STABILITY PROGRAMME

OF THE

REPUBLIC OF CYPRUS

2010-2014

Ministry of Finance

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OF THE
REPUBLIC OF CYPRUS

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INTRODUCTION

In accordance with the recently-adopted Council Regulation (EC), setting out the new European Semester, Cyprus submits its Stability Programme (SP) for the period 2010-14. The SP has been prepared in line with the updated guidelines, set out in the "Guidelines on the format and content of the Stability and Convergence Programmes". The new "European Semester" has come into effect as of January 1, 2011 and under this new procedure countries are required to prepare the SP, taking into account the key policy orientations provided in the Annual Growth Survey and agreed by the European Council on 12/1/2011. This SP incorporates these new elements and directions of policy.

The SP is the product of consultations with political parties and social partners. From these consultations, a consensus to take measures to reduce the fiscal deficit in a sustainable manner has emerged and a number of measures have been proposed and adopted. The Government of the Republic of Cyprus ("the Government") will remain engaged in a continuous dialogue with political parties and social partners, with a view to safeguarding a systematic monitoring of the implementation of the SP and agreeing on additional measures, if deemed necessary to safeguard the achievement of the targets set in the SP.

Recent events in sovereign debt markets have revealed institutional weaknesses and have brought about fundamental reforms of the governance structure of the euro area. Cyprus supports the effort to strengthen the institutional structure in the euro area and is currently working with all partners in finalising the legislative changes needed.

In 2010 Cyprus reported that the general government deficit increased to 6% of GDP in 2009. Accordingly the ECOFIN Council adopted a recommendation of the Commission that an excessive deficit existed in the case of Cyprus, in accordance with Article 126 of the Treaty. The Council called on Cyprus to take effective action, with measures based mainly on the expenditure side, to lower the deficit below 3% of GDP by 2012 at the latest.

Cyprus has managed to cope with the financial crisis in a satisfactory manner. Following a difficult year in 2009, the economy of Cyprus exhibited positive growth rate in 2010 with its GDP estimated to have registered an increase of some 1%. The SP envisages a further, albeit modest by historical standards, acceleration of growth in 2011 to 1.5% and rising to 3% by 2014. This is estimated to be the potential growth of the economy, taking into account the effects of the financial crisis on economic growth in Cyprus in the medium term.

This growth trajectory is considered plausible and it is in line with growth projections of trading partners.

The modest recovery witnessed in 2010, in combination with concrete policy actions, including a tight control over current expenditures and, to some extent, one-off revenues, led to a noteworthy improvement in public finances compared to the previous year. The general government deficit, which widened to 6% of GDP in 2009, was reduced to an estimated 5.3% in 2010. The debt-to-GDP ratio is estimated to have increased to about 60.9% in 2010.

Furthermore, imbalances were to some extent, ameliorated, as evidenced by the reduction of the current account deficit and the containment of private credit growth, compared to 2007-2008.

Notwithstanding the challenging economic environment, which Cyprus is facing, the overriding aim of fiscal policy, set out in the SP, is to lower the deficit to below 4½% and ideally to about 4% in 2011 and below 3% by 2012. Thereafter, the Government aims at lowering the deficit further, by some 0.5 percentage points of GDP, on average annually in line with the recommendations of the Annual Growth Survey, thus reversing the upward trend of public debt-to-GDP.

The Government has already announced measures of permanent nature that aim at enhancing revenues and curtailing expenditures, in line with the targeted fiscal consolidation. These measures include control over public sector hiring and a reduction in civil servant employees, as well as imposing ceilings on certain spending categories, thus ensuring that overall public expenditure will remain below projected nominal GDP growth and consequently public revenues. In addition, the reduced VAT rate was introduced on foodstuffs and pharmaceuticals, excise taxes on petroleum and tobacco products were increased and a levy/tax was introduced on bank deposits. Further measures planned include an amnesty on the issuance of title deeds for buildings with minor irregularities (a measure that will substantially reduce the backlog of title deed issuances) and specific legislative actions to tackle tax evasion and tax avoidance. Further measures planned but not yet adopted include public sector reforms, which will aim at containing the wage bill of the civil service. Moreover, a dialogue to reform the public sector pension system, while preserving their social character is in progress.

The key challenge now, especially against the background of the uncertainties surrounding the economic developments in the euro area, is to consolidate the recovery, promote growth in the medium term and strengthen fiscal consolidation, while maintaining social cohesion.

In the first instance, policies aim at addressing the unemployment problem, which has particularly affected new entrants into the labour market, as well as, the tourism and construction sectors. Policies in this area include maintaining the wage burden of taxation at relatively low levels and supporting the retraining of unemployed and vulnerable groups. In parallel, the Government is playing a role in guiding wage

determination in the economy as a whole, through adopting a restrictive stance in public sector wage setting.

Additionally, the Government aims at re-directing available public resources in favour of growth-enhancing expenditure categories and social cohesion while, at the same time, safeguarding macroeconomic stability.

Finally, structural reforms will be undertaken which will help boost the economy's growth potential and help consolidate public finances in the medium and long term. Such reforms include the introduction of a Medium-Term Budgetary Framework, a reform of the public pensions and the healthcare system, the strengthening of one-stop shop arrangements for investors and the reduction of the administrative burden of laws and regulations for enterprises.

The planned fiscal consolidation and an ongoing correction of household and corporate balance sheets will help to further alleviate the internal and external imbalances of the Cypriot economy. Indeed, the current account and particularly the trade balance, have narrowed down in 2009-2010, and it is expected that they will continue to remain contained in the medium term. In addition, expected wage moderation will help contain competitiveness pressures in the labour intensive sectors of the economy, such as hotels and restaurants.

Overall, policies aim mainly at supporting investment and private sector development contributing towards enhancing productivity and competitiveness of the economy, and promoting "green economy". These priorities are incorporated in the National Reform Programme, which is launched for the first time together with the Stability Programme. The related expenditures are incorporated in the central scenario of this SP.

Within this policy framework, the Government supports the efforts of the Central Bank to further strengthen the supervision of the banking sector, based on the EU and Basel III framework.

While the SP sets out a realistic plan for the medium term, it acknowledges that the Euro area is going through a challenging juncture. Consequently, there are uncertainties in relation to the external environment of Cyprus, and therefore risks to the projections and the short- and medium-term prospects. The Government considers the fiscal targets set out in the SP as feasible and credible. However, especially due to the risks that lie ahead, the Ministry of Finance is monitoring closely, on a monthly basis, the timely implementation of the SP and is committed to adopt additional measures, if deemed necessary, to ensure the achievement of the fiscal and public debt targets.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The overriding objective of Cyprus economic policy is to enhance growth and the standards of living of all citizens, in particular of low-income groups, to maintain macro-financial stability, implement structural reforms that improve the functioning of the market mechanism and ensure that the government sector provides, adequately and efficiently, services to the public. Structural reforms will be implemented in various areas, covering pensions, healthcare and the business environment. Within the overall government finance constraints and targets, fiscal policy will focus on growth and social cohesion, through redirection of resources to growth-enhancing activities and prioritization of expenditure programmes. A more efficient and leaner government, that can tackle effectively these challenges, will be important in this process.

Fiscal Policy

Undoubtedly, the biggest challenge facing policy makers at the current juncture is to ensure that the economy recovers fully and resumes its potential in the medium term and that the public finances are strenghthened, with the debt-to-GDP ratio reversing its upward trend and declining close to the reference value.

Particular emphasis will be placed on the need to curtail current expenditure and restructure public spending, in favour of capital expenditure, which can boost the economy's growth potential. Redirecting resources towards infrastructure is particularly important at this juncture, due to the expected negative growth of the construction sector. Emphasis is also attached to targeted social spending, which aims at directing more resources to those in real need.

The modest recovery witnessed in 2010, in combination with concrete policy measures and a tight control over current expenditures, led to a considerable improvement in public finances compared to the previous year. The general government deficit, which widened to 6% of GDP in 2009, was reduced to an estimated 5.3% in 2010. The debt-to-GDP ratio is estimated to have increased moderately to 60.9% in 2010. The overriding aim, set out in the SP, is to further reduce the deficit to below 4½% and ideally to roughly 4% in 2011 and 2½% in 2012.

To achieve this, the Government has already adopted measures, which amount in total to 1.5 percentage points of GDP. These include a reduction in the number of employees of the civil service, further operating expenditure cuts, the application of VAT on foodstuffs and pharmaceuticals as of 10/1/2011 at a rate of 5%, increased excise duties on petroleum products and tobacco as of 17/6/2010 and 10/12/2010 respectively, a bank levy/tax at 0.095% imposed on bank deposits and town planning amnesty for buildings constructed with minor irregularities, opening the way for the issuance of a backlog of outstanding title deeds.

Box 1. The Annual Growth Survey: Implementing a rigorous fiscal consolidation

The most urgent task for the EU is to restore confidence by preventing a vicious cycle of unsustainable debt, disruption of financial markets and low economic growth. Public expenditure must be put on a sustainable track, as a pre-requisite for future growth. Annual adjustments of the structural budget balance in the order of 0.5% of GDP will be clearly insufficient to bring debt ratios close to the 60% requirement. Therefore, stronger consolidation is needed and should be implemented on the basis of the reinforced fiscal rules proposed by the Commission.

- All Member States, especially those in excessive deficit procedure, should keep public expenditure growth firmly below the rate of potential GDP growth, while prioritising sustainable growth friendly expenditure in areas such as research and innovation, education and energy. All Member States should demonstrate that their Stability or Convergence Programmes are based on prudent growth and revenue forecasts.

- Member States in excessive deficit procedure should set out the expenditure path and the broad measures they intend to take in order to eliminate their excessive deficits.

- Member States facing very large structural budget deficits, very high levels of public debt or high levels of financial distress need to frontload their efforts in 2011. Where economic growth or revenues turn out to be higher than expected, fiscal consolidation should be accelerated.

- Some Member States may need to increase taxes. Indirect taxes are more growth-friendly than direct taxes and broadening tax bases is preferable to increasing tax rates. Unjustified subsidies, e.g. environmentally harmful subsidies, should be eliminated.

Source: Annual Growth Survey, 12.1.2011, COM(2011)

In addition a number of other measures are being discussed, which will likely be implemented in 2011, and will have additional fiscal impact for 2011 and 2012. These include:

- Reduction of the size of the public sector wage bill, following intensive discussions;
- Pension reforms for the broader public sector, with a view to improving affordability and sustainability, while safeguarding adequacy;
- A reform of the system of social transfers in order to target benefits better and help more those in greater need.

Additionally, a number of structural fiscal reforms are underway, which should lead to better planning of spending, easier control of expenditures and to considerable savings on interest expenditure:

- The implementation of a binding Medium-Term Budgetary Framework (MTBF), which will institutionalize expenditure rules, give more independence to spending ministries and, at the same time, increase their accountability;
- The introduction of binding fiscal rules through primary legislation;
- Enhancement of public debt and cash management systems.

In spite of the economic crisis and slowdown of economic activity—and conscious of the need to reverse the upward trend of public debt—this SP reaffirms its ambitious Medium-Term Objective of a balanced budget.

Monetary and Financial Sector Policies

While monetary policy falls under the responsibility of the Eurosystem, and the ECB, the broader responsibility for financial stability is shared by the Central Bank of Cyprus and the Ministry of Finance.

Financial stability is a key component of the overall policy framework, given the importance of the sector for the economy of Cyprus. A Memorandum of Understanding has been signed by all supervisory authorities and the Ministry of Finance, and a domestic standing committee has been established and is operational with the mandate to oversee financial stability developments in Cyprus.

At the same time, the enhancement of financial sector surveillance at the EU level, via the setting up of the European Systemic Risk Board, and the establishment of the new EU Supervisory Authorities will further strengthen the overall policy framework for Cyprus. The Government, in close cooperation with the Central Bank, will continue to monitor developments in the financial markets.

Structural Reforms

These challenging times call for an active implementation of structural reforms, which will help maintain medium and long-term growth at satisfactory levels and boost the economy's agility and competitiveness. This is crucial, given that the economy's potential growth has been affected by the crisis.

Cyprus is submitting simultanesously its National Reform Programme (NRP), which highlights all the important structural reforms, which are planned to be pursued in Cyprus. In addition, this SP includes a description of a number of other fiscal structural budgetary reforms which are underway.

These measures include, inter alia, the following:

- Adopting a restrictive stance in public sector wage setting process;
- Reforming the COLA system, without affecting the low and middle income groups. To this end extensive consultation with all stakeholders will take place;
- Strenghthening one-stop shop arrangments for investors;
- Maintaining a business friendly taxation regime and extending double tax treaties;
- Reducing red tape and administrative burden, in line with the policy initative of the EU.

The implementation of these measures is an important pillar of this SP and the funding of the measures included constitutes an important element of the proposed budget.

