewable energy, energy efficiency, security of supply and climate mitigation and adaptation. The information provided, including in the draft plan submitted on 29 January 2019, will further contribute to the identification and assessment of energy and climate-related investment needs for Cyprus.

## Environment

**Cyprus' weak environmental performance is a major concern.** Waste generation remains significantly higher than the EU average and has been increasing since 2014. Cyprus landfills most of its municipal waste (75 % vs 24 % the EU average). Only 17 % <sup>(66)</sup> of waste is recycled, significantly below the EU average of 46 % in 2016. Furthermore, an overarching policy framework for the circular economy is lacking.

**Effective waste management remains a considerable challenge.** The current facilities for waste treatment do not achieve high recycling rates and the lack of economic instruments such as landfill taxes makes recycling economically unattractive. According to the 2018 early warning report (European Commission, 2018j), Cyprus' main obstacles to a proper waste management are: (i) a lack of infrastructure and collection systems for recycling, (ii) weak coordination among competent authorities and the insufficient capacity of the local governments, and (iii) the lack of financial incentives to recycle. Significant

investment gaps have been identified in the area of waste management for Cyprus to meet its 2020 municipal waste recycling target (50 %), set up an effective management system that promotes recycling. Furthermore, complying with the higher recycling targets for the post-2020 period might be even more difficult without additional measures.

**Water management notably in urban areas is characterised by inefficiencies.** Water scarcity, in combination with over-abstraction of groundwater, is the main challenge for Cyprus. The newly adopted water pricing policy under the Water Framework Directive covers only some water services. On urban wastewater, there is a considerable amount of wastewater that is still discharged without collection or treatment — only around half of the total waste water undergoes secondary treatment.

**Cyprus remains vulnerable to climate change.** According to the national plan and strategy for adaptation to climate change, the implementation of measures in the vulnerable sectors (water resources, land use, seaside areas, biodiversity, forestry, agriculture, fisheries, tourism, energy, infrastructure and public health) has begun. Droughts and water scarcity are major concerns and an insufficient policy response might affect the country's rural economy and tourism. Therefore, sustainable management and efficient use of its natural resources are essential for Cyprus to mitigate adverse climate change effects, preserve and restore its natural environment and ensure sustainable economic growth in the long term. To this end, the effective management and protection of Natura 2000 areas, especially from incompatible activities or developments that fragment or degrade them (particularly within private land) is of utmost importance.

## Transport

**Passengers' transport in Cyprus is highly dependent on private cars.** Only 3 % of passengers use buses and there are no railways or trams. Cyprus has one of the highest car ownership rates in the world (more than 600 cars per 1 000 inhabitants) and a very low use of green transport. In particular in the greater urban area of Nicosia — the largest agglomeration in the country — the proportion of trips by public transport is only 3 % and by bicycle 2 %. The continuous increase of

<sup>(65)</sup> Regulation (EU) 2018/1999 of the European Parliament and of the Council of 11 December 2018.

<sup>(66)</sup> Including 4 % of composting.

congestion together with the lack of sustainable transportation is likely to have a serious impact on the environment and attractiveness of the country's urban areas.

### Professional services

**Some regulated professions in Cyprus remain relatively restricted.** Professions such as real estate agents, lawyers and architects are particularly restricted, hindering the mobility of professionals and competition (European Commission, 2017e and 2017f). In particular, licensing requirements, residency requirement or shareholding requirements restrict access to these professions. Existing requirements do not seem to be proportionate. They therefore need to be assessed to check that they encourage competition and ensure a more efficient allocation of resources in certain professions.

### Retail trade

**Despite the good performance of the retail sector, the procedures to set up and run a retail shop remain complex and hinder further growth.** On the regulatory environment for retail, both for the establishment of retail outlets and their daily operations, the Retail Restrictiveness Indicator places Cyprus among the four Member States with the highest restrictions (European Commission, 2018k and 2018l). The low ranking is a result of complex licencing procedures and operational restrictions i.e. shop opening hours and distribution channels.

## 4.4.3. GOVERNANCE AND INSTITUTIONAL QUALITY \*

### Justice system

**Serious inefficiencies remain in the justice system in Cyprus.** According to the EU Justice Scoreboard, the clearance rate for administrative cases decreased from 113% in 2016 to 74% in 2017, while disposition time increased from 1.582 days in 2016 to 2.162 in 2017 (European Commission, 2019d). The main inefficiencies stem from outdated and complex rules for civil procedures, lack of specialisation of courts, a low level of digitalisation and poor quality of buildings. The lack of formal lifelong training for

judges and the limited use of mediation are additional sources of inefficiency. The shortcomings of the justice system hinder the use of insolvency and foreclosure frameworks, cause long proceedings, including for financial disputes and weaken the payment culture in the country.

**A comprehensive reform of the justice system is considered a priority by the authorities.** An action plan covering a broad range of reforms spanning over several years has been prepared and its implementation is regularly monitored. Measures are gradually being implemented to address the main challenges. These include the creation of a task force of judges to clear the large backlog of cases for which the recruitment process for the judges and supporting staff is currently underway. A 'mini' electronic registry has been developed and is now pilot running in all district courts and in the Supreme Court, until the e-justice system is fully operational. Other on-going measures include assessing the recruitment and promotion criteria for judges and establishing a training school for judges. In parallel, the civil procedure rules are expected to be revised by the end of 2019. The new rules intend to strengthen the enforcement of judgments and to improve the efficiency of the judicial system as a whole.

**Action is being taken to increase the specialisation of courts.** Judges are expected to be appointed for the handling of financial disputes, including judicial procedures for non-performing loans. Relevant legislation was submitted to the House of Representatives for approval in February 2019, whilst the recruitment procedure has been launched. A new Administrative Court of International Protection, competent mainly for asylum seekers, has been set up. Moreover, the establishment of a Commercial Court is expected in 2019. Relevant legislation was submitted to the House of Representatives for approval in October 2018. The creation of these specialised courts is expected to help in shortening the length of proceeding and address the backlog of cases. On the establishment of a Court of Appeal, relevant legislation is under preparation. However, the recruitment of the judges is a controversial point among authorities. The issue is linked to the separation of powers and the independence of the judiciary and warrants close monitoring.

### Public administration

**The performance of the public sector is close to the EU average.** Based on the Global Competitiveness Index (WEF, 2018), the Cypriot public sector ranks close to the EU average and higher than the global average. Main inefficiencies were identified in the legal framework in settling disputes and e-participation, i.e. the use of online services by government to inform, interact and engage the general public and stakeholders, both below the EU average.

### The reforms of the public administration and the local governments are yet to be completed.

A set of bills to modernise: (i) the appraisal system of civil servants, (ii) promotion procedures and (iii) the Public Service Commission are still to be adopted and implemented. The reform of the local governments has been stalled in the House of Representatives since 2015. Currently it is gathering momentum and a revised proposal is expected to be re-submitted in the coming months. The reform will benefit the local communities by improving local public services and water and waste management and simplifying the process of issuing title deeds and building permits. The reform also intends to set up a common accounting and financial reporting framework for all local governments, which could improve the management of public finances.

### Institutional changes are being made to support growth-friendly policies.

In addition to the Deputy Ministry for Shipping established in 2017, a Deputy Ministry for Tourism is operational since January 2019. It will be the competent authority in charge of implementing the national strategy for tourism. As mentioned in Section 4.4.1, an Economy and Competitiveness Council was set up in June 2016 to monitor the economy's developments with regard to competitiveness and to recommend policy measures. In addition, a national research and innovation council was created, while discussions are currently underway for the establishment of a Deputy Ministry for Research, Innovation and Digital Transformation. The proposal for the creation of a Deputy Ministry for growth and competitiveness has been held back.

