



Brussels, 5.6.2019
COM(2019) 530 final

REPORT FROM THE COMMISSION

Cyprus

**Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of
the European Union**

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (the Treaty) lays down the excessive deficit procedure (EDP). That procedure is further set out in Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹, which is part of the Stability and Growth Pact (SGP). Specific provisions for euro-area Member States under the EDP are laid down in Regulation (EU) No 473/2013².

According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3 %, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value, or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; and (b) whether the ratio of government debt to GDP exceeds the reference value of 60 %, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace.³

Article 126(3) of the Treaty provides that, if a Member State does not fulfil the requirements under one or both of those criteria, the Commission has to prepare a report. That report must also “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

¹ OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, adopted by the Economic and Financial Committee on 5 July 2016, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

² Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

³ The concepts of 'sufficiently diminishing' and 'satisfactory pace' are defined in Article 2(1a) of Regulation (EC) 1467/97 as being fulfilled if “the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark”. The Regulation then provides that “the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available”. Regulation (EC) 1467/97 further provides that “the influence of the cycle on the pace of debt reduction” should be taken into account. Those elements have been translated into a debt reduction benchmark, as set out in the Code of Conduct on the SGP and endorsed by the Council. Compliance with the debt benchmark is assessed on the basis of three different configurations: the backward-looking, the forward-looking and the debt reduction benchmark adjusted for the impact of the cycle.

This report, which represents the first step in the EDP, analyses Cyprus' compliance with the deficit and debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Data notified by the Cypriot authorities on 29 March 2019⁴ and subsequently validated by Eurostat⁵ show that the general government headline deficit in Cyprus reached 4.8% of GDP in 2018, while debt stood at 102.5% of GDP, above the 3% and 60% of GDP Treaty reference values, respectively. For 2019, the notification planned a general government headline surplus of 3.4% of GDP and a debt ratio of 95.9% of GDP. Cyprus' 2019 Stability Programme, which was received by the Commission on 30 April 2019, plans a headline surplus of 3.0% of GDP and a debt ratio of 95.7% of GDP.

The notified data show that Cyprus did not comply with the deficit criterion in 2018 (see Table 1), as the general government headline deficit notified was larger than the 3%-of-GDP reference value. According to the Commission 2019 spring forecast, released on 7 May 2019, Cyprus is expected to comply with the deficit criterion in 2019 and 2020, as its headline balance is projected to achieve a surplus of 3% of GDP and 2.8% of GDP, respectively. On the basis of the scenario included in the Stability Programme, Cyprus is also expected to comply with the deficit criterion as of 2019, with a projected headline surplus of 3.0% of GDP in 2019 and 2.6% of GDP in 2020.

Cyprus' non-compliance with the deficit criterion in 2018 provides evidence of a *prima facie* existence of an excessive deficit for the purposes of the SGP before, however, considering all factors as set out below.

While its debt ratio is above 60% of GDP in 2018, Cyprus complied with the transitional debt rule in 2018 and is projected to comply with the debt reduction benchmark in 2019 and 2020. This suggests that Cyprus complies with the debt criterion for the purposes of the SGP.

Table 1. General government deficit and debt (% of GDP)

	2016	2017	2018	2019		2020	
				COM	SP	COM	SP
General government balance	0.3	1.8	-4.8	3.0	3	2.8	2.6
General government gross debt	105.5	95.8	102.5	96.4	95.7	89.9	89.1

Source: 2019 Stability Programme (SP) and Commission 2019 spring forecast (COM)

The Commission has therefore prepared this report to comprehensively assess the departure from the deficit criterion and examine whether the launch of an excessive deficit procedure is warranted. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the

⁴ According to Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Cyprus can be found at: <http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables>.

⁵ Eurostat news release No 67/2019, <https://ec.europa.eu/eurostat/documents/2995521/9731224/2-23042019-AP-EN/bb78015c-c547-4b7d-b2f7-4fffe7bcdfad>

assessment of the adjustment path towards the Medium-Term Budgetary Objective (MTO). The report takes into account the Commission 2019 spring forecast.