2. ECONOMIC OUTLOOK

World Economy in 2010 and prospects for 2011

Following the severe downturn of 2008-09, the world economy begun to recover gradually in 2010. Nevertheless, considerable differences across countries and regions have been observed, particularly between Asia vis-à-vis the US and Europe, reflecting to a great extent the imbalances, which had built up in previous years. In advanced economies, the need for deleveraging, weak labour market prospects, low levels of consumer confidence and the pressures emanating from the sovereign market crisis, especially in the euro area, had a negative impact on recovery. By contrast, growth in emerging economies remained dynamic and broadly based, reflecting also the comparative advantages of many of these countries.

Undoubtedly, the shock emanating from the global crisis still casts its shadow over the global economy and the prospects for the near and medium term. Important determinants for the eventual recovery will be the unwinding of stimulus measures from the fiscal and monetary side, exchange rate and oil price developments, the situation in labour markets, and the behaviour of the financial system, once support measures are gradually withdrawn. Confidence effects are also key for a sustainable recovery.

Tensions in euro area sovereign debt markets have dominated policy discussions during 2010. Determined action to provide financial assistance to Greece and Ireland in the context of an EU-IMF programme, averted a further deterioration of the financial situation in the EU, and underlined the need to proceed, in a more determined manner, to address structural problems in the euro area. The agreement to strengthen further economic governance and the financing capacity of the European Financial Stability Facility (EFSF), in conjunction with the agreement to establish a permanent European Stability Mechanism (ESM) and to implement the Euro Plus Pact for the Euro, are important steps, likely to boost confidence in the EU and the euro area. Furthermore, the ambitious anticipated reforms of the financial system are essential for addressing the vulnerabilities in the banking system.

In the EU, growth resumed in 2010, reaching 1.8% compared to the previous year, after a contraction of 4.2% in 2009. With the recovery gathering pace for a number of straight quarters, notwithstanding the risks in the near and medium term, the European economy has seemingly gained sufficient traction to put most countries on a self-sustained growth path.

The upturn has been notably strong in Germany, where economic activity is estimated to have expanded by around 3.5% in 2010, more than double than that of the euro area. While it was mostly exports that led the recovery initially, growth is now evenly distributed among the main components and domestic demand provided an even

bigger growth contribution than net trade. Latest business sentiment data suggest that the favourable momentum of the German economy will continue. Meanwhile, growth in France was just below the E.U average (around 1.5%), in Italy slightly below, at 1.3%, while Spain remained in recession. Outside the euro area, strong growth was registered in Poland and, to a lesser extent, the UK, with the exception of a poor 4th quarter. Among the smaller economies, the rebound is particularly pronounced in Slovakia (4.0%) and Sweden (5.5%), the latter two posting the highest growth rates in the EU in 2010. In contrast, GDP has contracted in Greece, Latvia, Romania and, mildly, in Bulgaria and Ireland.

Looking ahead, the pace of GDP growth in the EU is set to moderate into mid-2011, given the fading of temporary factors that kick-started the recovery, such as the exceptional stimulus measures. Another factor that is set to weigh on growth prospects in the short to medium term is the fiscal consolidation phase that many Member States are embarking on to put the fiscal situation on a sustainable path, as well as the likely tightening of monetary policy. Possible oil price increases constitute an additional risk factor. Nevertheless, by 2011, all EU countries, with the exception of Greece and Portugal, are expected to be out of recession.

The United Kingdom, which is by far the most important economic partner of Cyprus, grew by 1.3% in 2010, compared with a contraction of around 5% in 2009. House prices declined, against the background of subdued housing market activity. Looking ahead, external demand and the past depreciation of the pound sterling should support economic activity. However, domestic demand growth is expected to remain constrained by tight credit conditions, household balance sheet adjustment and substantial fiscal tightening. Prospects are also uncertain both due to the considerable size of the financial services sector in the country, as well as the difficult conditions in the labour market, which continue to weigh heavily on the confidence of individuals.

In the United States, the GDP growth for 2010 is estimated at 2.9%, mainly due to business investment and government spending, but at the same time dampened by a large negative contribution from net exports. The recovery in employment has been shallow and this weakness in the labour market is one of the most important obstacles to the recovery. Overall the recovery is expected to remain moderate in the medium term. Low levels of consumer confidence and the need for further household balance sheet adjustment may constrain the recovery and the labour market is expected to improve only gradually. Meanwhile, the recovery of the housing market is being held back by excess supply and weak demand. For 2011 growth in the United States is forecast to reach 3%, moderating somewhat to 2.7% in 2012.

The economy in Russia, which is an important economic partner for Cyprus, staged a recovery beginning in the third quarter of 2009. Growth for the whole of 2010 is estimated at around 4%, following a contraction of around 8% in 2009. Economic growth has been increasingly led by recovering domestic demand rather than external

demand. Looking ahead, the pace of the recovery is likely to be shaped by commodity price developments and domestic credit growth. For 2011 growth in Russia is forecast to reach 4.5% and 4.4% in 2012.

Economic activity in Japan picked up in 2010 reaching an estimated growth around 4% compared with a decline of 6.3% in 2009. For 2011 growth is forecast to reach 1.6%. Private consumption in 2011 is likely to weaken, given the adverse effects of the earthquake.

Cyclical Developments and Current Prospects in Cyprus

The economy of Cyprus has coped with the financial crisis in a satisfactory manner. Despite the continued uncertainty surrounding the external environment, the economy of Cyprus grew by around 1% in 2010, according to preliminary estimates, compared to a contraction of 1.7% in 2009.

Overall, growth was supported by a satisfactory export performance, in particular for services (business and financial services). In constant prices, total exports are estimated to have grown by 2.2% in 2010.

However, confidence effects, coupled with increases in structural unemployment, are holding consumption growth back, while construction continues to exhibit a gradual correction, following the years of overheating in 2007-2008.

Total investment, is estimated to have increased by 6.9% in real terms, solely due to stock adjustment. A continued fall was recorded in construction investment (-6.2%) and investment in machinery and equipment (-4.2%), while investment in transport equipment remained unchanged. The continued decline in investment in construction reflects the continued correction of the sector, in particular with regard to the demand for investment in secondary residences in coastal areas.

Consumption remained subdued in 2010, owing to increased unemployment and confidence effects that remains fragile as reflected in monthly surveys. Public consumption is estimated to have increased by 0.5% as a result of lower government spending and containment in public sector employment.

At the same time imports of goods and services are estimated to have increased marginally, or by some 0.7%, owing to lower private consumption and investment.

From a sectoral point, services continued to be the main engine to growth. The agricultural sector is estimated to have contracted by 0.7% in 2010, construction also continued to contract, with output estimated to have declined by 6.2%. The tertiary sector has continued to experience moderate growth as a result of growth in financial intermediation and other business services, as well as in the health and education

sectors. Meanwhile, the hotels and restaurants sector, which has been operating below potential for a number of years due to intense competition from other near-by destinations, experienced an increase in tourist arrivals in 2010 of some 1½% compared the previous year. Revenue was also on the rise, increasing by 3.8% for 2010.

Table I: Selected Economic Indicators 2008-2010

annual % change	**2008**	**2009**	**2010 (est.)**
GDP growth (constant prices)	3.6	-1.7	0.9
Private consumption	*7.1*	*-2.9*	*-1.5*
Gross Fixed Capital Formation	*6.0*	*-9.1*	*-5.5*
Exports	*-0.3*	*-11.3*	*2.2*
Imports	*8.1*	*-19.3*	*0.7*
GDP deflator	*5.1*	*-0.3*	*2.0*
Tourist arrivals (000's)	2.403,7	2.141,2	2.173,0
Tourist arrivals (%)	-0.5	-10.9	1.5
HICP	4.4	0.2	2.6
Productivity growth	0.9	-1.0	0.4
Employment growth	2.7	-0.7	0.5
Nominal Earnings (%)	7.4	4.3	2.4
Unemployment rate (Labour Force Survey)	3.7	5.3	6.2
Trade balance of goods (% of GDP)	-31.9	-25.0	-26.9
Trade balance of services (% of GDP)	20.9	19.8	21.8
Current account balance (% of GDP)	-16.8	-7.8	-7.8

Following many years of tight labour market conditions, even with a significant inflow of foreign workers, the slowdown of economic activity has visibly affected employment growth and unemployment. During 2010 employment is estimated to have increased by ½% compared with the previous year, after growing by an average of around 2% annually during the period 2005-2009. The unemployment rate has averaged 6.2%.

Wage growth has moderated, reflecting the effects of the slow down of economic activity, which affected the outcome of collective bargaining agreements. Overall, earnings are estimated to have increased by 2.4% in nominal terms and stabilised in real terms. In particular, moderation was observed in the sectors mostly affected by the economic crisis (construction, manufacturing and tourism). As a consequence, nominal earnings were contained and real earnings are estimated to have decreased, reversing the trend observed in previous years. Nominal unit labour costs are

estimated to have increased by 2% while real unit labour costs to have decreased by some ½%.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), accelerated in 2010. After having decelerated to 0.2% in 2009 as oil prices fell and economic activity weakened, inflation picked up to 2.6% in 2010, mainly due to the increases applied in excise duties on petroleum and tobacco products, as well as, rising energy and commodity prices. In contrast, and largely due to improved weather conditions, other food categories included in the basket – such as meat, fruit and vegetables –contributed in containing inflation growth. Harmonized core inflation, that is HICP excluding seasonal food and energy, declined significantly to around 0.5% in 2010, compared to around 2% in 2009.

The current account balance in 2010 remained at around previous years' level. Exports grew by 9.6% in 2010, compared to a decline of 12.9% in 2009. Goods registered strong demand, particularly industrial products of manufacturing origin, which expanded by 22.7%. Export of services also performed well, notwithstanding the subdued demand in the area of shipping and tourism. In particular business services and financial intermediation expanded by 33.2% and 9.2% respectively. Imports expanded by 8.7% compared to a decline of 21.1% the year before. The biggest increase was witnessed in imports of transport equipment (43.4%) due to the expansion of the public transportation network and fuels and lubricants (31.4%). The income account, which in 2009 registered a deficit of 1.6% of GDP, recorded a deficit of 2.7% in 2010. For the whole year of 2010, the current account deficit is estimated at 7.8% of GDP. (The evolution of this item is documented later in the SP)

In financial markets, and while the financial system in Cyprus remained liquid over the past couple of years, credit growth decelerated to more sustainable levels, as a result of lower demand and tighter credit standards by banks. From a very high level of growth of 32.1% in 2008, it decelerated to 9.7% in 2009 and 9.3% in 2010. The deceleration was particularly pronounced in the categories of consumption and business credit. Credit for housing also decelerated but remained relatively high reflecting the continuation of projects approved prior to the crisis, albeit at a lower pace. From the deposit side, the growth of deposits accelerated to 20.2% in 2010 compared with a modest rate of 3.8% in 2009, reflecting further increases in non resident deposits, mainly from Russia and Greece.

Medium-term Scenario 2011-2014

Taking into account the high degree of uncertainty in the external environment, the medium-term scenario incorporated in the SP envisages a gradual recovery towards a lower, compared to pre-financial crisis period, potential GDP growth.

Table II: External Growth Assumptions 2011-2012

	2011	2012
EU	**1.7**	**2.0**
UK	*2.2*	*2.5*
Germany	*2.2*	*2.0*
Greece	*-3.0*	*1.1*
Euro area	**1.5**	**1.8**
Russia	**3.8**	**4.0**

For the preparation of the underlying macroeconomic framework presented here, the following key assumptions have been made for 2011-14, which are based on information available with cut-off date February 25, 2011 (Table 8):

- The recovery in the EU, USA and Russia will gather pace in 2011-12 (see Table II with External Growth Assumptions).
- The price of crude oil (Brent crude), which averaged $79.6 per barrel in 2010 assumed to reach $110 per barrel in subsequent years.
- The dollar/euro exchange rate will average around 1.4$/€ in 2011 and 2012.
- Based on the external assumptions for growth, it follows that tourist arrivals will increase by 2.8% in 2011, 3% in 2012 and slightly above 3% thereafter. Revenues will increase by 3.8% in 2011, 4% in 2012 and slightly above 4% thereafter.
- Nominal earnings will rise by about 3.5% on average per annum and real earnings by about 1% on average during 2011-2014. Hence, real unit labour costs are projected to decelerate by 0.7% per annum over the same period.
- Employment will expand by 0.8% on average per annum over 2011-14, in line with the assumption that the inflow of foreign workers will moderate in the medium term.

A more detailed exposition of the methodology behind the projections is included in Box 2.