### Privatisations and State-owned enterprises

### Progress on privatisation and governance of State-owned enterprises has been limited.

Following the completion of the privatisation of the Limassol port, only a small number of privatisation projects remain active, such as the privatisation of Larnaca port and, with slow progress, the privatisation of the National Lottery and the Troodos Residences. The corporatisation of the Cyprus Telecommunications Authority has stalled at the House of Representatives since 2017. A law to improve the corporate governance and monitoring of the functioning of the State-owned enterprises is pending for adoption at the House of Representatives since 2015. In the meantime, the government is preparing guidance on the functioning of the State-owned enterprises.

### Business environment

### The business environment has only moderately improved and key reforms are still pending.

Although the ease of doing business in Cyprus improved according to the latest World Bank Doing Business report (World Bank 2018a), the relative position of the country in the ranking deteriorated. Cyprus is ranked in 57<sup>th</sup> position (a drop of four places compared to last year) and performs below the EU average - at 23<sup>rd</sup> position.

### Obtaining necessary permits and licences to invest in Cyprus remains cumbersome.

The law that aims to significantly reduce the time it takes for a strategic investor to obtain all the necessary permits and licences to invest in Cyprus is still pending adoption by the House of Representatives. Furthermore, the procedures for issuing building permits, which are mainly issued at local level, are complex and lengthy and the planned simplification reform based on external experts' recommendations has been delayed (European Commission, 2018b).

### The tax compliance burden in Cyprus has eased.

With a more efficient electronic filing and payment process, Cyprus has shortened the time to comply with tax obligations. According to the Paying Taxes 2019 Report (World Bank, 2018b), Cyprus has reduced the time needed to pay and file

taxes <sup>(67)</sup> from 127 hours in 2016 to 122.5 hours in 2017. This is significantly below the unweighted EU average (around 172 hours) and median (around 143.3 hours).

**Consumers' trust in the institutional framework to defend their rights is low, as is their trust in product safety.** Cypriot consumers' trust in organisations (e.g. public authorities, non-governmental organisations and retailers or providers of services) to protect their consumer rights increased by 4 percentage points since 2016 but is still below the EU average, mostly because it has the lowest trust in the EU for retailers/providers of services. Consumers' trust in product safety has decreased by 3 percentage points since 2016 and is among the lowest in the EU. (European Commission, 2019c)

#### Public procurement

**Despite measures taken, the number of contracts with single bidders and directly awarded contracts is still high.** Over the last years, Cyprus has taken concrete measures for simplifying the award procedures for public contracts, increase competition and put in place an efficient e-procurement system. Trainings and guidance are also provided to contracting authorities, particularly regarding the effective market sounding and proper preparation of the competitions. However, there is still a high number of contracts with a single bidder, 48 % of procedures in 2018, mainly identified in the healthcare sector. The country ranks among the first in the EU when it comes to the number of direct awards (25 % of total procedures in 2018), also identified in the health care sector. In addition, Cyprus has among the highest number of contracts awarded exclusively based on the lowest price (93 % of public contracts awarded in 2018) in the EU, contrary to best practice favouring the use of more quality-based criteria.

**Efficiency, transparency and qualitative assessment of public tenders could be further improved by strengthening capacity.** The government has announced measures, such as the

creation of a central pool of experts that would take over procurement functions from the small contracting authorities, expanding existing framework contracts and introducing an electronic market place for very low procurements. In parallel, efforts are being made to strengthen the capacity of individual contracting authorities. These measures are expected to improve the efficiency and transparency of the public procurement procedures.

#### Fight against corruption

**The adoption and implementation of measures against corruption need to be accelerated.** The national anti-corruption strategy for 2017-2022 was adopted in 2017. A draft Action plan for 2019-2021 has been prepared, but its political approval is pending. Although some initial steps have been taken, many anti-corruption measures remain at an early stage. The draft law setting up the new anti-corruption authority is still to be adopted. The new authority would ensure consistency and effectiveness in preventing and combatting corruption, carry out administrative investigations, keep a register of lobbyists and coordinate the anti-corruption action plan. The draft law to protect whistle-blowers has been pending parliamentary approval since 2017. A bill regulating lobbying activities is under legal vetting. Asset declarations are to be filled in by heads of public bodies, the President, members of the executive and members of parliament. For certain categories (President, ministers and members of parliament) declarations have been submitted to the Specialized Parliamentary Committee and are now public. However, it is still unclear how the verification of declarations of assets and interests for public officials is carried out.

**Perceived corruption remains high despite minor improvements concerning its control.**

According to the Global Competitiveness report 2018 (WEF, 2018), Cyprus had fewer incidents of corruption than in the previous year. The World Bank Governance Indicators also noted a slight improvement in the corruption control index. However, the perception of corruption remains one of the highest in Europe, with 94% of people and 100 % of businesses interviewed considering corruption as widespread in their country (European Commission, 2017g).

<sup>(67)</sup> The time to comply indicator reflects the number of hours it takes to prepare, file and pay (or withhold) corporate income tax, value added or sales tax and labour taxes, including payroll taxes and mandatory social contributions (in hours per year).

**The independence of prosecution and the capacity of law enforcement to carry out corruption investigations remain weak.** There are no special safeguards to ensure the independence of the public prosecutors, which has also been noted by Council of Europe's Group of States Against Corruption.<sup>(68)</sup> Moreover, police departments entrusted with carrying out corruption investigations lack specialised expertise and experience difficulties in gathering evidence, which slows down the pace of the investigations.

the cultural and natural heritage, the development and marketing of local products, the promotion of sustainable urban mobility and the circular economy and the regeneration and security of public space.

#### 4.4.4. TERRITORIAL DISPARITIES

**Despite the country's relatively homogenous character, there are some disparities between urban and mountainous areas.** Cyprus accounts for a single Nomenclature of Territorial Units for Statistics II region, hence there is no available data that allows the characterisation of regional disparities in terms of GDP, productivity or other variables.

**During the last decades development was uneven between urban and rural and mountainous regions.** While the remote mountainous and rural areas have been steadily losing population, the urban, sub-urban and coastal areas have been growing. Two key problem areas can be identified: (i) some core urban areas are in decline as they face complex and varied problems due to the exodus of the population and businesses to more competitively-priced areas with better accessibility and infrastructure. This situation has been accompanied by a more general deterioration in economic and social conditions. Moreover, there is higher unemployment in urban areas and (ii) population decline in mountainous areas, due to their disadvantages in terms of job opportunities and quality of life.

**Integrated development might be beneficial for these areas.** The local economy of these areas could benefit from the regeneration of disadvantaged zones in urban areas, investments in tourism assets and services, the improvement of

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<sup>(68)</sup> Group of States Against Corruption recommended Cyprus to strengthen "the independence of the prosecutorial functions", 4th evaluation round.

## ANNEX A: OVERVIEW TABLE

Commitments	Summary assessment <sup>(69)</sup>
2018 country-specific recommendations (CSRs)	
<p><b>CSR 1:</b> Adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration and the governance of State-owned entities and local governments.</p> <p>Adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration</p> <p>and the governance of State-owned entities</p> <p>and local governments.</p>	<p>Cyprus has made <b>limited progress</b> in addressing CSR 1</p> <p>There has been <b>limited progress</b> in improving the efficiency of the public administration by further promoting e-governance. However, the adoption of key legislation on modernising the functioning of the public administration is still pending.</p> <p>There has been <b>limited progress</b> on the governance of State-Owned Enterprises. The draft law is still pending adoption by the House of Representatives since 2015. In the meantime, a proposal to the Council of Ministers and guidance notes are being prepared, which include most of the draft law provisions.</p> <p>There has been <b>limited progress</b> related to the reform of local governments. Relevant legislation,</p>

<sup>(69)</sup> The following categories are used to assess progress in implementing the 2017 country-specific recommendations (CSRs):

**No progress:** The Member State has not credibly announced nor adopted any measures to address the CSR. This category covers a number of typical situations, to be interpreted on a case-by-case basis taking into account country-specific conditions. They include the following:

- no legal, administrative, or budgetary measures have been announced
- in the national reform programme,
- in any other official communication to the national Parliament/relevant parliamentary committees or the European Commission, publicly (e.g. in a press statement or on the government's website);
- no non-legislative acts have been presented by the governing or legislative body;
- the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures to be taken (unless the CSR explicitly asks for orientations or exploratory actions). However, it has not proposed any clearly-specified measure(s) to address the CSR.