2. DEFICIT CRITERION

Cyprus' general government headline balance switched from a surplus of 1.8% of GDP in 2017 to a deficit of 4.8% in 2018. The latter includes the 8.3% of GDP one-off impact of the government support for the sale and orderly winding down of the Cyprus Cooperative Bank. Net of one-offs, the headline balance amounted to a surplus of 3.5% of GDP in 2018.

According to the Commission 2019 spring forecast, the general government balance is expected to return to a surplus of 3.0% of GDP in 2019. In 2020, the Commission forecast projects a headline surplus of 2.8% of GDP under a no-policy-change assumption.

The multiannual trajectory included in the Stability Programme is for headline surpluses over the forecast horizon. In particular, the Stability Programme plans a headline surplus of 3.0% of GDP in 2019 and 2.6% of GDP in 2020. Thus, the Stability Programme and the Commission 2019 spring forecast project similar headline surpluses for 2019. For 2020, the slight difference between the Commission forecast and the Stability Programme projections stems from the macroeconomic assumptions, more dynamic revenue based on track-record and more conservative assumptions on expenditure in the Commission forecast.

The general government headline deficit reached 4.8% of GDP in 2018, which is well above and not close to the Treaty reference value of 3% of GDP.

The excess over the 3%-of-GDP reference value in 2018 is not exceptional, as it neither results from an unusual event nor from a severe economic downturn for the purposes of the Treaty and the SGP. The Commission 2019 spring forecast projects a continued strong growth in 2019, at 3.1%, and some slowdown in 2020, to 2.7%.

The excess over the 3%-of-GDP reference value is temporary for the purposes of the Treaty and the SGP. In particular, the budgetary forecasts as provided by the Commission and the Stability Programme indicate that the general government balance will return to surpluses as of 2019, thus not exceeding the reference value.

In sum, the 2018 deficit was above and not close to the 3%-of-GDP Treaty reference value. The excess is considered to be not exceptional, although temporary for the purposes of the Treaty and the SGP. The analysis thus suggests that *prima facie* the deficit criterion for the purpose of the Treaty and Regulation (EC) No 1467/1997 is not fulfilled based on the 2018 outturn data before, however, consideration is given to all relevant factors set out below.

3. DEBT CRITERION

The general government gross debt-to-GDP ratio increased to 102.5% in 2018, partly reversing the sharp decrease to 95.8% of GDP in 2017. That increase was mainly due to the issuance of a series of government bonds in April and July 2018 related to the government support measures for the sale and orderly winding down of the Cyprus Cooperative Bank, which amounted to 15% of GDP (EUR 3.2 billion). That development was reflected in a sizeable positive stock-flow adjustment in 2018, representing a level-shift upwards for the government debt trajectory. However, the debt-to-GDP ratio in 2018 increased by only 7 percentage points of GDP from the previous year, as the strong underlying fiscal performance, the snowball effect and active debt management operations partially

compensated for the Cyprus Cooperative Bank-related debt increase. Debt dynamics are discussed in more detail in Section 4.3.

The Commission 2019 spring forecast expects a steady debt reduction in the coming years, to 96.5% of GDP in 2019 and below 90% in 2020.

According to the Stability Programme, debt-to-GDP ratio is projected to sharply decline over 2019-2022, mainly due to projected high primary surpluses (above 4.0% of GDP) and strong nominal GDP growth. Government debt is projected to decrease to 95.7% of GDP in 2019 and further to below 90% in 2020. The difference from the Commission's projection at unchanged policy mainly stems from more optimistic projections of growth and inflation and a lower stock-flow adjustment.