This rather conservative profile is reflected in key determinants of demand with regard to exports, where a recovery is foreseen in line with the envisaged rebound in

foreign demand (Table II). For other components of demand, notably investment in construction, the SP assumes further downward correction. Furthermore, the SP assumes that private consumption will grow in line with disposable income growth, thus allowing for some rebalancing of household balance sheets, especially compared with the past few years, when consumption expanded briskly. Against this background, the current account deficit is expected to register a gradual downward trend throughout the programming period, reflecting the envisaged improvement of public sector savings investment balance.

In more detail, private consumption growth is projected to exhibit a moderate gradual increase over the medium term, as households continue to improve their balance sheets, following consumption growth exceeding the growth of real disposable income in recent years. The SP assumes that private consumption will grow in line with disposable income, or by some 1.8% over the period 2011-14, compared with 3.4% in the period 2005-10. The key drivers are employment growth, which is projected to average the same period by 0.8%, and real wage growth of some 1%.

Public consumption growth is expected to moderate somewhat in the medium term, as a result of the consolidation assumed in the SP. Compared with an average growth of 3.9% over the period 2005-2010, public consumption growth is set to stabilize at around 0% per annum over 2011-14.

Investment is expected to exhibit low growth over the medium term, owing mainly to the projected continuing correction of the construction sector. The envisaged correction in construction investment is assumed to affect mainly the market for residences and, to a much smaller degree, non-residential construction and infrastructure which are assumed to exhibit continued growth over the medium term. Overall, gross fixed capital formation will increase by 1.8% over the period 2011-14, compared with around 3% increase during 2005-10. Investment in machinery and equipment is also assumed to decline in 2010 and recover thereafter, while investment in transport equipment will exhibit positive growth over the short and medium term, as the significant correction experienced in 2009 is reversed. Specifically, during 2011-14 investment in machinery and equipment and investment in transport equipment will expand on average by around 2% per annum, following a very large adjustment for investment in transport equipment in 2009-10.

Box 2. Forecasting GDP

In light of the agreement to provide more transparency in the forecasting methods, this box provides a short overview of the forecasting methodology used by the Ministry of Finance. The projections used in the Stability Programme are based on analysis of the demand, as well as, the supply side of the economy. The projections from the supply side are used for cross checking the results derived from the analysis of the demand side.

Employment and productivity trends, as well as, trends in monetary aggregates are also taken into account.

The main elements of the model of demand are as follows:

- Government Consumption is projected by using information regarding compensation of employees and intermediate consumption of the public sector.
- The most important driver of private consumption is disposable income. In its basic form disposable income includes income from employment and other transfers, net of taxes and social security contributions. It also takes into account credit availability, since this is found to fit the data relatively well. The elasticity used in the projections is assumed to be considerably lower than the historical average, reflecting the expectation that households will go through a process of "mending their balance sheets" and will, therefore, spend in line with disposable income in the medium term.
- For investment, the main determinant is past GDP growth, although other factors are also taken into account (e.g., credit and interest rates). For investment in construction, a separate model is used, which projects investment as a function of the estimated current stock of dwellings, relative to a "normal" level, which is consistent with the growth in the number of households. In recent years the number of residences built increased substantially due to foreign demand; hence this method allows us to project the anticipated correction in the sector over the medium term.
- Exports are projected using simple export equations that essentially include foreign income as the main explanatory variables. Trends are also taken into account, therefore it is generally projected that those sectors that experience rising market shares will continue to do so in the medium term; the opposite for those sectors which lose shares over time. The destinations taken into account are the EU and UK, as well as Russia.
- For imports, simple import relationships are utilized that include as explanatory variables domestic income and consumption, as well as demand for investment goods domestically.
- Deflators are estimated in a variety of ways, but in general taking into account historic relationships between domestic and foreign prices and sectoral deflators.

The forecasting methods are constantly updated to reflect recent structural developments in the economy, as well as, new techniques, which can be incorporated in the analysis.

The potential GDP growth estimates of the Ministry of Finance, as well as projections of international organizations, are used for cross checking purposes.

Table III: Medium Term Framework, 2011-2014

annual % change	2005-10	2011	2012-14
GDP growth (constant prices)	2.6	1.5	2.7
Private consumption	*3.4*	*0.5*	*2.3*
Gross Fixed Capital Formation	*2.9*	*-0.5*	*2.5*
Exports	*0.6*	*2.6*	*4.2*
Imports	*1.6*	*1.8*	*2.4*
GDP deflator	*2.8*	*3.7*	*2.4*
Tourist arrivals (000's)	2,334.2	2,233.2	2,376.3
Tourist arrivals (%)	-1.2	2.8	3.2
HICP	2.3	3.4	2.3
Productivity growth	1.0	1.0	1.8
Employment growth	1.7	0.5	0.9
Nominal Earnings (%)	4.4	3.7	3.4
Unemployment rate (Labour Force Survey)	4.8	6.0	5.6
Trade balance of goods (% of GDP)	-27.6	-26.3	-26.3
Trade balance of services (% of GDP)	21.9	21.3	22.6
Current account balance (% of GDP)	-9.5	-7.3	-6.0

Imports are assumed to continue to moderately rebound in 2011 following the small increase in 2010 and the precipitous fall witnessed in 2009, when imports of goods and services are estimated to have declined by around 20%. It is estimated that imports will increase by 1.8% in 2011 and by around 2-2½% thereafter. In the same view, exports are also forecast to increase in 2011 by 2.6% and to further recover in the medium term to almost 4-4½%. This moderate performance masks differences among sectors. For example, it is assumed that receipts from tourism will increase by 4% in nominal terms and 2% in real terms in 2011, as the world economy wrestles with the ongoing recovery. A similarly modest growth is projected in transport services, following a contraction in previous years. Growth is expected to come from the Russian market and to a lesser extent from Germany, Scandinavian countries, as well as other tourist destinations. On the other hand, financial services and other business services are assumed to continue exhibiting more robust growth rates over the medium term. Specifically financial services are forecast to expand by around 8%, while other business services by 6%.

This central scenario implies an improvement of the current account deficit to around 7% of GDP in 2011 and 2012 and a further improvement thereafter to around 5% of GDP by 2014. Overall, forecasts in the Balance of Payments are based on the assumed fiscal consolidation. The improvement in the savings investment balance comes from the implied improvement of the public sector and takes into account that in the private sector, after the significant improvement in 2010, the financial deficit is likely to modestly increase.

Based on this scenario, real GDP is projected to expand by some 1½% in 2011 and gradually recover to some 3% by 2014. The public sector's contribution to growth will diminish, in line with the envisaged fiscal consolidation.

From a sectoral perspective, the picture is mixed as some sectors are forecast to perform poorly, relative to trend, while others are expected to continue performing satisfactorily. Table IV provides growth rates by sector. The growth rates take into account the adjusted potential growth rates consistent with the downward revision of the growth potential of the economy. The baseline scenario included in this SP envisages growth significantly below trend in construction, while hotels and restaurants are assumed to improve marginally following the negative recent performance. At the same time, financial intermediation is assumed to continue growing significantly, although at more conservative levels compared to trend. Retail trade and a number of rapidly growing sectors, such as other business activities, are assumed to gradually converge to their trend growth levels over the medium term.

Table IV: Sectoral growth rates

(annual % change)	**2010**	**2011**	**2012-2014**
Agriculture	-0.7	-0.7	-0.7
Construction	-6.2	-0.6	2.4
Retail Sector	0.6	1.4	2.9
Hotels and Restaurants	0.7	1.1	2.4
Financial Intermediation	4.2	4.4	4.7
Real Estate and Other Business Activities	2.0	2.0	3.7
of which Real Estate	*1.5*	*1.5*	*3.0*

The inflation rate constitutes a major uncertainty given the large swings in the price of oil and other commodities. Based on the harmonized definition, inflation averaged 0.2% in 2009 owing, largely, to lower oil prices, as well as, the price of food and other imported consumer goods and accelerated to 2.6% in 2010. Based on the external assumptions, oil prices are forecast to average $79.6 per barrel in 2010 and around $112.8 per barrel in 2011. The dollar/euro exchange rate is assumed to be around 1.4$/€. Inflation is forecast to increase to 3.4% in 2011 owing to the application of the reduced VAT rate on foodstuffs and pharmaceuticals and higher excise duty rates on tobacco and petroleum products and to then hover around 2¼% in the medium term.

In the labour market, the medium-term scenario envisages further, albeit relatively small, employment gains compared to recent years, mainly resulting from increased participation of foreign workers and a gradual increase in the participation rate of female and old-aged workers. While employment growth will remain positive in some sectors, in other sectors more directly exposed to the external sluggish growth, such as

hotels and restaurants and construction, some increase in unemployment is forecast. Thus, overall, the gainfully employed population is forecast to continue increasing at around 0.8% on average per annum. The unemployment rate will remain at around 6% in 2011 and decline thereafter to 5.3% as growth resumes in 2014. Productivity growth is expected to average 1.6% per annum over the medium term, which is above the performance recorded over the period 2004-2008. Nominal earnings are expected to be contained and real earnings are forecasted to remain low in 2011-2014, thus implying gradual improvement of wage competitiveness. Nominal unit labour costs will increase by some 2% in 2011-2014, compared to 3% in 2005-10, while real init labour costs will remain negative over the same period.

Box 3. Risks to medium-term forecasts

The risks to growth over the medium term are balanced.

External Environment

- The ongoing economic recovery of the world economy relies on the extraordinary support measures which several countries introduced as the financial crisis deepened. These measures are gradually being withdrawn. However, the impact on growth of major trading partners of Cyprus, including UK, may be less pronounced, than assumed in the SP.
- Upward trend of commodity prices, especially oil prices.
- Volatility of exchange rates.

Domestic Economy

- Likely improvement of confidence effects could have a positive effect on private consumption and investment, stronger than envisaged in the SP.
- The vulnerabilities associated with competitiveness losses in tourism could prove critical, especially as competition for market shares becomes more intense.

3. KEY ISSUES RELEVANT FOR POLICY

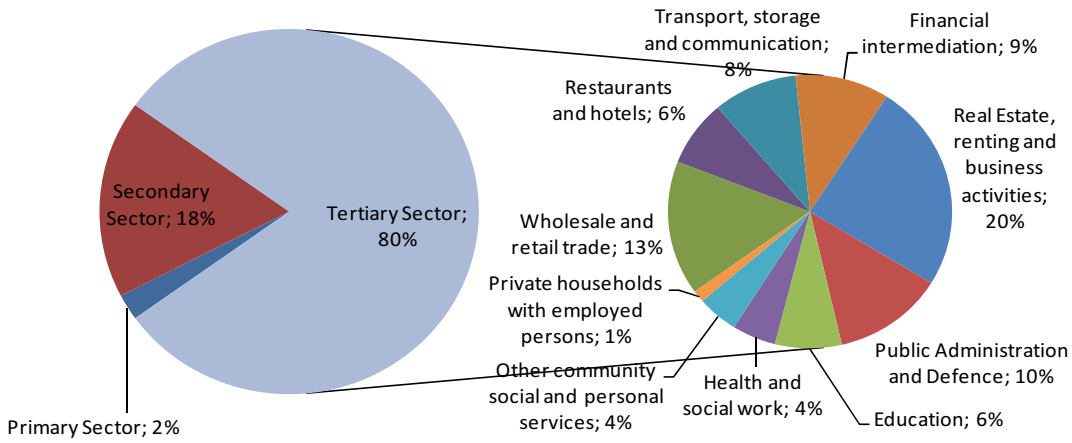
The analysis of the current outlook and the medium-term prospects raises a number of important issues, which are relevant for policy. Among these key issues, this section focuses on three areas: (i) the evolution of business services (ii) the banking system in Cyprus (iii) the evolution of the current account.

The evolution of business services in Cyprus, 2004-2008.

One of the most important structural features for the Cyprus economy of the past 30 years is the movement away from primary and secondary sectors of the economy in favour of services. Initially, tourism was the prevalent area of growth, especially following the Turkish invasion in 1974. However, it is becoming all the more evident that during the recent decade Cyprus is moving away from its dependence on tourism, with financial, business and other services increasingly becoming the main source of growth (Figure 1). For example, during the period 1995-2009, the share of tourism (hotels and restaurants) fell from 8% of GDP to 6%, whereas financial services increased from 4% to 8% and business services increased from a share of 15% to 18% of GDP.