**Limited progress:** The Member State has:

- announced certain measures but these address the CSR only to a limited extent; and/or
- presented legislative acts in the governing or legislative body but these have not been adopted yet and substantial further, non-legislative work is needed before the CSR is implemented;
- presented non-legislative acts, but has not followed these up with the implementation needed to address the CSR.

**Some progress:** The Member State has adopted measures

- that partly address the CSR; and/or
- that address the CSR, but a fair amount of work is still needed to address the CSR fully as only a few of the measures have been implemented. For instance, a measure or measures have been adopted by the national Parliament or by ministerial decision, but no implementing decisions are in place.

**Substantial progress:** The Member State has adopted measures that go a long way towards addressing the CSR and most of them have been implemented.

**Full implementation:** The Member State has implemented all measures needed to address the CSR appropriately.

	which was submitted to the House of Representatives in 2015 is being amended.
<p><b>CSR 2:</b> Step up efforts to improve the efficiency of the judicial system by revising civil procedures, increasing the specialisation of courts and setting up a fully operational e-justice system. Take measures to fully operationalise the insolvency and foreclosure frameworks and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.</p> <p>Step up efforts to improve the efficiency of the judicial system by revising civil procedures, increasing the specialisation of courts and setting up a fully operational e-justice system.</p> <p>Take measures to fully operationalise the insolvency and foreclosure frameworks</p> <p>and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.</p>	<p>Cyprus has made <b>some progress</b> in addressing CSR 2</p> <p><b>Limited progress</b> in improving the efficiency of the judicial system. A number of measures are being implemented, but they are not yet completed. The civil procedures are still under revision and the specialisation of courts is only at an initial stage. Important measures to specialise the courts, including establishing a Commercial Court, creating new jurisdictions dealing with disputes related to credit facilities and appointing judges dedicated to handling financial disputes, are still pending. The e-justice system has not yet been developed.</p> <p><b>Substantial progress</b> on making the insolvency and foreclosure tools operational with the enactment of strengthened legal frameworks. The effective use and the overall impact of the amended frameworks will be assessed over time. Measures to improve the efficiency and effectiveness of the Insolvency Service and the profession of insolvency practitioners are still pending.</p> <p><b>Limited progress</b> on the issuance and transferring of title deeds. Efforts to reduce the backlog are ongoing, however, limited progress was achieved so far. A roadmap to reform the licensing and permitting procedures based on findings of external experts is still under preparation and further legislative amendments to ensure a reliable and swift system are pending.</p>
<p><b>CSR 3:</b> Accelerate the reduction of non-performing loans by implementing a comprehensive strategy, including legislative</p>	<p>Cyprus has made <b>substantial progress</b> in addressing CSR 3</p>

<p>amendments allowing for the effective enforcement of claims and facilitating the sale of loans. Integrate and strengthen the supervision of insurance companies and pension funds.</p> <p>Accelerate the reduction of non-performing loans by implementing a comprehensive strategy, including legislative amendments allowing for the effective enforcement of claims and facilitating the sale of loans.</p> <p>Integrate and strengthen the supervision of insurance companies and pension funds.</p>	<p><b>Substantial progress</b> in implementing a comprehensive strategy to address the high level of non-performing loans. The measures undertaken are: (i) the adoption of a legal package to facilitate the enforcement of claims and the sale of loans, (ii) the partial sale of a public bank and the transferring of non-performing loans to an asset management company and (iii) the adoption of a decision to introduce in 2019 a subsidy scheme for defaulted loans backed by primary residence. Additional measures to ensure an overall positive impact of the strategy are still pending.</p> <p><b>No progress</b> on creating a single independent supervisory authority for insurance companies and pension funds as the bill is still pending for adoption.</p>
<p><b>CSR 4:</b> Prioritise the implementation of key elements of the action plan for growth, in particular fast-tracking strategic investments, and take additional measures to improve access to finance for small and medium-sized enterprises. Improve the performance of State-owned enterprises including by resuming the implementation of privatisation projects.</p> <p>Prioritise the implementation of key elements of the action plan for growth, in particular fast-tracking strategic investments,</p> <p>and take additional measures to improve access to finance for small and medium-sized enterprises.</p>	<p>Cyprus has made <b>limited progress</b> in addressing CSR 4</p> <p><b>No progress</b> as the bill for simplifying and shortening the procedures to obtain the necessary permits for strategic investments is still pending adoption.</p> <p><b>Some progress</b> as a few measures are being implemented, mainly supported by EU funds.</p>

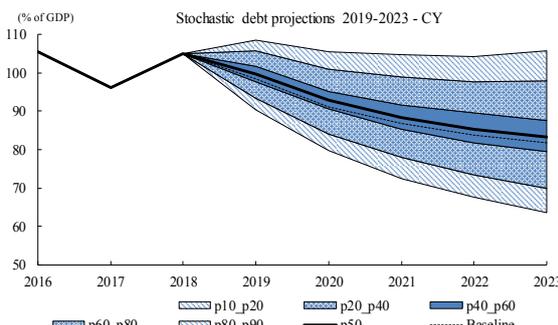
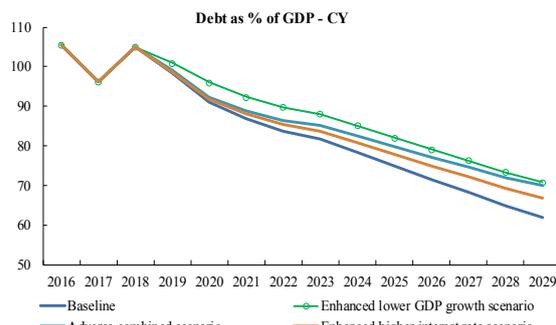
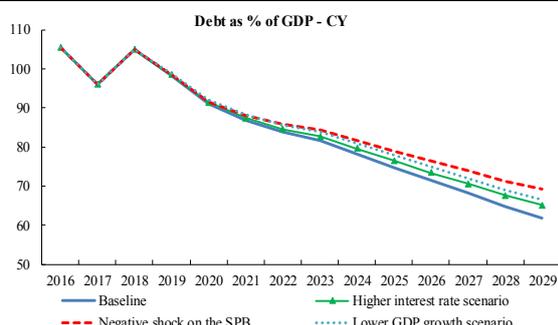
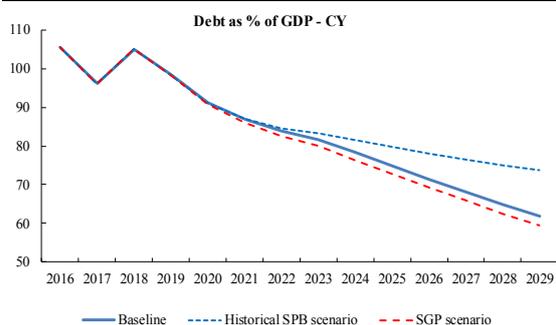
<p>Improve the performance of State-owned enterprises including by resuming the implementation of privatisation projects.</p>	<p><b>Limited progress</b> as only few efforts have been made to improve the performance of the State-Owned Enterprises. A proposal to the Council of Ministers and relevant guidance notes are under preparation. Limited progress was also made on the privatisation of the Larnaca Port / Marina, as the tendering is slowly progressing. The project is expected to advance in 2019. For the other privatisation projects, including the corporatisation of the Cyprus Telecommunications Authority (CyTA), the timeline is uncertain.</p>
<p><b>CSR 5:</b> Complete reforms aimed at increasing the capacity and effectiveness of the public employment services and reinforce outreach and activation support for young people who are not in employment education or training. Complete the reform of the education and training system, including teacher evaluation and actions to increase the capacity of vocational education and training. Take measures to ensure that the National Health System becomes fully functional in 2020, as planned.</p> <p>Complete reforms aimed at increasing the capacity and effectiveness of the public employment services and reinforce outreach and activation support for young people who are not in employment education or training.</p> <p>Complete the reform of the education and training system, including teacher evaluation and actions to increase the capacity of vocational education and training.</p> <p>Take measures to ensure that the National Health</p>	<p>Cyprus has made <b>limited progress</b> in addressing CSR 5</p> <p><b>Limited progress</b> insofar, as the capacity of the public employment services increased, but only temporarily and measures to increase the effectiveness are still pending. There has also been limited progress in outreaching and activating young people not in employment, education or training. An action plan was prepared, but its implementation is very slow.</p> <p><b>Limited progress</b>, as only some areas are progressing well, such as teachers' appointment system, revised curricula and the introduction of new specialisations in vocational and technical education, in line with labour market needs. However, only limited progress has been made on teachers' evaluation, where a proposal is still pending. Slow and fragmented progress has been made with the reform of the vocational education and training system, while no progress has been recorded as regards the capacity (infrastructure and facilities).</p> <p>There has been <b>some progress</b> in undertaking</p>