Table 2: Compliance with the debt reduction benchmark

	2017	2018	2019		2020	
			COM	SP	COM	SP
Gross debt ratio	95.8	102.5	96.4	95.7	89.9	89.1
Gap to the debt benchmark ^{1,2}			-6.5	-9.1	-4.7	-8.7
Structural adjustment ³	0.2	0.7				
<i>To be compared to:</i>						
Required adjustment ⁴	-1.2	-3.7				

Source: 2019 Stability Programme (SP), Commission 2019 spring forecast (COM), Commission calculations.

Notes:

¹ Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

² Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

³ Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

⁴ Defines the remaining annual structural adjustment over the transition period which ensures that - if followed - Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Following the abrogation of the excessive deficit procedure in 2015, Cyprus was subject to a three-year transition period to comply with the debt reduction benchmark. That transition period started in 2016 until 2018. As of 2019, since government debt is projected to remain above 60% of GDP, the debt reduction benchmark is applicable.

The notified data show that Cyprus made sufficient progress towards compliance with the debt reduction benchmark in 2018 (see Table 2), as the change in the structural balance is estimated to have exceeded the required minimum linear structural adjustment (MLSA) in 2018 (by 4.3% of GDP).

According to the Commission 2019 spring forecast, Cyprus is also forecast to comply with the debt reduction benchmark in 2019 and 2020, as its debt-to-GDP ratio is expected to be below the benchmark, with a negative gap to the debt benchmark of 6.5% of GDP and 4.7% of GDP, respectively.

On the basis of the scenario included in the Stability Programme, Cyprus is also expected to comply with the debt criterion in 2019 and 2020. Cyprus is expected to meet the debt reduction benchmark, as illustrated by a negative gap to the debt benchmark of 9.1% of GDP and 8.7% of GDP, respectively.

Cyprus thus complies with the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/97.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report “*shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*”. Those factors are further clarified in Article 2(3) of Regulation (EC) No 1467/97, which also provides that “*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and to the Commission*” need to be given due consideration.

According to Article 2(4) of Regulation (EC) No 1467/97, the relevant factors shall be taken into account when assessing compliance on the basis of the deficit criterion. However, if the ratio of the government debt to GDP exceeds the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit (as provided for in paragraphs 4, 5 and 6 of Article 126 of the Treaty) only if the following double condition is fully met, namely that the general government deficit remains close to the reference value and its excess over the reference value is temporary. Hence, since the government debt-to-GDP ratio is 102.5% of GDP and the deficit is 4.8% of GDP, and thus not close to the Treaty reference value, the relevant factors cannot be taken into account in the steps leading to the decision on the existence of an excessive deficit for Cyprus.

According to Article 2(6) of Regulation (EC) No 1467/97, if the Council decides that an excessive deficit exists in a Member State, the relevant factors shall be taken into account in the subsequent procedural steps, in particular in establishing a deadline for the correction of the excessive deficit and eventually extending that deadline.

The following subsections consider in turn (1) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (2) the developments in the medium-term government debt position, its dynamics and sustainability; (3) the medium-term economic position; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term budgetary position

The ex-post assessment of Cyprus’ compliance with the preventive arm finds that the structural balance reached a surplus of 2.0% of GDP in 2018, well above the medium-term objective of a balanced budgetary position in structural terms. According to the Commission 2019 spring forecast, Cyprus is expected to remain above its medium-term budgetary objective in 2019 and 2020.

Headline, structural balance and adjustment towards the MTO

Headline balance

Cyprus' headline balance fell to a deficit of 4.8% of GDP in 2018, from a surplus of 1.8% of GDP in 2017 and 0.3% of GDP in 2016. The revenue-to-GDP ratio rose by 0.8 percentage points of GDP, on the back of strong economic growth, including the buoyant tax intake, and favourable labour market developments. The expenditure-to-GDP ratio increased by 7.3 percentage points of GDP, mostly due to the impact of the government support measures for the sale and orderly winding down of the Cyprus Cooperative Bank. The Commission 2019 spring forecast projects a general government surplus of 3.0% of GDP in 2019 and 2.8% of GDP in 2020. The Stability Programme targets a headline surplus of 3.0% of GDP in 2019 and a 2.6% of GDP in 2020.