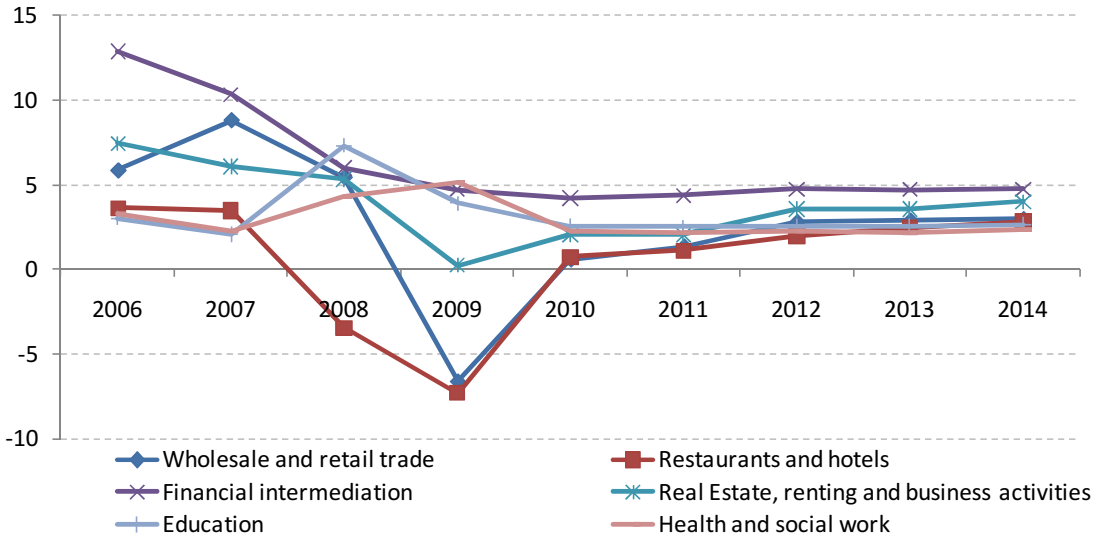
A number of factors are behind this expansion of services. Firstly, Cyprus offers an attractive business environment, characterized by a relatively low corporate tax rate, now standing at 10 percent. Taking into account the taxation on dividends, the total effective taxation on corporations approaches 20%. Secondly, attractive double-tax treaties concluded with a number of countries, including Russia, have boosted business activities in Cyprus, by inducing a channel of business deals. Thirdly, macro-financial stability and the adoption of the euro in 2008 have played an important role in consolidating and strengthening the position of Cyprus in terms of market share in services-related activities. All of the above are complemented by the high quality of banking, legal and accounting services offered by Cyprus to international investors.

Figure 1: Distribution of Value GDP, 2009



Source: Statistical Service of Cyprus

Figure 2: Growth in services, 2006-2014



Source: Statistical Service of Cyprus and Ministry of Finance

Looking at the growth path of services during the period 2006-2010(f), the financial sector and business sector were the fastest growing sectors at the beginning of the period (Figure 2). Transport, tourism and real estate were the sectors most significantly affected by the crisis.

Financial services are projected to continue growing for the whole programming period 2011-2014, remaining a significant factor for growth in the medium term. In fact, projections on the growth in services for the programming period 2011-2014 underline the importance of financial and business services, taking into account of lower potential growth for a number of sectors (construction and real estate in particular), and lower public sector spending in the medium term.

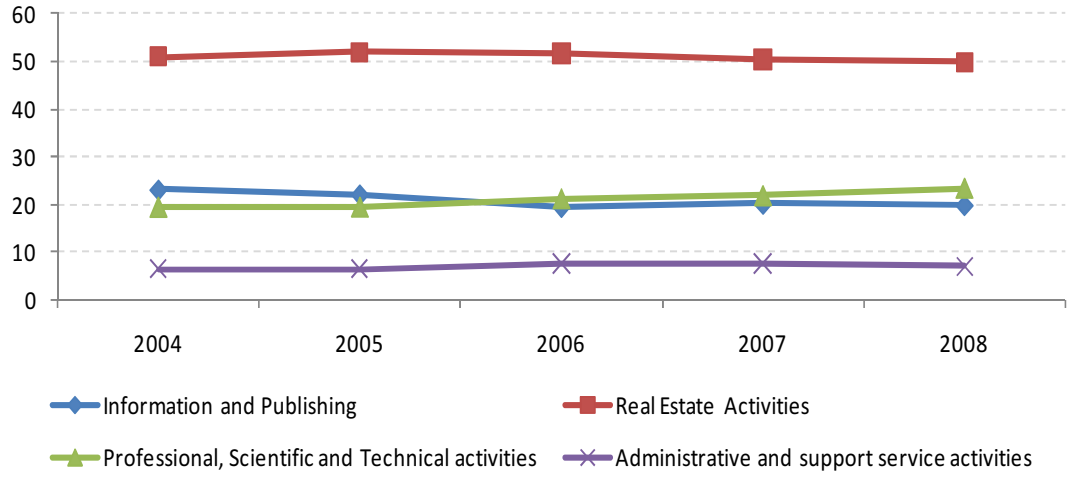
This section provides a detailed overview of business services, where Cyprus has acquired a comparative advantage over the past few years.

Historical developments in business services

Business services are a highly diversified group of services comprising (i) real estate activities, (ii) information and publishing, (iii) professional, scientific and technical activities and (iv) administrative and support service activities.

As seen in Figure 3, real estate activities are the largest component of business services. The share of the value added of this sector, over the total value added of real estate and business services, remained stable at around 50% over the period 2004-2008. Professional, scientific and technical activities services increased their share in the total value added of services from 19% in 2004 to 23% in 2008. Information and publishing, on the other hand, decreased their share somewhat, from 23% in 2004 to 20% in 2008.

Figure 3: Distribution of Value Added in Real Estate and Business Services, 2004-2008 (%) (Share in total value added of business services)



Source: Statistical Service of Cyprus

Finally, Administrative and supporting activities form the smallest part of business services where the share in value added ranges between 7-8% over the period under consideration.

Composition of business services

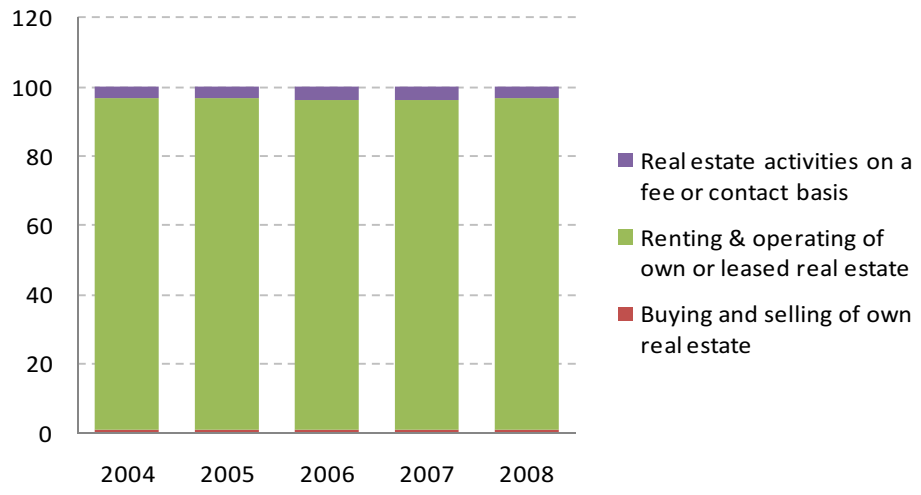
(i) Real Estate Activities

Real estate activities consist of three main categories, namely: (a) Buying and selling of own real estate, (b) Renting and operating of own or leased real estate and (c) Real estate activities on a fee or contact basis. The second category is the major building block of real estate activities, with an average share of 96% through the period 2004-2008.

(ii) Information and Publishing

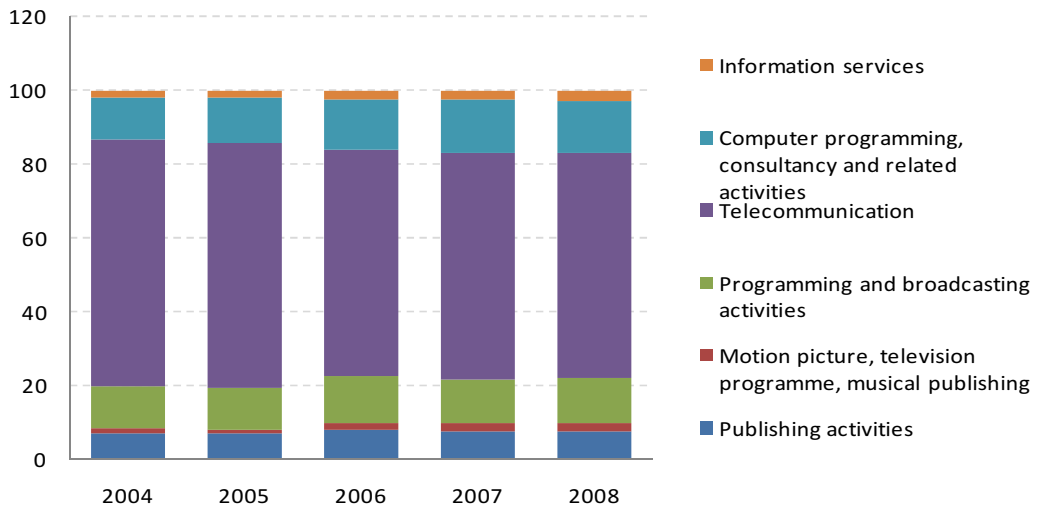
Information and publishing consists of six main categories, the most important of which being telecommunication. In 2008, telecommunication accounted for 60.7% of the value added of all information and publishing activities, down from 66.8% in 2004. In Telecommunication, all services provided by public and private telecommunication companies that relate to fixed and mobile telephone services, internet and television packages are included. Computer programming, consultancy and related activities services amounted to 14.3% of value added in 2008, up from 11.4% in 2004, while Programming and broadcasting activities services amounted to 12% in 2008, up from 11.7% in 2004. Motion picture, television programme and musical publishing activities comprised 2.7% of value added in 2008 and information services were the smallest category at 2.3% in 2008.

Figure 4: Real estate activities (share in total 49.8%, 2008)



Source: Statistical Service of Cyprus

Figure 5: Information and publishing (share in total 20%, 2008)

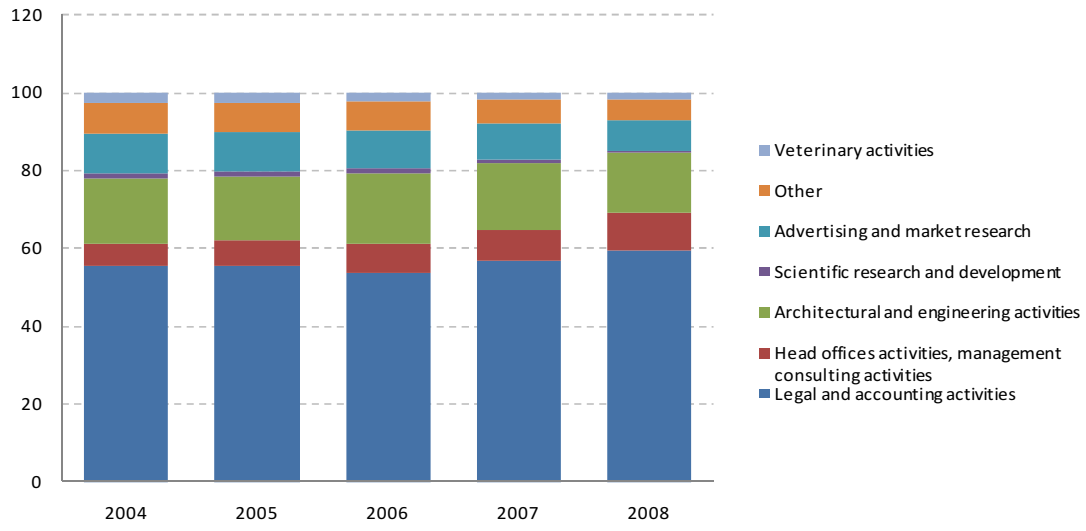


Source: Statistical Service of Cyprus

(iii) Professional, scientific and technical activities

The largest component in the professional, scientific and technical activities category consists of "legal and accounting activities" with a share in value added of almost 60%. Companies included in this category include many large accounting and legal firms based in Cyprus and a significant part of their activities related to services provided to multinational corporations. The second largest component, "architectural and engineering activities", has a share of 15.4% in 2008 in the total value added of this group of activities. "Head offices, management and consulting activities" and "advertising and market research" are the third and fourth largest components with a share in 2008 of around 9% and 8% respectively.