System becomes fully functional in 2020, as planned.	measures to ensure that the National Health System becomes functional in 2020 as planned. Secondary legislation has been adopted and the reform of the primary healthcare system is advancing.
Europe 2020 (national targets and progress)	
Employment rate target: 75% - 77% of the population aged 20–64.	70.8% (2017). Employment increased in all sectors, but it remains below the pre-crisis level, when Cyprus was already meeting its national target.
R&D target: 0.5 % of GDP	In 2017, R&D intensity in Cyprus was 0.56% of GDP composed of 37% -48% including non-profit- private investment (0.20% of GDP) and 52% public investment (0.29% of GDP).
National greenhouse gas emissions target: - 5 % in 2020 compared with 2005 (in sectors not included in the EU emissions trading scheme)	3% (c.t. 2005) (2017). Greenhouse gas emissions in Cyprus continue to increase, and according to preliminary 2017 data and the latest national projections, Cyprus is expected to miss its target with a significant margin of around 12 percentage points.
2020 renewable energy target: 13 %	9.85% (2017) Cyprus renewable energy share increase from 9.3 % in 2016 to around 9.9 % in 2017; achieving the target for 2020 appears problematic. Considering Cyprus' high potential in this area the objective is still possible, but it would require a significant shift of the national energy policies.
Energy efficiency, 2020 energy consumption targets:  Cyprus' 2020 energy efficiency target is 2.2Mtoe expressed in primary energy consumption	2.5 Mtoe (2017). Primary energy consumption was reduced during the economic recession from 2.5 Mtoe in 2012 to 2.2 Mtoe in 2015, but in line with the sustained economic growth rose again to 2.5 Mtoe in 2017. This poses a serious challenge in reaching the target without strong additional measures. Furthermore, over 90 % of Cyprus' energy consumption continues to be covered by imported oil and oil products.

Early school/training leaving target: 10 %.	8.5 % (2017). Cyprus has reached the national and EU2020 target, even though the early school/training leaving rate increased further in 2017, especially among female pupils.
Tertiary education target: 46 % of population aged 30-34.	55.9 % (2017). Tertiary education attainment rose further to 55.9% surpassing both the national and the EU2020 target. However, skills mismatches persist and the share of science, technology, engineering and mathematics graduates is particularly low.
Target for reducing the number of people at risk of poverty or social exclusion, expressed as an absolute number of people: 27 000 (base year 2010: 19.3 %).	The share of people at risk of poverty or social exclusion is high at 25.2% but declining. The overall rate declined for the second year in a row by 19 000 compared to 2016 or 29 000 compared to 2015, the number of children at risk of poverty or social exclusion also recorded significant improvement. This can be attributed to a positive economic and labour market conditions as well as the roll out of the guaranteed minimum income scheme.

# ANNEX B: COMMISSION DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

General Government debt projections under baseline, alternative scenarios and sensitivity tests													
CY - Debt projections baseline scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
<b>Gross debt ratio</b>	<b>96.1</b>	<b>105.0</b>	<b>98.4</b>	<b>91.0</b>	<b>86.9</b>	<b>83.8</b>	<b>81.7</b>	<b>78.3</b>	<b>74.8</b>	<b>71.4</b>	<b>68.2</b>	<b>64.9</b>	<b>61.9</b>
<i>Changes in the ratio (-1+2+3)</i>	-9.4	8.8	-6.6	-7.3	-4.2	-3.1	-2.2	-3.4	-3.4	-3.4	-3.2	-3.3	-3.0
<i>of which</i>													
<b>(1) Primary balance (1.1+1.2+1.3)</b>	<b>4.3</b>	<b>5.5</b>	<b>5.5</b>	<b>5.2</b>	<b>4.3</b>	<b>3.6</b>	<b>2.9</b>	<b>3.0</b>	<b>3.1</b>	<b>3.2</b>	<b>3.1</b>	<b>3.4</b>	<b>3.2</b>
<b>(1.1) Structural primary balance (1.1.1-1.1.2+1.1.3)</b>	<b>4.1</b>	<b>4.4</b>	<b>3.6</b>	<b>2.9</b>	<b>2.8</b>	<b>2.9</b>	<b>2.9</b>	<b>3.0</b>	<b>3.1</b>	<b>3.2</b>	<b>3.1</b>	<b>3.4</b>	<b>3.2</b>
<i>(1.1.1) Structural primary balance (bef. CoA)</i>	4.1	4.4	3.6	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
<i>(1.1.2) Cost of ageing</i>					0.1	0.1	0.0	-0.1	-0.2	-0.3	-0.2	-0.5	-0.3
<i>(1.1.3) Others (taxes and property incomes)</i>					0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
<b>(1.2) Cyclical component</b>	<b>0.3</b>	<b>1.2</b>	<b>1.8</b>	<b>2.2</b>	<b>1.5</b>	<b>0.7</b>	<b>0.0</b>						
<b>(1.3) One-off and other temporary measures</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>(2) Snowball effect (2.1+2.2+2.3)</b>	<b>-3.2</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-2.2</b>	<b>0.2</b>	<b>0.5</b>	<b>0.7</b>	<b>-0.4</b>	<b>-0.3</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.2</b>
<i>(2.1) Interest expenditure</i>	2.6	2.7	2.4	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.2	2.2	2.3
<i>(2.2) Growth effect</i>	-4.2	-3.5	-3.5	-2.7	-0.4	0.0	0.3	-0.9	-0.9	-0.9	-0.9	-0.9	-0.8
<i>(2.3) Inflation effect</i>	-1.6	-2.0	-1.3	-1.7	-1.6	-1.6	-1.6	-1.6	-1.5	-1.5	-1.4	-1.3	-1.3
<b>(3) Stock-flow adjustments</b>	<b>-1.8</b>	<b>17.2</b>	<b>1.3</b>	<b>0.0</b>									



Short term	Medium term	S1	Debt sustainability analysis (detail)							DSA	S2	Long term
			Baseline	Historical SPB	Lower GDP growth	Higher interest rate	Negative shock on SPB	Stochastic projections				
<b>HIGH</b> (S0 = 0.5)	<b>MEDIUM</b>	<b>LOW</b> (S1 = -0.7)	<b>MEDIUM</b>	<b>MEDIUM</b>	<b>MEDIUM</b>	<b>MEDIUM</b>	<b>MEDIUM</b>	<b>MEDIUM</b>		<b>MEDIUM</b>	<b>LOW</b> (S2 = -0.9)	<b>MEDIUM</b>
			Debt level (2029)	61.9	73.9	66.5	65.1	69.2				
			Debt peak year	2018	2018	2018	2018	2018				
			Percentile rank	17.0%	29.0%							
			Probability debt higher					10.5%				
			Dif. between percentiles					42.2				

**Note:** For further information, see the European Commission Fiscal Sustainability Report (FSR) 2018.

[1] The first table presents the baseline no-fiscal policy change scenario projections. It shows the projected government debt dynamics and its decomposition between the primary balance, snowball effects and stock-flow adjustments. Snowball effects measure the net impact of the counteracting effects of interest rates, inflation, real GDP growth (and exchange rates in some countries). Stock-flow adjustments include differences in cash and accrual accounting, net accumulation of assets, as well as valuation and other residual effects.