MTO and structural balance

Cyprus' structural balance reached a surplus of 2.0% of GDP in 2018, up from 1.3% of GDP in 2017 and 1.1% of GDP in 2016. The 2018 structural balance was therefore well above the MTO of a balanced budgetary position in structural terms.

According to the Commission 2019 spring forecast, the structural surplus is expected to narrow to 1.1% of GDP in 2019 and 0.7% of GDP in 2020, partly explained by the widening of the positive output gap. On the basis of the information in the Stability Programme, the recalculated structural balance is projected at 1.5% of GDP in 2019, 1.0% of GDP in 2020 and to narrow further over the programme horizon. Both the Commission 2019 spring forecast and the Stability Programme expect the structural balance to remain above the medium-term objective in 2019 and 2020. The divergence compared to the Commission forecast is due to the difference in the planned headline surplus and a narrower output gap projection resulting in a narrower cyclical adjustment.

Public investment

After its trough of 2.1% of GDP in 2014, public investment in Cyprus increased to 2.7% of GDP in 2017, bringing it in line with the EU average. Public investment rose further to 5.5% of GDP in 2018, although the increase is mostly explained by the inclusion in the general government sector of two new entities (i.e. Sedipes and Kedipes) resulting from the sale and orderly winding down of the Cyprus Cooperative Bank. In particular, those entities recorded an investment of around EUR 670 million, corresponding to the fixed assets received as collateral from the former Cyprus Cooperative Bank. As a share of total government expenditure, public investment in Cyprus reached 7.3% in 2017 and 12.4% in 2018.

According to the 2019 Stability Programme, public investment is projected to decrease to around 2.0% of GDP over the forecast horizon.

The government's main investment priorities are outlined in the Government strategy statement. In accordance with the NRP for 2019, the overall aim of the strategy is to increase growth potential, improve competitiveness and safeguard the long-term sustainability of growth. In order to make Cyprus more attractive to investors, emphasis is placed on reforms that aim to create an efficient business environment, facilitate investment, promote better regulation and streamline procedures. Other priorities relate to reforms aiming to increase the efficiency of the public sector, promote SMEs and entrepreneurship and improve the efficiency of justice delivery. Those reforms are also reflected in the country-specific recommendations. Looking forward, investment (both public and private) is expected to be

channelled in the areas of energy, tourism, shipping, industry, education, health, justice, research and innovation, digitalisation and environment.

4.2. Medium-term government debt position

Despite its increase in 2018 due to banking support measures, partly reversing the decrease of 2017, government debt is projected to steadily decline as of 2019 due to projected continued high primary budget surpluses and strong nominal GDP growth. However, fiscal risks are still present, according to the Commission fiscal sustainability analysis. In particular, the high government debt makes Cyprus vulnerable to potential financial or economic shocks. These risks are somewhat mitigated by the contained medium-term financing needs and improved financial market perceptions of Cypriot sovereign risk.

Debt dynamics

After declining considerably (by almost 10 percentage points of GDP) to 95.8% of GDP at the end of 2017, government debt rose to 102.5% of GDP in 2018. That increase was mainly due to the one-off government support for the sale and orderly winding down of the Cyprus Cooperative Bank, in particular the issuing of a series of government bonds in April and July 2018, which amounted to 15% of GDP (EUR 3.2 billion). The transaction represented a level-shift upwards in Cyprus' government debt. However, the debt-to-GDP ratio in 2018 increased by only 7 percentage points of GDP compared to 2017, as the strong underlying fiscal performance, the snowball effect (i.e. changes in the debt-to-GDP ratio related to the difference between nominal growth and the interest rate) and active debt management operations partially compensated for the Cyprus Cooperative Bank-related debt increase. The latter entailed repaying part of the debt from the accumulated cash balances, in particular the government fully repaid the debt owed to the Central Bank of Cyprus (amounting to EUR 483 million or 2.3% of GDP) in December 2018.