Figure 6: Professional, scientific and technical activities (share in total 23%, 2008)

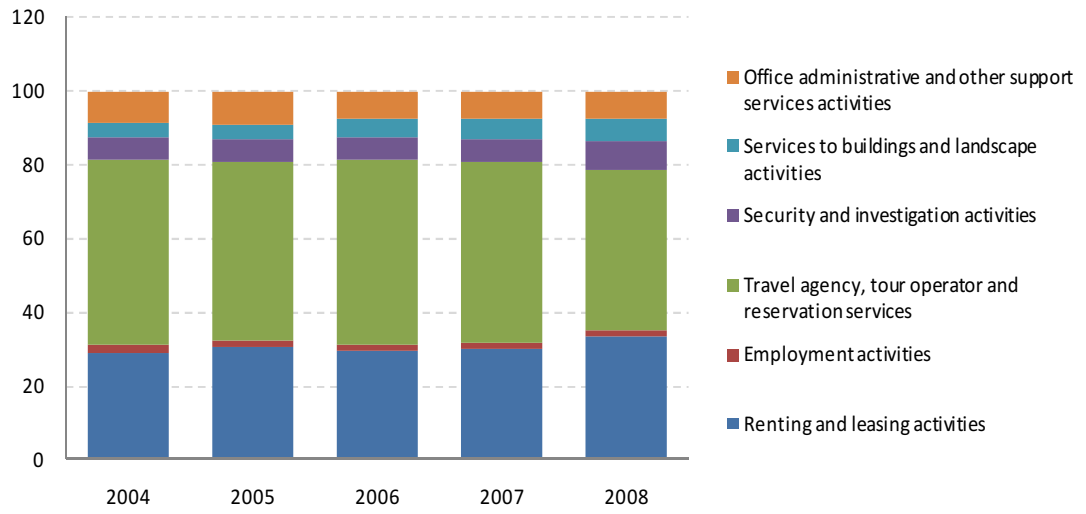


Source: Statistical Service of Cyprus

(iv) Administrative and support service activities

In this group of business activities, "Travel agency, tour operator and reservation activities" are the largest component with a share in value added of around 43%. Despite being the largest component, its share in value added has been declining since 2004 when the share was around 51%. On the other hand, "Renting and leasing activities" seem to be gaining some momentum, increase their share in value added from around 29% in 2004 to 33% in 2008.

Figure 7: Administrative and support service activities (share in total 7%, 2008)



Source: Statistical Service of Cyprus

The Banking System in Cyprus

During the past 25 years Cyprus has developed considerably in the area of services, beyond the traditional tourism-related activities. Indicatively, the share of services other than tourism in total GDP rose from 62½% in 1995 to 75½% in 2010 (estimate). More specifically, the share of financial intermediation as a whole has risen from 4% in 1995 to 9% in 2010 (in constant prices).

The structure of the Banking System

A few large players dominate the Cypriot banking sector. The domestic banking market is dominated by Bank of Cyprus, Marfin Popular Bank, Hellenic Bank and the greek subsidiary Alpha Bank. Together they hold about 56% market share of total lending, whereas the Cooperative Sector holds another 20%.

In total, there are forty (40) banks subject to authorisation and supervision by the CBC operating through branches and offices all over Cyprus.

- Seven (7) of them are locally based banks, of which the largest 3 are listed on the Cyprus Stock Exchange and are also internationally active with presence mainly in Greece but also the UK, Australia, Russia and other Eastern European Countries. The remaining locally based banks are small locally activated banks among which is a small state owned institution specialising in house mortgage lending and the Central Cooperative Bank (CCB) which acts as the central banker of credit co-op institutions (managing their liquidity). CCB also acts as the central body for the affiliated cooperatives (all cooperatives except one) guaranteeing all their liabilities.
- Eight (8) are subsidiaries of foreign banking groups (of which 6 are subsidiaries of banks from EU countries mainly from Greece and 2 are subsidiaries from other non-EU countries).
- Twenty five (25) are branches of foreign banks (of which 9 are branches of banks from EU countries and 16 are branches of banks from countries other than EU).
- All, but one, foreign branches described above and one foreign subsidiary, transact almost exclusively with non residents. This group holds about 10% of the market share in terms of total domestic deposits and lending. The presence of these banks in Cyprus relates to the strategic planning of their parent banks and their domestic operations are minimal.

Total banking system assets, as at 31 Dec 2010, were in the region of €156bn, of which about €31bn relates to the overseas operations of the three domestic banking groups mentioned above. Foreign owned branches account for about €8bn or 5% of total banking system assets. Foreign owned subsidiaries hold assets of about €37bn representing 23% of the total banking system assets. However, substantial amounts of their assets relate to booking transactions funded by their parents which in most cases

retain the credit risk. This practice is part of the respective banking groups' tax planning activities and aim at taking advantage of the low tax rate in Cyprus. It is evident from the above, that a significant part of the Cyprus Banking Sector's assets does not relate to and is not directly affected by the local economy. The following table provides further details of the breakdown of the banking system assets.

Table V: Bank Asset Structure (including overseas operations of locally based banking groups)

As at 31 Dec 2010 €million	Total Assets	Lending (Net of provisions)		Securities and other investments held[*2]	Exposures[*3] for which the credit risk is born by the parent bank	Bank placements
		Residents[*1]	Non Residents including Brass Plates[*1]			
EU branches	**1.501**	211	178	--	88	1.086[*4]
Non EU branches	**6.314**	197	1.946	577	17	3.443[*4]
EU subsidiaries	**30.279**	5.041	4.268	12.992	11.035	7.458[*4]
Non EU subsidiaries	**6.268**	865	3.955	183	3.576	1.063[*4]
Locally based banks	**95.937**	24.678	36.219	11.458	--	18.552[*5]
Coop Sector	**16.173**	12.121	31	2.245	--	888
Total Banking System	**156.472**	43.113	46.597	27.455	14.716	32.490

[*1]In relation to the resident/non resident distinction it is important to note that as per the EU statistical definition, all companies registered in Cyprus are classified as residents. In the case of Cyprus, where several foreign owned and foreign activated companies are registered in Cyprus due to the tax incentives present, this definition does not convey a fair picture of the domestically activated companies. In the above table this distortion is partly overcome by reclassifying a specific subcategory of residents, that of "Brass Plate" companies (companies registered in Cyprus but with no physical presence in Cyprus) into the non – residents category. Still, some element of foreign owned foreign activated companies, those with physical presence in Cyprus, remains under residents and cannot be distinguished.

[*2]Mostly sovereign and bank bonds.

[*3] Exposures relate both to loans granted and securities held. The credit risk is effectively transferred to the parent bank by a legally binding agreement with a right of set-off of the exposures against the amounts due to the parent bank (i.e. the funding provided by the parent bank).

[*4]Mostly placements with their head office/ parent.

[*5]Mostly placements with overseas banks.

It is important to note that the above table includes the activities of the three locally based banking groups with operations abroad. Accordingly, lending to non residents by locally based banks includes loans granted to customers in Greece amounting to €24bn, in other South East European countries, Russia and Ukraine €3.4bn and in other countries, mainly UK and Australia €3.8bn. Furthermore, other exposures to the Greek economy (Placements with Greek Banks and Greek bank and sovereign bonds held) are in the region of €7bn for the locally based banking groups of which €5.7bn relate to Greek Government bonds. We further note that most of the latter are held to maturity by the banks, almost half of them mature until 2013 and a substantial part was acquired at a significant discount. For the foreign owned subsidiaries with Greek exposures (in this case being the subsidiaries of Greek banks) Greek exposures are backed by funding from the parent bank and, for most of the amounts involved, with a legal right of set-off. Thus the credit risk associated with these exposures is considered very low.

Nonetheless, business conducted with non residents is an important element of all banks business (excluding the Cooperative sector and the small state controlled bank). Non-resident and brass plate deposits have been growing steadily and consistently over the years currently comprising about 45% of total customer deposits in Cyprus of which about 60% are in foreign currency. Given the short term nature and the volatility of these deposits, the Central Bank of Cyprus has imposed high liquidity requirements in order to ensure that banks can withstand severe withdrawals. For example, there is a 70% stock liquidity requirement imposed on banks in relation to their foreign currency customer deposits whereas for the local currency deposits there are, in addition to a minimum stock liquidity ratio of 20%, maximum mismatch ratios for the short term maturity time bands up to a month. Liquid assets are defined as short term bank placements with highly rated banks and high quality tradable securities. Forthcoming guidelines to be issued by the CBC requiring banks to carry out liquidity stress testing and to demonstrate a positive liquidity position for the first 30 days of the stress scenario, will impose a very high withdrawal percentage by non-residents. The following table provides the recent growth history of the deposits of banks, in Cyprus (i.e. excluding deposits of Cypriot banks through their overseas operations).

Table VI: Total Deposits held by banks in Cyprus

€million	31,12,2010	31,12,2009	31,12,2008	31,12,2007
Total Deposits	**69,940**	**58,155**	**56,005**	**52,514**
Euro / +CYP in 2007	47,260	41,942	38,110	34,029
Other Currencies	22,680	16,213	17,895	18,485
Analysed by residence*:				
Residents	37,256	34,933	33,752	32,033
Non Residents	32,684	23,222	22,253	20,481

*Brass Plate Companies (i.e. companies registered in Cyprus but with no physical presence in Cyprus) are classified under non residents in this table

The Cooperative Credit Institutions (CCIs) continue to play an important role in the Cypriot banking system. Cooperatives' overall market share has been broadly stable, at around 10% in terms of total assets of deposit-taking institutions. CCIs are involved only in traditional banking and have no activities in foreign markets.

The cooperative credit sector has been going through a major consolidation in the last 5 years, mostly in response to the new regulatory and competitive environment. The number of cooperative credit institutions, which was around 360 in 2005, has come down to 101 in February 2011. The 101 CCIs operating in Cyprus hold an operating license either on a stand alone basis (1 CCI) or through their affiliation to the Cooperative Central Bank (CCB) Ltd which acts as the Central Body (CB) based on article 3 of the EU directive 2006/48/EC.

Both banks and cooperatives operate on the "traditional" banking model of raising deposits and granting loans with limited reliance on wholesale funding. Loans to deposits ratio is calculated at 95%. Banks do not have exposure to toxic assets, proprietary trading is very limited whereas they are not allowed to own investment property other than that obtained in satisfaction of debts and which must be disposed within three years. Also foreign currency exposure of banks is limited. In conclusion, the banks' risks relate to the risk of default on credit granted to customers for which the banks apply prudent lending criteria at the time of granting and, to a great extent, they also require tangible security as a second way out in case of default of the customer.

The way in which banks fund their operations is demonstrated in the following analysis of their liabilities structure:

Table VII: Banks' Liabilities structure (including overseas operations of locally based banking groups)

As at 31 Dec 2010 €million	Total Liabilities	Deposits		Total funding by parent	Due to Other Banks	Capital & Reserves	Loan Capital
		Residents excluding Brass Plates	Non Residents including Brass Plates				
EU branches	**1.501**	608	471	109	274	34	--
Non EU branches	**6.314**	359	3.805	1.120	704	244	--
EU subsidiaries	**30.279**	3.914	5.034	18.370	1.309	1.116	100
Non EU subsidiaries	**6.268**	194	1.250	3.812	596	315	--
Locally based banks	**95.937**	18.944	48.088*	--	14.561	7.172	3.140**
Coop Sector	**16.173**	13.353	170	--	731	1.448	--
Total Banking System	**156.472**	37.372	58.818	23.411	18.175	10.329	3.246

*includes €26billion deposits raised and held at the overseas branches and subsidiaries of three locally based banking groups, from residents in the countries of operation

**of which hybrid capital €1,6bn

Notwithstanding the recent financial crisis that undoubtedly had an indirect effect on Cypriot banks, the financial position of banking institutions remains healthy. Capital buffers above the minimum required of 8% as well as substantial pre-impairment income are judged satisfactory to absorb a sharp increase in bad debts in case the situation deteriorates further. Table VIII below shows a number of consolidated profitability indicators for the locally active banks[1] which underline the strong financial position of banks in Cyprus. Table IX shows some further financial soundness indicators for the whole consolidated banking system[2].

[1] Those branches and subsidiaries of foreign banks that are situated in Cyprus for the strategic [tax] planning reasons of their parent banks and have little or no business interest in the local market, have been excluded.

[2] Consolidated banking system means locally based banking groups at consolidated level, i.e. including their overseas activities through branches and subsidiaries abroad, and all locally established branches and subsidiaries of foreign owned parent banks.

Table VIII: Profitability indicators (locally active banks including the overseas activities of locally based banking groups)

	2010	2009	2008	2007
Net interest income	2,475m	2,057m	2,004m	1,878m
Operating profit	1,513m	1,438m	1,416m	1,675m
Provisions charge	617m	634m	292m	208m
Net profit after tax	606m	705m	959m	1.233m
After Tax Return on total assets	0.44%	0.55%	1.03%	1.72%
After Tax Return on own funds	7.49%	9.34%	14.0%	21.1%
Cost to Income ratio	53.7%	53.6%	51.1%	44.5%
Net interest margin	1.7%	1.7%	2.3%	2.7%

Table IX: Other financial soundness indicators (all banks, at consolidated level)

	Dec 2010	Sept 2010	Year 2009	Year 2008	Year 2007
Solvency Ratio	12.2%[3]	11.7%	11.8%	10.6%	12.5%
NPLs as defined by the CBC*	7.4%	7.2%	5.9%	4.6%	5.3%
NPLs including fully collateralised loans	11.6%	11.7%	9%	N/A	N/A
Provisioning Coverage	56.7%	56.7%	61%	70.7%	72.8%

*Non Performing Loans are defined by the Central Bank of Cyprus as credit facilities in arrear over 3 months (classified at customer level) excluding those fully covered by collateral.