[2] The charts present a series of sensitivity tests around the baseline scenario, as well as alternative policy scenarios, in particular: the historical structural primary balance (SPB) scenario (where the SPB is set at its historical average), the Stability and Growth Pact (SGP) scenario (where fiscal policy is assumed to evolve in line with the main provisions of the SGP), a higher interest rate scenario (+1 pp. compared to the baseline), a lower GDP growth scenario (-0.5 pp. compared to the baseline) and a negative shock on the SPB (calibrated on the basis of the forecasted change). An adverse combined scenario and enhanced sensitivity tests (on the interest rate and growth) are also included, as well as stochastic projections. Detailed information on the design of these projections can be found in the FSR 2018.

[3] The second table presents the overall fiscal risk classification over the short, medium and long-term.

a. For the short-term, the risk category (low/high) is based on the S0 indicator. S0 is an early-detection indicator of fiscal stress in the upcoming year, based on 25 fiscal and financial-competitiveness variables that have proven in the past to be leading indicators of fiscal stress. The critical threshold beyond which fiscal distress is signalled is 0.46.

b. For the medium-term, the risk category (low/medium/high) is based on the joint use of the S1 indicator and of the DSA results. The S1 indicator measures the fiscal adjustment required (cumulated over the 5 years following the forecast horizon and sustained thereafter) to bring the debt-to-GDP ratio to 60% by 2033. The critical values used are 0 and 2.5 pps. of GDP. The DSA classification is based on the results of 5 deterministic scenarios (baseline, historical SPB, higher interest rate, lower GDP growth and negative shock on the SPB scenarios) and the stochastic projections. Different criteria are used such as the projected debt level, the debt path, the realism of fiscal assumptions, the probability of debt stabilisation, and the size of uncertainties.

c. For the long-term, the risk category (low/medium/high) is based on the joint use of the S2 indicator and the DSA results. The S2 indicator measures the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical values used are 2 and 6 pps. of GDP. The DSA results are used to further qualify the long-term risk classification, in particular in cases when debt vulnerabilities are identified (a medium / high DSA risk category).

## ANNEX C: STANDARD TABLES

Table C.1: **Financial market indicators**

	2013	2014	2015	2016	2017	2018
Total assets of the banking sector (% of GDP) <sup>1)</sup>	497.7	517.6	512.9	468.1	410.9	335.4
Share of assets of the five largest banks (% of total assets)	64.1	63.4	67.5	65.8	84.1	-
Foreign ownership of banking system (% of total assets) <sup>2)</sup>	33.9	35.2	19.2	21.6	19.1	18.9
Financial soundness indicators: <sup>2)</sup>						
- non-performing loans (% of total loans)	-	38.6	36.3	35.4	30.7	28.1
- capital adequacy ratio (%)	13.5	15.3	16.6	16.8	16.3	15.5
- return on equity (%) <sup>3)</sup>	-37.9	-7.1	-7.7	1.7	-11.5	3.9
Bank loans to the private sector (year-on-year % change) <sup>1)</sup>	-9.4	-4.2	3.6	-8.3	0.7	-5.4
Lending for house purchase (year-on-year % change) <sup>1)</sup>	-6.8	-2.8	-3.0	-1.0	-0.7	-0.3
Loan to deposit ratio <sup>2)</sup>	-	83.7	83.2	77.9	71.9	65.6
Central Bank liquidity as % of liabilities <sup>1)</sup>	-	12.4	6.9	1.3	1.6	1.5
Private debt (% of GDP)	340.1	352.4	353.5	337.8	316.3	-
Gross external debt (% of GDP) - public	-	-	-	-	-	-
- private	-	-	-	-	-	-
Long-term interest rate spread versus Bund (basis points)*	493.0	483.7	404.1	368.3	230.6	174.5
Credit default swap spreads for sovereign securities (5-year)*	943.9	423.1	330.6	262.5	180.0	117.3

(1) Latest data Q3 2018. Includes not only banks but all monetary financial institutions excluding central banks.

(2) Latest data Q2 2018.

(3) Quarterly values are annualised.

\* Measured in basis points.

**Source:** European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators)

Table C.2: **Headline Social Scoreboard indicators**

	2013	2014	2015	2016	2017	2018 <sup>6</sup>
<b>Equal opportunities and access to the labour market</b>						
Early leavers from education and training (% of population aged 18-24)	9.1	6.8	5.2	7.6	8.5	:
Gender employment gap (pps)	10.4	7.7	8.3	9.7	9.5	10.2
Income inequality, measured as quintile share ratio (S80/S20)	4.9	5.4	5.2	4.9	4.6	:
At-risk-of-poverty or social exclusion rate <sup>1</sup> (AROPE)	27.8	27.4	28.9	27.7	25.2	:
Young people neither in employment nor in education and training (% of population aged 15-24)	18.7	17.0	15.3	16.0	16.1	:
<b>Dynamic labour markets and fair working conditions<sup>†</sup></b>						
Employment rate (20-64 years)	67.2	67.6	67.9	68.7	70.8	73.7
Unemployment rate <sup>2</sup> (15-74 years)	15.9	16.1	15.0	13.0	11.1	8.7
Long-term unemployment rate <sup>3</sup> (as % of active population)	6.1	7.7	6.8	5.8	4.5	2.7
Gross disposable income of households in real terms per capita <sup>4</sup> (Index 2008=100)	81.8	75.9	78.0	82.1	84.6	:
Annual net earnings of a full-time single worker without children earning an average wage (levels in PPS, three-year average)	:	:	:	:	:	:
Annual net earnings of a full-time single worker without children earning an average wage (percentage change, real terms, three-year average)	:	:	:	:	:	:
<b>Public support / Social protection and inclusion</b>						
Impact of social transfers (excluding pensions) on poverty reduction <sup>5</sup>	37.0	41.5	36.2	35.6	35.9	:
Children aged less than 3 years in formal childcare	24.0	25.5	20.8	24.9	28.2	:
Self-reported unmet need for medical care	4.4	4.7	1.5	0.6	1.5	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	43.0	43.0	50.0	:

(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 households with zero or very low work intensity (LWI).

(2) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.

(3) Long-term unemployed are people who have been unemployed for at least 12 months.

(4) Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2019.

(5) Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).

(6) Average of first three quarters of 2018 for the employment rate, long-term unemployment rate and gender employment gap. Data for unemployment rate is annual (except for DK, EE, EL, HU, IT and UK data based on first three quarters of 2018).