According to the Commission 2019 spring forecast, the debt-to-GDP ratio is expected to steadily decline to 96.4% of GDP in 2019 and further to below 90% of GDP in 2020. The decrease is mainly explained by projected high primary budget surpluses of around 5% of GDP and strong nominal GDP growth.

According to the Stability Programme, government debt is projected to sharply decline over 2019-2022. Government debt is projected to sharply decrease to 95.7% of GDP in 2019 and further to below 90% in 2020. The Commission 2019 spring forecast projects the debt decline in 2019 to be somewhat smaller than the Stability Programme projection, mainly due to more conservative projections of growth and inflation and a higher stock-flow adjustment (in the form of accumulation of financial assets).

Interest expenditure

In line with the general trend in the euro area, interest rates on Cypriot debt instruments are at historical lows. The 7-year bond reached yields of around 0.9% at the end of April 2019, while the yield of the 10-year bond stood at around 1.4%, reaching record low levels since 2015. Based on notified data, the implicit interest rate declined in recent years, from 3.0% in 2015 to 2.4% in 2018. It is projected to remain around 2.4% in 2019.

Debt sustainability

The Cypriot authorities have been using favourable market conditions to refinance the outstanding debt against much lower rates at considerably longer maturity.

The fiscal sustainability analysis points to fiscal risks in the short term, although the projected large primary surplus should enable a significant reduction of government debt in 2019 and thus somewhat mitigate that risk. The S0 indicator signals risks of fiscal stress over a one-year horizon.⁶ In particular, the vulnerabilities come from both fiscal and financial-competitiveness sides. It is mainly explained by the one-off banking support measures which led to the deterioration of several fiscal variables, such as the primary balance and the net and gross government debt in 2018, as well as by the high private sector debt. Finally, financial market perceptions of Cypriot sovereign risk have improved, further mitigating short-term risks.

In the medium and long term, Cyprus faces medium fiscal sustainability risks. The negative value of the S1 sustainability gap indicator points to the fact that no upfront fiscal adjustment effort is needed to reduce the debt below the reference value of 60% of GDP by 2033, pointing therefore to a low risk in the medium term. However, the debt sustainability analysis shows that the debt-to-GDP ratio would decline to slightly above the critical 60% threshold by 2029, pointing to a medium risk.⁷ Over the long-term, Cyprus is deemed to be at medium fiscal sustainability risk. The S2 sustainability gap indicator shows a low risk, while the DSA indicates a medium risk in the long term due to vulnerabilities linked to the high debt burden.

The risks indicated above and the high level of government debt underscore the importance of maintaining fiscal discipline over the medium to long term and sustaining growth-enhancing structural reforms in order to ensure a declining trajectory of the government debt.

4.3. Medium-term economic position

Despite the implementation of several structural reforms, potential growth in Cyprus remains constrained, as legacy issues persist, such as the very large share of non-performing loans in the financial sector and high private and public indebtedness. Cyprus made some progress in addressing the 2018 CSRs, in particular by implementing important measures in the context of a comprehensive strategy to reduce non-performing loans, easing the access to finance for the SMEs and preparing the implementation of the first phase of the national health insurance system.

Cyclical conditions, potential growth and inflation

Cyprus was one of the European countries hit most severely by the economic crisis and, thus, requested external financial assistance. It underwent the economic adjustment programme during 2013-2015 with an emphasis on the financial sector. However, legacy issues

⁶ For further information, see ‘Fiscal Sustainability Report 2018’, European Economy Institutional Paper, No. 094.