To properly interpret the NPL ratios shown above, one must bear in mind an important peculiarity of the Cyprus legal system, this being the delay in reaching legal settlement and liquidating collateral. This affects the speed of recovery of nonperforming loans and results in the banks accumulating in their books long-due delinquent loans which are either covered by bad debt provisions, or by collateral which will eventually be liquidated in satisfaction of the debts. An important additional ratio to consider is that of net NPLs after provisions, currently standing at 3.3%.

The resilience of Cypriot banks has been confirmed by the 2010 EU-wide stress tests. In particular, Bank of Cyprus and Marfin Popular Bank participated in the exercise which was conducted using the scenarios, methodology and key assumptions provided by CEBS. As a result of the assumed shock under the adverse scenario, the estimated consolidated Tier 1 capital ratio for Bank of Cyprus would change to 9.4%

[3] This ratio is estimated to have risen to12.8% following a rights issue of €488m in February 2011 at Marfin Popular Bank.

in 2011 compared to 10.5% as of end of 2009 and for Marfin Popular Bank it would change to 8.5% in 2011 compared to 9.4% as of end of 2009. An additional sovereign risk shock would have a further impact of 1.4 percentage points on the estimated Tier 1 capital ratio of Bank of Cyprus, bringing it to 8% at the end of 2011 and 1.4 percentage points to 7.1% for Marfin Popular Bank, compared with the CRD regulatory minimum of 4%.

The results of the stress test suggested a buffer of 470 mln EUR of the Tier 1 capital of Bank of Cyprus and a buffer of 302 mln EUR for Marfin Popular Bank against the threshold of 6% of Tier 1 capital adequacy ratio agreed exclusively for the purposes of this exercise. Hellenic Bank voluntarily and in co-operation with the CBC carried out the same exercise with equally positive results.

Since this exercise, the two major banks have proceeded with substantial new share capital issuances, further enhancing their capital buffers. In October 2010, Bank of Cyprus issued additional share capital of €345m whereas Marfin Popular Bank followed in February 2011 with new capital of €488m. Hellenic Bank issued in October 2010 hybrid capital of a net amount of €50m (new issue of €150m, repayment of existing debt €100m). Furthermore, Marfin Popular Bank has announced its plans for issuing €660m of convertible capital securities within 2011. The bank is currently proceeding with the issue of €294mn (part of the €660mn announced) fully loss absorbing contingent convertible hybrid instruments which will enhance the bank's Tier 1 and Total Regulatory Capital. Moreover, Bank of Cyprus is proceeding with the issue, in May 2011, of €1,3bn fully loss absorbing contingent convertible hybrid instruments (of which €0,6bn are expected to replace existing hybrid instruments).

The supervisory regime

Banking System Supervision is split between the Central Bank of Cyprus - being the competent authority for the supervision of banks - and the Co-operative Societies Supervision and Development Authority being the competent authority for the supervision of Co-operative Societies. The legal and regulatory framework of the two authorities is aligned with EU requirements but also with the requirements and guidelines of the EBA (formerly CEBS) and the Basel Committee on Banking Supervision. Both Supervisory Authorities conduct their work through a combination of off-site monitoring and on-site examination. Off-site monitoring entails the submission by banks of an extensive range of periodic returns which cover numerous aspects of banking operations. Any areas of concern revealed through the returns are taken up promptly with the bank involved for remedial action.

On-site examinations are carried out with a view to assessing the current financial position and soundness of a bank and its future prospects at a given time. In this respect, the following main areas are covered:

- the quality of the management of the bank, including internal control and risk management aspects;
- the bank's loan portfolio, with emphasis on credit risk management, the quality of the loan portfolio and the adequacy of the provisions for bad and doubtful debts;
- the bank's treasury operations with emphasis on risk management;
- the profitability of the bank including the analysis of its income generation and costs and the assessment of the returns achieved;
- the compliance with the conditions of the bank's licence and with Central Bank directives, regulations and instructions on internal governance, capital adequacy, liquidity, large exposures, etc.;
- adherence to the requirements of the anti-money laundering legislation and guidance notes.

Supervision is exercised on a consolidated basis and covers the bank and its subsidiary companies which carry out banking related activities.

All CCIs are regulated and supervised by the Authority for the Supervision and Development of Cooperative Societies (ASDCS). Additionally and due to the fact that CCB is also a bank, under the provisions of the Banking Law is supervised by the Central Bank of Cyprus, the CCB and affiliated CCIs are also subject to consolidated supervision by the Central Bank of Cyprus. The CCB Ltd engages in accepting deposits mainly from its member societies, financing their requirements and generally managing their liquid assets.

The regulatory regime is very conservative and the EU Capital Requirements Directive was transposed adopting the more conservative option for areas where national discretion was allowed. In addition, strict liquidity requirements are imposed to address non-resident deposits while a maximum loan to value ratio of 70% is imposed for property financing (80% for the primary residence). There are restrictions for banks' investments in companies outside the financial sector whereas overseas expansion requires supervisory approval which is granted only if the business plan is feasible and the bank has sufficient capital and liquidity to support expansion. Banks are not allowed to invest in property other than for property used for their operations and there are limits on foreign currency open positions.

In line with EU requirements, each bank conducts an Internal Capital Adequacy Assessment Process (ICAAP) to determine the amount of capital necessary to cover the nature and level of the risks to which the bank is or might be exposed. The CBC carries out, on an annual basis for each bank, a Supervisory Review and Evaluation Process (SREP) to assess the adequacy of the bank's capital, imposing additional capital requirements in case where capital is not commensurate with the bank's

assessed risk profile, and takes into account the results of stress testing. The SREP includes on-site review of all significant overseas operations. Furthermore, the CBC organises supervisory colleges for the locally based banking groups and participates in those organised by the foreign home supervisors of locally established, foreign owned subsidiaries. Moreover, Cyprus participates in the IMF Financial Sector Assessment Program (FSAP) and undergoes annual Article IV surveillance.

Recent and planned policy initiatives

The Cypriot financial sector is sound; the overall position of the banking sector is considered healthy, with a strong liquidity position and a comfortable capital adequacy as well as sufficient profitability. There is a continuous and close monitoring of the liquidity and capital adequacy position of financial institutions by the supervisory authorities.

An ad hoc committee has been set up under the chairmanship of the Central Bank in its capacity as supervisor of banks and responsible for the overall financial stability, with the participation of the MoF and the other supervisors, which monitors closely the developments of the financial sector.

In response to the exceptional turbulence in world financial markets, Cyprus implemented in November 2009 a scheme providing for the issue of special government bonds allocated to credit institutions with a view to enhance liquidity in the economy and exercise a dampening impact on interest rates, the final objective being the real economy. These bonds, of an overall amount of almost €3 billion and with a duration of three years were given to eligible credit institutions to use them as collateral to obtain liquidity from the ECB and interbank markets against a remuneration and appropriate collateral.

Furthermore, it is noted that Cyprus proceeded in July 2009 with the amendment of the two deposit insurance schemes (one for commercial banks and one for cooperative credit institutions). The main amendments include the following: (i) increasing the level of cover from 20,000 euros to 100,000 euros per customer) per bank, (ii) cover the deposits in all currencies (up to then only deposits in European currencies covered), (iii) increasing payout to 100 percent of guaranteed deposits i.e. abolition of the coinsurance component, (iv) shortening the payout time below the statutory minimum of three months by increasing preparedness, and (v) improving financial strength and coverage by increasing member contributions, supplementary contributions, and borrowing arrangements.

Cyprus has created the regulatory framework for covered bonds. Covered bonds will provide banks with another financing instrument – medium and long term financing at favourable terms. The Bill has been enacted in December 2010.

A framework draft law for financial crisis has been prepared, to enable the Cypriot Council of Ministers, following a proposal of the Minister of Finance and taking into

account the opinion of the Governor of the Central Bank of Cyprus (CBC), to take, 'in a period of a financial crisis', measures intended to address liquidity or insolvency problems affecting financial institutions, in full compliance with the relevant acquis framework, after approval of these measures by the House of Representatives.

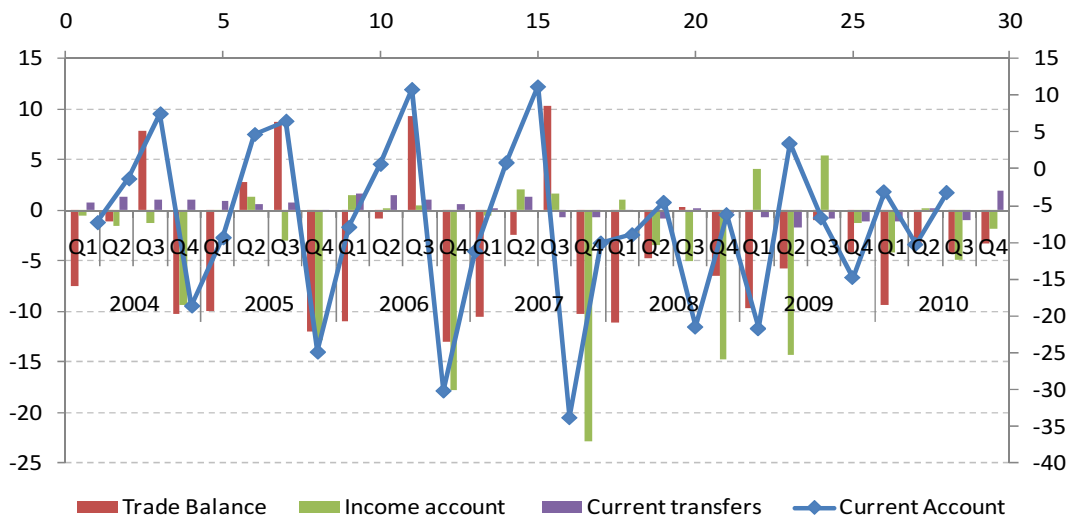
As regards further measures to safeguard the stability of the banking system, a new permanent Financial Stability and Resolution Fund has been launched by the Government in close collaboration with the CBC. This fund, which will be gradually built up, will safeguard the confidence in the banking system and ensure the smooth resolution of banks if the need arises. Another measure that the CBC favours is the maintenance of higher capital ratios for systemically important financial institutions. The codification of these measures is currently in progress.

The evolution of the Current Account

The evolution of the current account in Cyprus is characterized by fluctuations, as shown in Figure 8 below. The sources of fluctuations stem mainly from the trade balance and income account. Considering the trade balance, given Cyprus's dependence on oil as energy source, the fluctuations in the price of oil are a constant factor that largely determines fluctuations in the trade balance of goods. Income account on the other hand, is dominated by fluctuations in the income from investment and thus depends mainly on foreign firms' profitability.

As seen in Figure 8, during the period 2007-2008 the current account was persistently negative. What was exceptional in that period was, on the one hand, the price of oil and, on the other, an extraordinary increase in the imports of vehicles, both of which drove the trade balance excessively negative.

Figure 8: Current Account, 2004:Q1-2010:Q4, % GDP



Source: Central Bank of Cyprus

Trade in services is dominated by trade in business and travel services. Fluctuations in the trade balance of services stem mainly from fluctuations in travel services.

Trade Balance

Trade in goods

Concerning the trade balance in goods, over the period 2004:Q1-2010:Q4, significant deterioration was recorded during the years 2007-2008, as seen in Figure 8, due to the two factors mentioned above. First, imports of motor vehicles grew exceptionally high, due to the general boom of the economy. As Table X shows, imports of passenger vehicles account for around 50%-60% of total imports in transportation equipment. In 2007, imports of passenger vehicles increased by 72.1%. During 2008, imports of passenger vehicles remained high, but in 2009 they declined sharply, by 48.4%. In 2010, imports of passenger vehicles increased by 15.2% compared to the year before, indicating that imports will return to their pre-2007 levels.