**Source:** Eurostat

Table C.3: Labour market and education indicators

Labour market indicators	2013	2014	2015	2016	2017	2018 <sup>4</sup>
Activity rate (15-64)	73.6	74.3	73.9	73.4	73.9	75.0
Employment in current job by duration						
From 0 to 11 months	15.7	18.5	18.1	19.7	20.0	:
From 12 to 23 months	8.5	7.6	9.5	9.7	10.2	:
From 24 to 59 months	17.9	15.7	14.9	13.7	13.7	:
60 months or over	57.9	58.2	57.5	56.9	56.1	:
Employment growth*						
(% change from previous year)	-5.9	-1.8	1.5	4.6	3.9	4.2
Employment rate of women						
(% of female population aged 20-64)	62.2	63.9	64.0	64.1	66.2	68.7
Employment rate of men						
(% of male population aged 20-64)	72.6	71.6	72.3	73.8	75.7	79.0
Employment rate of older workers*						
(% of population aged 55-64)	49.6	46.9	48.5	52.2	55.3	60.9
Part-time employment*						
(% of total employment, aged 15-64)	11.9	13.5	13.0	13.4	12.2	11.1
Fixed-term employment*						
(% of employees with a fixed term contract, aged 15-64)	17.5	19.0	18.4	16.5	15.3	14.2
Participation in activation labour market policies						
(per 100 persons wanting to work)	5.6	8.6	9.4	7.0	:	:
Transition rate from temporary to permanent employment						
(3-year average)	22.0	20.4	21.6	26.3	31.2	:
Youth unemployment rate						
(% active population aged 15-24)	38.9	36.0	32.8	29.1	24.7	20.1
Gender gap in part-time employment (aged 20-64)						
	7.1	6.3	5.4	4.3	6.6	6.8
Gender pay gap <sup>1</sup> (in undadjusted form)						
	14.9	14.2	14.0	13.9	13.7	:
<b>Education and training indicators</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
Adult participation in learning						
(% of people aged 25-64 participating in education and training)	7.2	7.1	7.5	6.9	6.9	:
Underachievement in education <sup>2</sup>	:	:	42.6	:	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	47.8	52.5	54.5	53.4	55.9	:
Variation in performance explained by students' socio-economic status <sup>3</sup>	:	:	9.5	:	:	:

\* Non-scoreboard indicator

(1) Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included.

(2) PISA (OECD) results for low achievement in mathematics for 15 year-olds.

(3) Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.

(4) Average of first three quarters of 2018 for the activity rate, employment growth, employment rate, part-time employment, fixed-term employment. Data for youth unemployment rate is annual (except for DK, EE, EL, HU, IT and UK data based on first three quarters of 2018).

**Source:** Eurostat, OECD

Table C.4: Social inclusion and health indicators

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
<i>Sickness/healthcare</i>	3.5	3.7	3.3	3.4	3.5	:
<i>Disability</i>	0.7	0.7	0.7	0.7	0.8	:
<i>Old age and survivors</i>	10.7	11.5	11.2	11.1	10.5	:
<i>Family/children</i>	1.5	1.5	1.4	1.4	1.3	:
<i>Unemployment</i>	1.6	2.0	1.5	1.2	1.0	:
<i>Housing</i>	0.6	0.4	0.3	0.4	0.3	:
<i>Social exclusion n.e.c.</i>	1.2	1.1	1.1	1.3	1.2	:
<b>Total</b>	19.8	20.8	19.6	19.4	18.7	:
<i>of which: means-tested benefits</i>	2.9	2.7	2.6	2.8	2.8	:
General government expenditure by function (% of GDP, COFOG)						
<i>Social protection</i>	12.9	13.4	13.7	13.6	13.8	:
<i>Health</i>	3.0	3.1	2.6	2.6	2.6	:
<i>Education</i>	6.3	6.8	6.0	6.0	6.0	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	44.0	43.1	44.8	44.3	44.9	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	27.5	27.7	24.7	28.9	29.6	25.5
At-risk-of-poverty rate <sup>1</sup> (% of total population)	14.7	15.3	14.4	16.2	16.1	15.7
In-work at-risk-of-poverty rate (% of persons employed)	7.9	8.9	7.8	9.1	8.2	7.9
Severe material deprivation rate <sup>2</sup> (% of total population)	15.0	16.1	15.3	15.4	13.6	11.5
Severe housing deprivation rate <sup>3</sup> , by tenure status						
<i>Owner, with mortgage or loan</i>	0.0	1.1	1.5	0.0	2.0	0.7
<i>Tenant, rent at market price</i>	1.9	2.6	3.0	1.3	1.6	1.7
Proportion of people living in low work intensity households <sup>4</sup> (% of people aged 0-59)	6.5	7.9	9.7	10.9	10.6	9.4
Poverty thresholds, expressed in national currency at constant prices*	8958	8148	7363	7072	7301	7642
Healthy life years (at the age of 65)						
<i>Females</i>	7.7	8.7	8.8	7.3	10.3	:
<i>Males</i>	8.8	9.5	10.4	8.4	11.2	:
Aggregate replacement ratio for pensions <sup>5</sup> (at the age of 65)	0.4	0.4	0.4	0.4	0.4	0.4
Connectivity dimension of the Digital Economy and Society Index (DESI) <sup>6</sup>	:	:	37.7	40.4	48.2	54.6
GINI coefficient before taxes and transfers*	42.9	43.8	44.8	47.4	47.1	45.8
GINI coefficient after taxes and transfers*	31.0	32.4	34.8	33.6	32.1	30.8

\* Non-scoreboard indicator

(1) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.

(2) Proportion of people who experience at least four of the following forms of deprivation: not being able to 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.

(3) Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.

(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.

(5) Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.

(6) Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.

Source: Eurostat, OECD

Table C.5: Product market performance and policy indicators

Performance indicators	2012	2013	2014	2015	2016	2017
Labour productivity per person <sup>1</sup> growth (t/t-1) in %						
Labour productivity growth in industry	-4.38	-2.63	4.65	4.51	6.16	3.97
Labour productivity growth in construction	-6.25	-8.36	-2.98	-1.86	8.18	14.21
Labour productivity growth in market services	0.33	0.47	-0.92	-0.52	-0.73	-0.67
Unit Labour Cost (ULC) index <sup>2</sup> growth (t/t-1) in %						
ULC growth in industry	10.70	-13.03	-2.01	-3.34	-5.50	-3.76
ULC growth in construction	2.82	1.10	-2.55	0.96	-7.28	-11.67
ULC growth in market services	1.15	-4.75	-2.79	-0.35	0.13	0.67
<b>Business environment</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Time needed to enforce contracts <sup>3</sup> (days)	735	735	1100	1100	1100	1100
Time needed to start a business <sup>3</sup> (days)	8.0	8.0	8.0	8.0	6.0	6.0
Outcome of applications by SMEs for bank loans <sup>4</sup>	:	1.41	1.34	1.76	0.76	1.57
<b>Research and innovation</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
R&D intensity	0.44	0.48	0.51	0.48	0.53	0.56
General government expenditure on education as % of GDP	6.30	6.80	6.00	6.00	6.00	:
Employed people with tertiary education and/or people employed in science and technology as % of total employment	47	48	50	49	48	48
Population having completed tertiary education <sup>5</sup>	35	35	36	36	38	38
Young people with upper secondary education <sup>6</sup>	88	90	92	94	91	90
Trade balance of high technology products as % of GDP	-1.00	-0.23	-1.24	-0.33	-1.90	-1.59
<b>Product and service markets and competition</b>				<b>2003</b>	<b>2008</b>	<b>2013</b>
OECD product market regulation (PMR) <sup>7</sup> , overall				:	:	1.65
OECD PMR <sup>7</sup> , retail				:	:	1.67
OECD PMR <sup>7</sup> , professional services				:	:	3.11
OECD PMR <sup>7</sup> , network industries <sup>8</sup>				:	:	2.64

(1) Value added in constant prices divided by the number of persons employed.

(2) Compensation of employees in current prices divided by value added in constant prices.

(3) The methodologies, including the assumptions, for this indicator are shown in detail here:

<http://www.doingbusiness.org/methodology>.

(4) Average of the answer to question Q7B\_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received most of it, two if only received a limited part of it, three if refused or rejected and treated as missing values if the application is still pending or don't know.

(5) Percentage population aged 15-64 having completed tertiary education.

(6) Percentage population aged 20-24 having attained at least upper secondary education.

(7) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: <http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm>

(8) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).