⁷ This debt sustainability analysis uses the Commission’s spring 2019 forecast (for 2019 and 2020) as a starting point. After 2020, the analysis is based on the following standard assumptions in the Commission methodology: (i) the structural primary balance, before the cost of ageing, is kept at a surplus of 2.7 % of GDP under the ‘no fiscal policy change’ assumption; (ii) inflation converges to 2.0 % by 2023 and remains stable after that; (iii) the real long-term interest rate on new and rolled-over debt converges linearly to 3 % (5 % in nominal terms) by the end of the 10-year projection period, in line with the assumptions agreed with the Economic Policy Committee’s (EPC) Ageing Working Group; (iv) real GDP grows at the rate projected according to commonly agreed methods with the EPC’s Output Gaps Working Group until t+10, and then grows according to the European Commission — Ageing Working Group’s projections (average rate of around 1.5 % in 2018-2029); and (v) ageing costs develop according to the 2018 Ageing Report projections

remained, as evidenced by the sale and orderly winding down of the second-largest bank (i.e. the Cyprus Cooperative Bank) in 2018. During 2012-2014, Cyprus experienced a recession, but real growth resumed since 2015. From 2016 onwards, Cyprus has been in a strong cyclical upswing, with an annual real growth at above 4% in 2016-2017 and close to it in 2018. The labour market recovered strongly and employment lately grew by around 4% per year, while wages increased moderately. Unemployment fell from nearly 17% at the peak of the crisis to 7.1% in February 2019. Long-term unemployment has also recently contracted.

Table 3: Macroeconomic and budgetary developments (% of GDP)

	2016	2017	2018	2019		2020	
				COM	SP	COM	SP
Real GDP (% change)	4.8	4.5	3.9	3.1	3.6	2.7	3.2
Potential GDP (% change)	0.8	2.1	1.9	2.1	2.8	2.1	3.1
Output gap (% of potential GDP)	-1.5	0.8	2.8	3.8	3.0	4.3	3.1
General government balance	0.3	1.8	-4.8	3.0	3	2.8	2.6
Primary balance	3.1	4.3	-2.3	5.4	5.3	4.9	4.8
One-off and other temporary measures	-0.1	0.0	-8.2	0.0	0.0	0.0	0.0
Government gross fixed capital formation	2.5	2.7	5.5	2.2	2.1	2.2	2
Cyclically-adjusted balance	1.1	1.3	-6.2	1.1	1.5	0.7	1.0
Cyclically-adjusted primary balance	3.8	3.9	-3.7	3.5	3.8	2.7	2.2
Structural balance (i)	1.1	1.3	2.0	1.1	1.5	0.7	1
Structural primary balance	3.9	3.9	4.5	3.5	3.8	2.7	2.2

Source: 2019 Stability Programme (SP) and Commission 2019 spring forecast (COM)

Notes:

(i) Cyclically-adjusted balance excluding one-off and other temporary measures.

Going forward, real growth is expected to be solid on the back of domestic demand, more specifically private consumption and investment. GDP growth is projected at 3.1% in 2019 and 2.7% in 2020, according to the Commission 2019 spring forecast. Inflation in Cyprus has been very subdued for several years and is expected to remain so. HICP is set to rise to 0.9% in 2019 (after 0.8% inflation in 2018) and further to 1.1% in 2020. Despite the implementation of several structural reforms, potential growth in Cyprus remains constrained, as legacy issues, including the very large share of non-performing loans in the financial sector and high private and public indebtedness, persist. Potential growth is estimated at around 2% in 2018-2020, with capital accumulation serving as a main positive contributor, followed by the total labour contribution (the latter driven by increasing employment). Total factor productivity, after years of negative contributions, is estimated to turn positive in 2019 and 2020, but still very close to zero.

The output gap is positive and increasingly so. It is projected to increase from 2.8% in 2018 to 4.3% in 2020.

Structural reforms

In the national reform programme⁸ (NRP) adopted on 15 April 2019, the government of Cyprus confirms its commitment to implement a wide-ranging structural reform programme that would help maintain sustainable growth in the long term. The main reform priorities as outlined in the NRP are focused on addressing the challenges identified in the 2018 Council country specific recommendations⁹ and the 2019 Cyprus country report¹⁰.