Table X: Imports in Transportation, 2004-2010 (€000's)

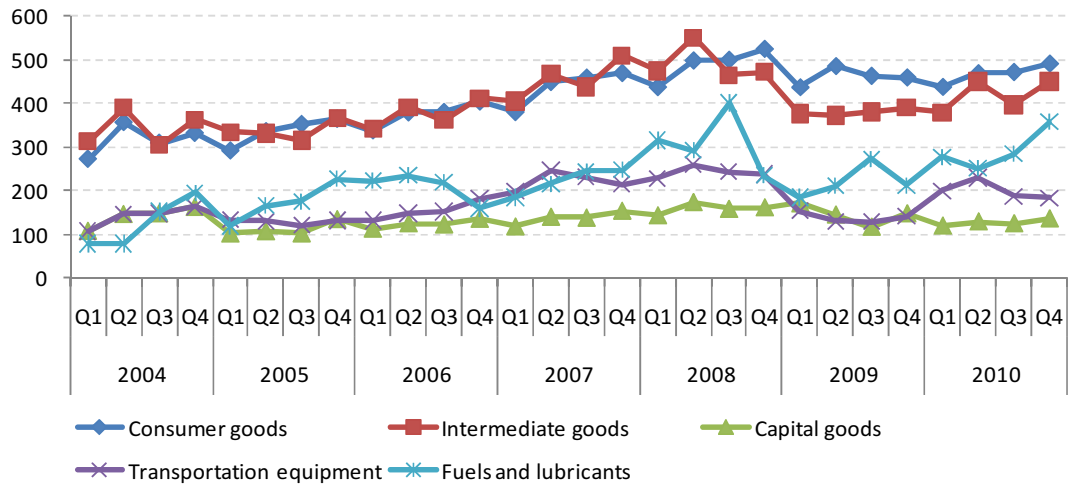
	Total	Passenger motor vehicles	Motor vehicles for the transport of goods	Special purpose lorries & vans	Public service type passenger motor vehicles	Motorcycles & bicycles	Other transport *	Parts for transport equipment
2004	565849	351205	61692	11868	962	6810	16901	116410
2005	516168	317245	48343	9551	3144	4805	18660	114422
2006	615674	351541	64445	10559	4755	6612	54101	123660
2007	638205	604854	80941	11767	4717	7609	24864	156766
2008	707052	582265	96716	20544	10057	12124	54793	161277
2009	554197	300357	45903	7756	3160	7576	35252	154193
2010	795542	345891	50626	3979	34910	6648	203672	149815

*Other transport consists of: (a) Aircrafts, helicopters, balloons and airships and (b) Other transport equipment.

Source: Statistical Service of Cyprus

Second, imports of fuel grew very fast in 2008 due to a corresponding increase in the price of oil in that year. As Figure 9 shows, imports of Fuels and Lubricants in 2008 increased by 39% in total, mainly due to a sharp increase in the third quarter of the year. Indicatively, the price of oil in 2008, on average, increased to €65 per barrel ($97) from €53 in 2007 ($72).

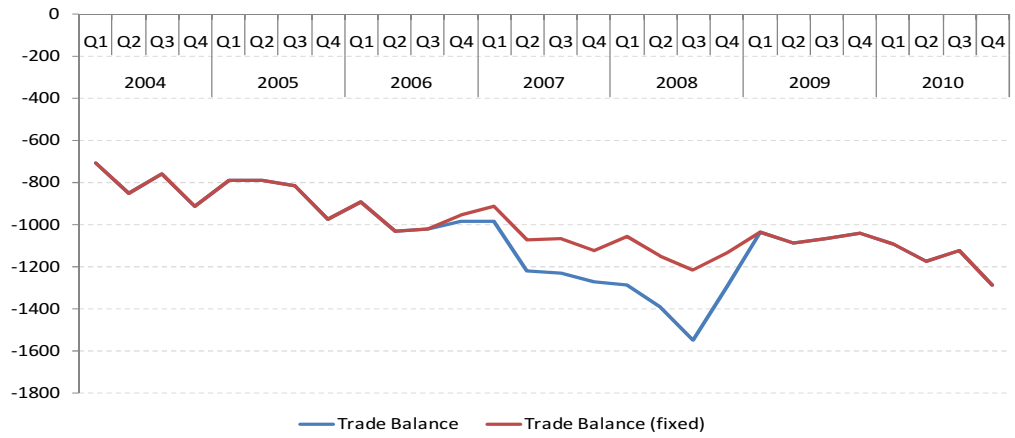
Figure 9: Imports of goods, 2004:Q1-2010:Q4, 000s (€)



Source: Statistical Service of Cyprus

In order to show the magnitude of the impact of these two factors on the trade balance in goods, figure 10 below depicts the trade balance in goods as percentage of GDP, both with actual imports and with imports in transportation equipment and fuel kept fixed at their 2006:Q4 levels for the years 2007 and 2008. Increases in imports in these categories accounted for an increase in the trade balance of goods as a percentage of GDP by 11% in 2007 and 17% in 2008.

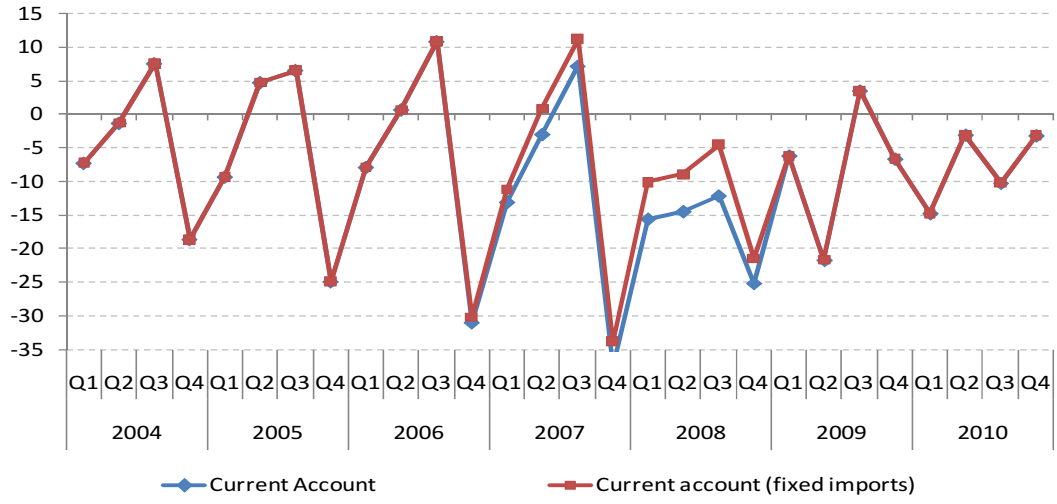
Figure 10: Trade balance in goods actual and with fixed imports in transportation and fuel, 2004:Q1-2010:Q4, % GDP



Source: Statistical Service and authors calculations

Turning next to the impact of the high imports in motor vehicles and the price of oil on the current account, Figure 11 below, shows the current account as a percentage of GDP both with actual imports and with fixed transportation and fuel imports at the 2006:Q4 levels. In total, in 2007, current account would have been around 29% lower and in 2008 around 33% lower than what it actually was.

Figure 11: Current account with actual and fixed imports of transportation and fuel, 2004:Q1-2010:Q4, % GDP

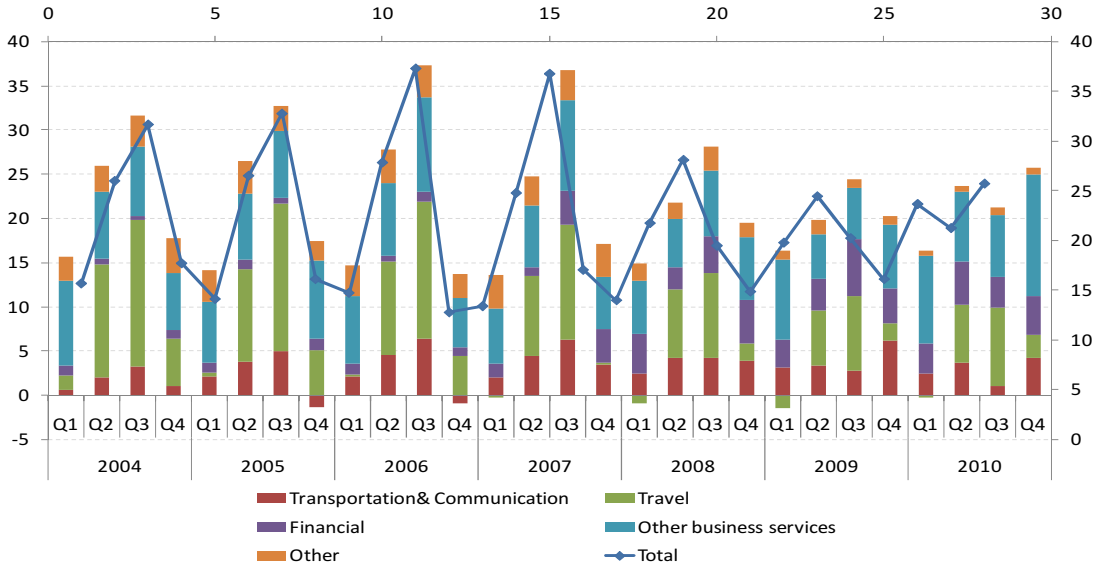


Source: Statistical Service of Cyprus, Central Bank of Cyprus and authors calculations

Trade in services

Trade in services, as shown in Figure 12, is dominated by exports in business services. Although fluctuating in nature, the variation stems mainly from fluctuations in travel export services (tourism). Following the crisis, the variation in the fluctuations diminished since travel exports remained low throughout.

Figure 12: Trade in services 2004:Q1-2010:Q4, % GDP

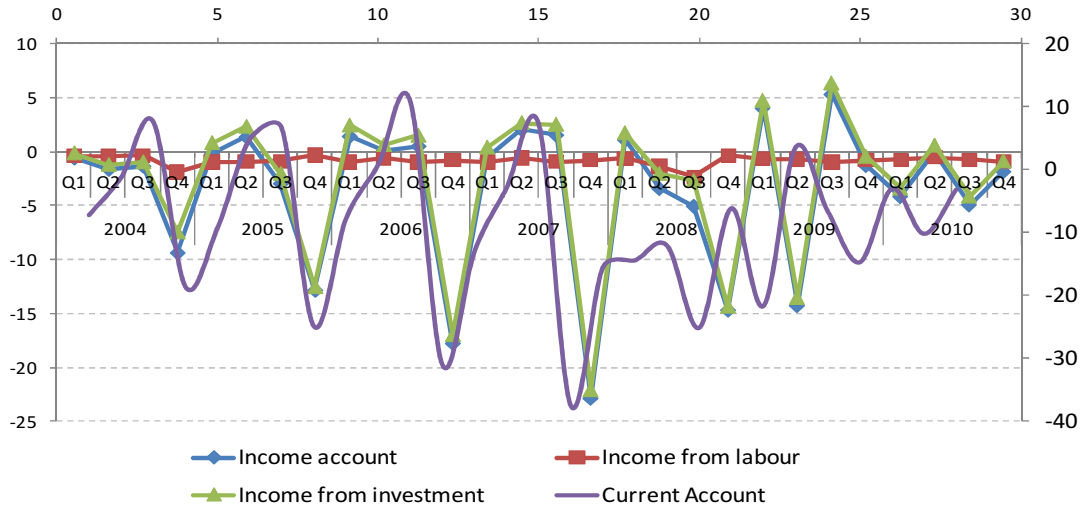


Source: Central Bank of Cyprus

Income account

The income account forms an important part of the current account, as shown in Figure 13, but is also characterized by considerable volatility. In Figure 13, where the income account is shown along with its components for the period 2004:Q1-2010:Q4, it is clear that the volatile part of the income account is essentially investment income. As such, changes in the income account are driven by movements in multinational corporations' profitability, which, purely for accounting purposes[4], are recorded in the income account as outflows but at the same time registered as FDI inflows (reinvested earnings) in the financial account. Reinvested earnings accounted for 2.8% of GDP in 2009, thus excluding this item, the current account deficit would have been significantly lower.

Figure 13: Income account and components, % GDP



Source: Central Bank of Cyprus

Savings and investment balance

The deterioration of the current account balance, which culminated in 2007-2008, reflected the high deficits recorded in the private savings investment balance, due to excessive private consumption. During this period the public sector savings investment balance improved, reflecting the observed surpluses in public finances (see Table 1d).

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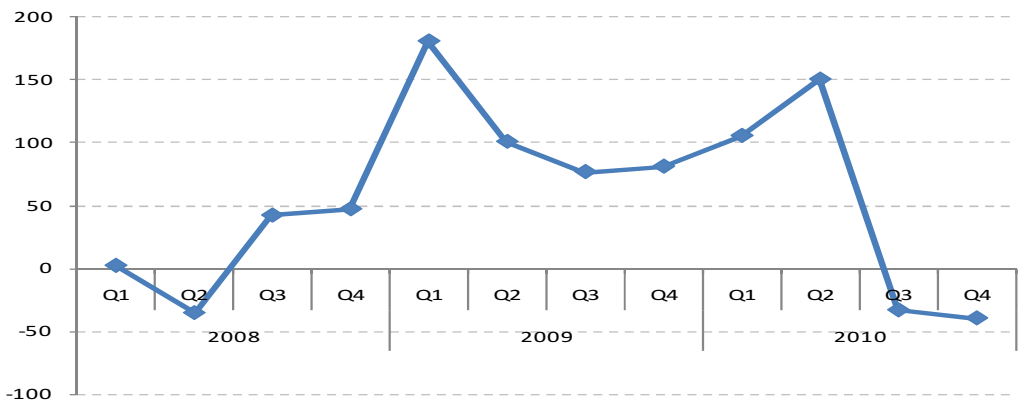
[4] It should be mentioned, that the treatment of reinvested earnings as outflows of the income account and income of the capital account is an accounting treatment which does not reflect an economic transaction, as profits of international companies do not flow out of the country.