**Source:** European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans).

Table C.6: **Green growth**

<b>Green growth performance</b>		<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
<b>Macroeconomic</b>							
Energy intensity	kgoe / €	0.13	0.12	0.13	0.13	0.13	0.13
Carbon intensity	kg / €	0.46	0.44	0.47	0.47	0.47	-
Resource intensity (reciprocal of resource productivity)	kg / €	0.88	0.68	0.68	0.67	0.75	0.86
Waste intensity	kg / €	0.10	-	0.11	-	0.13	-
Energy balance of trade	% GDP	-7.5	-6.3	-5.9	-4.1	-3.4	-4.2
Weighting of energy in HICP	%	9.42	9.53	9.33	8.35	7.46	7.43
Difference between energy price change and inflation	%	17.9	-7.0	-8.8	-17.5	-13.5	12.9
Real unit of energy cost	% of value added	17.3	16.9	15.2	15.7	16.2	-
Ratio of environmental taxes to labour taxes	ratio	0.23	0.25	0.27	0.26	0.25	-
Environmental taxes	% GDP	2.6	2.7	3.1	3.0	2.9	2.9
<b>Sectoral</b>							
Industry energy intensity	kgoe / €	0.08	0.10	0.13	0.12	0.11	0.10
Real unit energy cost for manufacturing industry excl. refining	% of value added	34.8	37.3	33.2	35.1	37.1	-
Share of energy-intensive industries in the economy	% GDP	3.5	2.9	2.9	3.0	3.2	-
Electricity prices for medium-sized industrial users	€ / kWh	0.23	0.20	0.18	0.14	0.12	0.14
Gas prices for medium-sized industrial users	€ / kWh	-	-	-	-	-	-
Public R&D for energy	% GDP	0.00	0.00	0.00	0.00	0.00	0.00
Public R&D for environmental protection	% GDP	0.00	0.00	0.00	0.00	0.00	0.00
Municipal waste recycling rate	%	13.6	14.6	16.8	17.9	17.2	16.1
Share of GHG emissions covered by ETS*	%	50.3	50.6	53.2	50.1	53.1	-
Transport energy intensity	kgoe / €	0.83	0.70	0.74	0.79	0.83	0.84
Transport carbon intensity	kg / €	1.79	1.50	1.59	1.72	1.80	-
<b>Security of energy supply</b>							
Energy import dependency	%	97.0	96.3	93.2	97.7	96.2	96.3
Aggregated supplier concentration index	HHI	0.0	0.0	0.0	0.0	0.0	-
Diversification of energy mix	HHI	0.90	0.88	0.88	0.87	0.87	0.86

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 prices)

Energy intensity: gross inland energy consumption (Europe 2020-2030) (in kgoe) divided by GDP (in EUR)

Carbon intensity: greenhouse gas emissions (in kg CO<sub>2</sub> equivalents) divided by GDP (in EUR)

Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)

Real unit energy cost: real energy costs as % of total value added for the economy

Industry energy intensity: final energy use in industry (in kgoe) divided by gross value added of industry, including construction (in 2010 EUR)

Real unit energy costs for manufacturing industry excluding refining : real costs as % of value added for manufacturing sectors

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Electricity and gas prices for medium-sized industrial users: consumption band 500–2000MWh and 10 000–100 000 GJ; figures excl. VAT.

Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste

Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP

Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG emissions (excl. land use, land use change and forestry) as reported by Member States to the European Environment Agency.

Transport energy intensity: final energy use in transport sector including international aviation, (in kgoe) divided by transport industry gross value added (in 2010 EUR)

Transport carbon intensity: GHG emissions in transport sector divided by gross value added of the transport activities

Energy import dependency: net energy imports divided by gross inland energy consumption plus consumption of international maritime bunkers

Aggregated supplier concentration index: Herfindahl-Hirschman index for net imports of crude oil and NGL, natural gas and hard coal. Smaller values indicate larger diversification and hence lower risk.

Diversification of the energy mix: Herfindahl-Hirschman index of the main energy products in the gross inland consumption of energy

\* European Commission and European Environment Agency

**Source:** European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes); Eurostat (all other indicators)

## ANNEX D: INVESTMENT GUIDANCE ON COHESION POLICY FUNDING 2021-2027 FOR CYPRUS

Building on the Commission’s proposal for the next Multi-Annual Financial Framework for the period 2021-2027 of 2 May 2018 (COM (2018) 321), this Annex presents the preliminary Commission services’ views on priority investment areas and framework conditions for effective delivery for the 2021-2027 Cohesion Policy <sup>(70)</sup>. These priority investment areas are derived from the broader context of investment bottlenecks, investment needs and regional disparities assessed in the report. This Annex provides the basis for a dialogue between Cyprus and the Commission services in view of the programming of the Cohesion policy funds (European Regional Development Fund, Cohesion Fund and European Social Fund Plus).

### **Policy Objective 1: A Smarter Europe – Innovative and smart industrial transformation**

Cyprus remains a moderate innovator, with innovation performance having declined since 2010. Public and private research and development expenditure levels are among the lowest in the EU and interaction between academia and businesses is very limited. In order to strengthen innovation performance and foster productivity growth, investments should be geared towards already identified or potential new smart specialisation areas, on the basis of national needs and potential. Priority investment needs<sup>(71)</sup> have been identified to **enhance research and innovation capacity of the business sector and increase the uptake of advanced technologies**, and in particular:

- promotion of business investment in research and innovation and entrepreneurial universities and collaboration between research institutions, universities and businesses;
- promotion of business technology transfer, networking, clusters and open innovation, including in cooperation with other countries;
- support of activities that allow innovations to reach the market, including diffusion of digital and other key enabling technologies, especially for start-ups and small and medium-sized enterprises;
- support of the establishment of Living Labs, test-beds and ecosystems that bring together the demand and supply sides to promote the development and actual use of innovative solutions for public sector needs.

Cyprus has a moderate digital enabling environment and low performance on digital transformation. Priority investments needs have been identified to **reap the benefits offered by digitalisation and E-services for citizens, businesses and public sector**, and in particular to:

- provide support for the increase of Information and Communications Technology uptake in small and medium-sized enterprises, including supporting infrastructures and services;
- increase the range of e-service provision (e-government, e-procurement, e-inclusion, e-health, e-learning, e-skilling, e-commerce) and their uptake by citizens and businesses.

Increasing entrepreneurship and the innovation capacity of the business sector and boosting investments and access to finance are crucial for the country to improve competitiveness of small and medium-sized enterprises. High priority investment needs have been identified to **enhance growth and competitiveness**

<sup>(70)</sup> This Annex is to be considered in conjunction with the EC Proposal for a Regulation of the European Parliament and of the Council on the European Regional Development Fund and on the Cohesion Fund COM(2018) 372 and the EC Proposal for a Regulation of the European Parliament and of the Council on the European Social Fund Plus COM(2018) 382, in particular as regards the requirements for thematic concentration and urban earmarking outlined in these proposals.

<sup>(71)</sup> The intensity of needs is classified in three categories in a descending order – high priority needs, priority needs, needs.