The 2019 Cyprus country report concluded that overall the Member State has made some progress in addressing the 2018 country-specific recommendations. More specifically, there has been substantial progress in implementing important measures in the context of a comprehensive strategy aimed to reduce non-performing loans, including by strengthening the legal frameworks of insolvency, foreclosure and the sale of loans. Cyprus has made some progress with regards to access to finance for the SMEs, by launching new financial instruments and preparing the implementation of the first phase of the national health insurance system. Only limited progress has been made in: (i) reforming the public administration and local governments, (ii) implementing planned privatisation projects, (iii) addressing inefficiencies in the judicial system, (iv) establishing a reliable system to transfer and issue title deeds, (v) improving the effectiveness of the public employment services in outreaching young people and (vi) reforming the education system. No progress has been made with regards to the strengthening of the supervision of insurance companies and pension funds and the simplification of administrative procedures for major investments.

Furthermore, in February 2019, the Commission concluded that Cyprus was experiencing excessive macroeconomic imbalances, namely high stock of private, public and external debt and non-performing loans in a context of still relatively high, even though declining, unemployment and weak potential growth.

4.4. Other factors considered relevant by the Commission

To preserve financial stability, the government adopted several measures to support the sale and orderly winding down of the Cyprus Cooperative Bank. Those support measures to the financial sector pushed the general government balance into deficit in 2018 and increased government debt in 2018, as discussed in sections 4.2 and 4.3. In particular, the one-off banking support measures affected negatively the general government balance by 8.3% of GDP (EUR 1.7 billion) in 2018.¹¹ Furthermore, the issuance of a series of government bonds

⁸ National reform programme Cyprus 2019. <https://ec.europa.eu/info/sites/info/files/2019-european-semester-national-reform-programme-cyprus-en.pdf>

⁹ [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910\(12\)&from=EN](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910(12)&from=EN)

¹⁰ 2019 Cyprus country report. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-cyprus_en.pdf

¹¹ The EUR 1.7 billion impact of the banking support measures related to the Cyprus Cooperative Bank on the general government fiscal accounts for 2018 is mainly calculated as follows: (i) a capital transfer of EUR 710 million, as a result of the acquisition value (EUR 2.17 billion) minus the real economic value of the non-performing loans received by the new entities (EUR 1.46 billion, resulting from the real economic value of the nominal value of non-performing loans, i.e. 20.94% of EUR 6.97 billion); (ii) an investment of around EUR 670 million, which corresponds to the fixed assets received as collateral from the former Cyprus Cooperative Bank; (iii) the guarantee received by Hellenic Bank (i.e. capital transfer) of EUR 155 million, and (iv) the Voluntary Redundancy Scheme (early retirement compensation) for Cyprus Cooperative Bank's employees (i.e. capital transfer) of EUR 133 million.

related to those support measures impacted the government debt by 15% of GDP (EUR 3.2 billion).

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97).

Article 12(1) of Regulation (EU) No 473/2013 requires that this report considers also "*the extent to which the Member State concerned has taken into account the Commission's Opinion on the country's Draft Budgetary Plan, as referred in Article 7(1)*" of the same Regulation. The Commission Opinion on Cyprus' Draft Budgetary Plan for 2019 concluded that Cyprus was compliant with the provisions of the SGP in 2018 and 2019 and invited the authorities to implement the 2019 budget.¹² The budget was adopted by Parliament on 14 December 2018 without major changes compared to the Draft Budgetary Plan. Among the few supplementary measures approved for the 2019 budget, the reduction of excise duty on fuels was the measure with the highest estimated impact of -0.3% of GDP on the revenue side in 2019.

4.5. Other factors put forward by the Member State

On 31 May 2019, the Cypriot authorities transmitted a letter with relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97. The analysis presented in the previous sections already broadly covers the key factors put forward by the authorities.

The Cypriot authorities highlight the fact that the fiscal performance in Cyprus remains strong and the excess over the 3%-of-GDP reference value in 2018 is entirely due to the temporary government support measures to the Cyprus Cooperative Bank. Furthermore, according to the letter, the one-off measures provided to the Cyprus Cooperative Bank were deemed necessary for financial stability reasons, as they facilitated the bank's exit from the financial market through an orderly wind down and a partial sale of the bank's activities to another banking institution.