<p>and to increase export market shares of small and medium-sized enterprises, and in particular to:</p> <ul style="list-style-type: none"> <li>• foster the creation of new firms, growth of start-ups/scale-ups, accelerators; develop and implement new business models for small and medium-sized enterprises through business advisory services;</li> <li>• facilitate access to finance and advanced business services for small and medium-sized enterprises;</li> <li>• boost internationalisation of small and medium-sized enterprises through cooperation and clustering, identification of and participation in new export markets, participation in industry led and research driven inter-regional cooperation networks and clusters;</li> <li>• support training and reskilling for smart specialisation areas within firms, research institutions, advisory services and build the necessary administrative capacity, in particular in digital skills.</li> </ul>
<p><b>Policy Objective 2: A low carbon and greener Europe – Clean and fair energy transition, Green and blue investment, circular economy, climate adaptation and risk prevention</b></p>
<p>Cyprus' building stock, constructed with no or very low level of thermal protection, represents a source of energy inefficiency. High priority investment needs have been identified to <b>promote energy efficiency measures</b>, and in particular to:</p> <ul style="list-style-type: none"> <li>• improve energy efficiency in residential and public buildings and small and medium-sized enterprises premises.</li> </ul>
<p>Cyprus is highly dependent on fossil fuels and its considerable potential for renewable energy generation has been underexploited so far. The high levels of greenhouse gas emissions are mostly due to energy production and transport. Priority investment needs have been identified to <b>promote renewable energy</b>, and in particular solar power, also in the context of the “Clean Energy for EU islands” Initiative, namely to:</p> <ul style="list-style-type: none"> <li>• promote small-scale electricity generation based on renewable energy sources, e.g. by renewable energy self-consumers, and locally led initiatives, notably in rural areas.</li> </ul>
<p>Cyprus is characterised by the over-abstraction of groundwater and water scarcity, while a considerable amount of wastewater is still discharged without collection or treatment. High priority investment needs have been identified to promote <b>sustainable water management</b> and improve resource efficiency, in particular:</p> <ul style="list-style-type: none"> <li>• reinforcement, upgrading of water supply networks, water leakage control and other water saving measures, including water reuse, for purposes other than drinking water (e.g. urban irrigation);</li> <li>• collection and treatment of wastewater.</li> </ul>
<p>Significant gaps still remain in reaching EU’s objectives in the area of solid waste management. Waste generation is higher than EU average. Cyprus landfills the majority of its solid waste and lags behind in recycling and reuse. High priority investment needs have been identified to ensure the <b>transition towards the circular economy</b> and to <b>improve waste management</b>, also in the context of the “Clean Energy for EU islands” Initiative, and in particular to:</p> <ul style="list-style-type: none"> <li>• promote separate collection schemes and units for waste streams (paper, plastic, metal, glass, and bio-waste), reuse centres, repair networks, composting and sorting plants, other measures to prepare for</li> </ul>

<p>reuse and recycling;</p> <ul style="list-style-type: none"> <li>• raise awareness and support sustainable consumption practices and behaviour;</li> <li>• modernise or upgrade existing recycling infrastructure to new long-term recycling targets.</li> </ul>
<p>Forest fires, agricultural land abandonment, erosion, desertification and loss of biodiversity are some of the consequences of climate change in Cyprus, which affect not only the rural economy but also tourism, thus compromising economic development. Investment needs have been identified to <b>mitigate climate change effects and enhance biodiversity</b>, and in particular:</p> <ul style="list-style-type: none"> <li>• prevention and preparedness measures and awareness-raising campaigns for disaster risk management, flood protection, development of early warning systems and training for civil protection units, management of land, forests and rivers to prevent specific risks;</li> <li>• support of green infrastructure in urban environment and effective management and protection of the Natura 2000 areas.</li> </ul>
<p><b>Policy Objective 3: A more connected Europe – Mobility and regional Information and Communications Technology connectivity</b></p>
<p>While road and port infrastructures are well developed, there is a very low use of green urban transport. Priority investment needs have been identified to <b>promote sustainable multimodal urban mobility</b>, in the framework of sustainable urban mobility strategies, in particular in Nicosia, as largest urban area:</p> <ul style="list-style-type: none"> <li>• promotion of a shift towards sustainable and accessible modes of transport, such as low-carbon collective public transport and active modes of transport, only for non-fossil-based means of transport;</li> <li>• support infrastructure investments into the backbone of the urban transport system, such as light rail or tramlines, in particular in Nicosia, and cycling friendly infrastructure.</li> </ul>
<p><b>Policy Objective 4: A more social Europe – Implementing the European Pillar of Social Rights</b></p>
<p>The share of youth not in education, employment or training is high and the labour market situation of young people remains precarious, while participation in, and targeting of, activation measures are limited. High priority investment needs have therefore been identified to <b>improve access to employment, in particular for youth and long-term unemployed, promoting self-employment and the social economy, and modernise labour market institutions and services</b>, and in particular to:</p> <ul style="list-style-type: none"> <li>• improve labour market matching and upskilling/reskilling of employees and promote a tailored and inclusive strategy and approach to the labour market integration of the youth, in particular through mapping and profiling of youth not in education, employment or training by Public Employment Services;</li> <li>• support active labour market measures accessible to all through the validation of competences, skills and career outplacement, targeted and well-designed wage and recruitment subsidies, job and training mobility measures, on-the-job training and second-chance programmes;</li> <li>• support self-employment, job creation and social innovation by facilitating, access to (micro-) finance and business development services, including for inactive people.</li> </ul>

Participation in vocational education and training and adult participation in learning remain low; Science, Technology, Engineering, Mathematics and Information and Communications Technology skills are lacking and a comprehensive lifelong learning approach is missing. Priority investment needs have therefore been identified to **improve the quality, effectiveness and labour market relevance of education and training and promote lifelong learning, including digital skills, better anticipating change and new skills requirements**, and in particular to:

- improve basic skills attainments, including for disadvantaged groups, and support digital skills' development and validation;
- improve the labour market relevance of education and training through enhanced monitoring and evaluation, including graduate tracking;
- make vocational education and training more attractive by combating stereotypes and set up flexible governance mechanisms; promote partnerships between relevant stakeholders in order to (a) provide information on labour market needs, (b) promote workplace learning and (c) invest in vocational education and training infrastructure in line with evolving skills needs;
- support continuous training for educators;
- implement adult learning programmes in consultation with social partners and civil society, supported by guidance and validation services.

Material deprivation and social exclusion rates are above pre-crisis levels and the number of asylum seekers is growing; healthcare spending is low and out-of-pocket payments high. Investment needs have therefore been identified to **address material deprivation, promote the socio-economic integration of third country nationals and marginalised communities, enhance access to affordable and effective services and social protection and improve effectiveness and resilience of healthcare systems and long-term care services**, and in particular to:

- strengthen cooperation between relevant stakeholders for increased outreach and personalised services to disadvantaged people and provide social inclusion and long-term integration measures; deliver basic material assistance to people most in need, including migrants and refugees, and community-based services for vulnerable groups;
- increase the provision of affordable high-quality early childhood education and care;
- improve the healthcare system and ensure integration of primary, hospital and long-term care.

**Policy Objective 5 – A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives**

Cyprus' remote mountainous and rural areas have been losing population and do not offer enough job opportunities or basic services, while some urban core areas face decline and varied problems (e.g. depopulation, deterioration of historic urban cores and of economic and social conditions). Priority investment needs have been identified, also in the context of the “Clean Energy for EU islands” Initiative, to **foster the integrated territorial development of urban, rural and mountainous areas**, and in particular to:

- promote Sustainable Urban Development strategies in the main urban centres, fostering their social, economic and environmental development, cultural heritage and security;
- promote the integration of smaller urban centres in the urban network, including urban-rural linkages;
- regenerate disadvantaged zones/areas in the urban areas, including the promotion of productive activities and the social economy in deprived neighbourhoods;
- promote circular economy, sustainable tourism, culture and cultural heritage and alternative economic activities in mountainous and rural areas, in the context of sustainable integrated development plans.

**Factors for effective delivery of Cohesion policy**

- broader use of financial instruments and/or contributions to a Cyprus’ compartment under InvestEU for revenue-generating and cost-saving activities;
- have in place a clear division of responsibilities in the programming, management and implementation cycle;
- improve public procurement performance, in particular by optimising the number of contracting authorities, while at the same time ensuring sufficient administrative capacity necessary for the effective administration and implementation of the Funds and its necessary support;
- ensure simplification and transparency of selection and implementation procedures;
- put in place improved and more efficient measures to prevent and address conflict of interest, fraud and corruption;
- strengthen Public Employment Services' effectiveness and enhance autonomy based on a multi-annual strategic roadmap;
- strengthen authorities' capacity to develop and implement training policy measures;
- promote social dialogue and social partners' capacity.

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