More specifically, the authorities state that the general government fiscal position deterioration in 2018, from a surplus of 1.8% of GDP in 2017 to a deficit of 4.8% of GDP in 2018, was exclusively due to the one-off banking support measures provided to the Cyprus Cooperative Bank. The authorities also point to the fact that, excluding those one-off measures, the general government headline balance was in surplus of around 3.4% of GDP in 2018, recording an improvement of 1.6 percentage points of GDP compared to the year before and a positive deviation by 0.5 percentage points of GDP from the target set in the 2019 Draft Budgetary Plan. The structural budget position improved in 2018, reaching a surplus of 2% of GDP compared to a surplus of 1.3% in 2017.

¹² However, the Commission Opinion underlined that both the Draft Budgetary Plan for 2019 and the Commission 2018 autumn forecast did not yet include the deficit-increasing (one-off) impact on the general government balance in 2018 from the banking support measures related to the Cyprus Cooperative Bank.

Finally, according to the letter, the general government headline deficit is expected to be corrected in 2019. In particular, the general government headline balance is projected to return to a surplus of around 3% of GDP in 2019 and 2.8% of GDP in 2020, reflecting the normalisation of the economic activity and the improving labour market. The letter states that the structural balance is projected to remain in surplus over the period 2019-2020, overachieving the medium-term budgetary objective.

5. CONCLUSIONS

General government gross debt is above the 60%-of-GDP reference value since 2011 and was notified at 102.5% of GDP in 2018. The Commission 2019 spring forecast and the Stability Programme expect a steady debt reduction in 2019, to below 100% of GDP. Cyprus complies with the transitional debt rule in 2018 and is projected to comply with the debt reduction benchmark in 2019 and 2020. This suggests that the debt criterion in the Treaty is fulfilled.

Following the general government headline surpluses of 0.3% of GDP in 2016 and 1.8% of GDP in 2017, the general government headline balance in Cyprus reached a deficit of 4.8% of GDP in 2018, much above the Treaty reference value of 3% of GDP. In the absence of the 8.3% of GDP one-off impact of the banking support measures, the general government balance would have amounted to a surplus of 3.5% of GDP in 2018. According to the Commission 2019 spring forecast and the Stability Programme, the general government headline balance is projected to return to surpluses of around 3% of GDP in 2019 and above 2.5% of GDP in 2020, in compliance with and well below the reference value (by more than 5.5 percentage points of GDP). The excess over the reference value in 2018 is not exceptional although temporary within the meaning of the Treaty and the SGP. This suggests that the deficit criterion as defined in the Treaty is *prima facie* not fulfilled in 2018.

In line with the Treaty, this report also examined the relevant factors. Those relevant factors include the fact that the general government headline deficit in 2018, including the excess over the reference value, was entirely due to the 8.3% of GDP one-off impact of the banking support measures, which also contributed to the increase of the general government debt in 2018. Furthermore, the structural balance reached a surplus of 2.0% of GDP in 2018 and is expected to remain above the medium-term objective of a balanced budgetary position in structural terms in 2019 and 2020. However, since the government debt-to-GDP ratio exceeds the 60% reference value and the double condition is not met - i.e. that the deficit remains close to the reference value and that its excess over the reference value is temporary - those relevant factors cannot be taken into account in the steps leading to the decision on the existence of an excessive deficit for Cyprus.

At the same time, Cyprus is expected to be fully compliant with all requirements of the Stability and Growth Pact in 2019 and 2020, including the projected overachievement of the medium-term budgetary objective and the projected sizeable general government surplus, thus ensuring compliance with the deficit criterion and the debt reduction benchmark. In light of the above, the opening of an excessive deficit procedure would not serve a meaningful purpose for fiscal surveillance. Therefore, the Commission considers that further steps leading to a decision on the existence of an excessive deficit should not be taken.