During 2009-2010 the observed improvement of the current account balance was due to an adjustment of the private savings investment balance, which more than offset the deterioration of the public sector savings investment balance.

International investment position

The international investment position for the end period 2008-2010, as a percentage of GDP, was, on average, positive despite the persistent negative current account. The available data include entities without physical presence in Cyprus and are only available for the period 2008:Q1-2010:Q4. Therefore, the available period does not permit adequate historical analysis.

Figure 14: International Investment Position, 2008:Q1-2010:Q4, % GDP

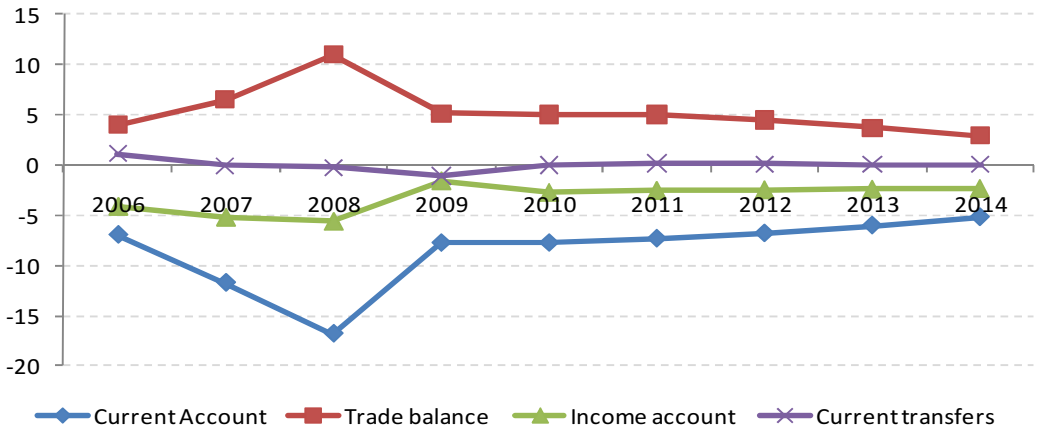


Source: Central Bank of Cyprus

Future prospects

The current account deficit during the programming period 2011-2014 is projected to gradually decrease by some 0.5 percentage points of GDP every year, from 7.8% of GDP in 2010 to 5% in 2014. The projections are sensitive to assumptions concerning the evolution of exports in goods and services, imports in goods and services and the income account.

Figure 15: Current Account 2006-2014, % GDP



Source: Central Bank of Cyprus and Ministry of Finance estimates

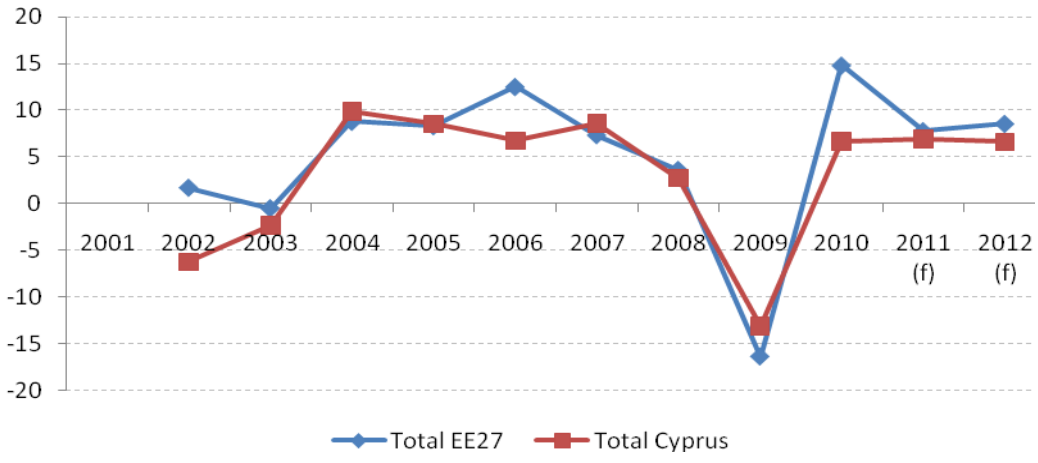
Concerning exports, international projections indicate an increase in the evolution of exports on a global scale stemming from the general improvement in the economic environment. Cyprus is projected to conform to the global increased trend, but expecting losses in the export share of tourism and gains in the export share of services, assuming the current trend continues.

The evolution of imports depends to a major extent on the developments in the price of oil on the one hand and the developments of private and public consumption on the other. Current evidence suggests that the price of oil will probably show higher increases than what initially anticipated.

Overall, the envisaged gradual improvement of the current account balance, is conditional to this assumed improvement of public finances by 3.5 percentage points. The private sector savings investment balance is assumed to show a moderate increase, as private consumption is assumed to expand slightly above disposable income, following the disaving observed in 2009-2010.

Risks to this scenario constitute the oil price increase, which implies a loss of real disposable income for households, which although it may be partially offset through higher private savings, would nevertheless lead to a deterioration of the private sector savings investment balance.

Figure 16: Total Exports EE27 and Cyprus 2002-2012, %



Source: Eurostat

Table XI: Share of Cyprus over EE27 exports in services, 2001-2012

	Total	Goods	Services		
			Total	Travel	Other Services
2006	0.15	0.03	0.55	0.7	0.4
2007	0.15	0.03	0.55	0.7	0.4
2008	0.15	0.03	0.53	0.7	0.6
2009	0.16	0.03	0.51	0.6	0.6
2010	0.15	0.03	0.51	-	-
2011	0.15	0.03	0.51	-	-
2012	0.14	0.03	0.50	-	-

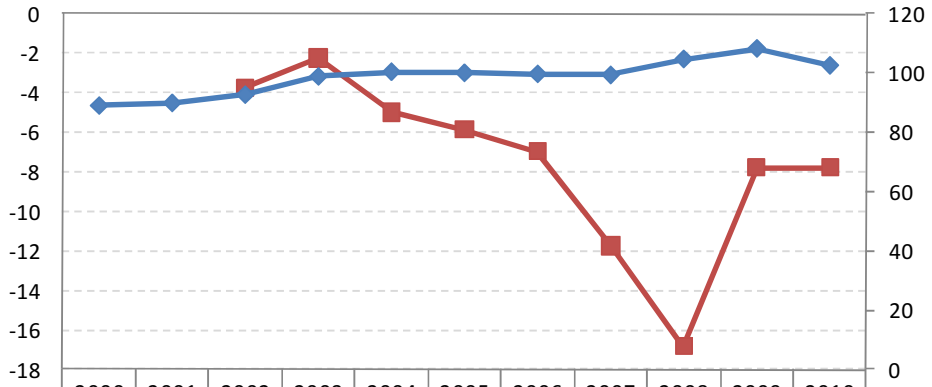
Source: Eurostat

Finally, income account volatility is expected to continue given its nature and future prospects depend on the extent of the revival of the profitability of multinational corporations. The recent evidence of economic recovery gives grounds to expect increased future profitability, but the impact of the crisis on potential growth and the relative uncertainty surrounding the sustainability of the recovery, indicate that profitability will not return at the pre-crisis levels. Therefore, the projections for the programming period assume a deteriorating income account albeit at lower levels than the pre crisis period.

The evolution of the current account also depends on the real effective exchange rate (REER). The real effective exchange rate affects the current account by its impact on imports and exports. An appreciation (depreciation) in the REER should result in higher (lower) level of imports of goods and services and lower (higher) level of exports. The extent of the effect depends on a number of factors and, as Figure 17 shows, the relationship between REER and the current account is not as

straightforward as theoretically expected. However, there is evidence to suggest that an appreciation in the REER increases the deficit in the current account and, therefore, the current account deficit will be higher or lower than projected, depending to the extent where the REER is expected to remain relatively high. The REER presented a deterioration in 2008 and 2009.

Figure 17: Current Account (% GDP) and REER 2000-2010



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
CA (% GDP)			-4	-2	-5	-6	-7	-12	-17	-8	-8
REER	89	90	93	99	100	100	100	99	105	108	103

Source: Central Bank of Cyprus and Eurostat

4. GENERAL GOVERNMENT BALANCE AND DEBT 2010-2014

Policy Strategy

Taking into account the uncertainties surrounding the prospects in the euro area, the main challenge facing policy makers at the current juncture is to address the macroeconomic imbalances prevailing in the Cyprus economy and particularly in the area of public finaces, through strenthening fiscal consolidation, while maintaining social cohesion and safeguarding growth and job creation. Against this background, the Government has designed a strategy that will safeguard the correction in public finances, thus allowing for an improvement in long term fiscal sustainability, as required by the Stability and Growth Pact. This requires a balanced policy mix, which aims at supporting the ongoing recovery but, at the same time, allows for a gradual withdrawal of the support measures and consolidation of public finances in a medium term horizon.

The general government budget balance exhibited an improvement in 2010, with the deficit currently estimated to have fallen to 5.3% of GDP from around 6% in 2009.

The improvement in public finances is attributed mainly to revenue enhancing measures, including, to some extent, measures of one-off nature. Public revenues also benefited from the moderate peak up of economic activity, albeit not as tax rich as was the case prior to the crisis, with tourism and business and financial services sectors being the main drivers of growth. In contrast, consumption and the precipitous adjustment of the construction sector continued to weigh heavily on public revenues.

Expenditure developments also contributed to the improvement of the budget balance, mainly owing to lower expenditure in public consumption, interest payments and lower gross fixed capital formation, as well as to the containment in the rate of growth of compensation of employees.

The containment of the deficit to 5.3% of GDP is below the ceiling set by the Economic and Financial Affairs Council of the European Union, in its recommendation in the context of the excessive deficit procedure. The Governments' budgetary policy aims at the correction of the excessive deficit by the end of 2012, thus leading to the reversal of the upward trend of debt-to-GDP ratio by the said year. To this end, the Government's overriding priority for 2011 is the reduction of the budget deficit to below 4½% of GDP, and ideally around 4%. To achieve this, the Government introduced a number of measures of permanent nature, both on the revenue and the expenditure side. These measures include:

- Adoption of a restrictive Budget for Central Government for 2011;
- Reduction of the number of employees in the Central Government by 1.000 per annum over the period of 2011-12;

- Increase of the excise duties on petroleum and tobacco products;
- Application of the reduced VAT rate on foodstuffs and pharmaceuticals;
- Town planning amnesty for buildings constructed with minor irregularities opening the way for the issuance of a backlog of outstanding title deeds; a set of legislative proposals have been approved by the House of Representatives;
- Application of a levy/tax on banks´ deposits subject to a minimum profitability.

In addition to the above, the Government has made progress with regard to the application of the appropriate tariffs on the consumption of water.

It is acknowledged that, the achievement of the fiscal targets set by the Government over the medium term, necessitate the adoption of additional measures, especially on the expenditure side. To this end the Government will continue the dialogue with political parties and social partners. The dialogue will evolve around the following topics:

- Systematic attempt to further curtail current expenditure;
- Dialogue with social partners for wage moderation, coordinated by the President of the Republic;
- Public sector reforms that will address the growing size of civil service. A modernization of the public sector is key and can result in leaner and more productive public services;
- Reform of the government pension system;
- Reform of the system of social transfers, with a view to targeting the needy i.e. the lowest income households.

Taking into consideration the social dimension of some of the envisaged fiscal measures, consensus building among stakeholders and the timely implementation of the fiscal consolidation measures constitutes a challenge.

In parallel, a number of institutional fiscal governance reforms are underway, aiming at controlling spending, improving planning of expenditures and bringing about a reallocation of resources, in favour of policy priorities of the government. These reforms are:

- The gradual implementation of a binding Medium-Term Budgetary Framework (MTBF), which will institutionalize expenditure rules, give more independence to spending ministries and, at the same time, increase their accountability;
- The introduction of binding fiscal rules through primary legislation;
- Enhancement of public debt and cash management systems;
- Further improvement of tax collection by addressing tax evasion and avoidance and strengthening tax administration.

Medium-Term Objective

In spite of the slowdown of economic activity and the unfavourable composition of growth and conscious of the need to improve fiscal sustainability, this Stability Programme reaffirms its ambitious Medium-Term Objective of a balanced budget.

The achievement of the MTO will imply the facilitation of a sufficient safety margin against the reference value and allow scope for the automatic stabilizers to operate freely, thus helping to dampen cyclical fluctuations. Prudent fiscal policies will be framed within a Medium Term Budgetary Framework and institute a policy response during "good times", when cyclical conditions are favourable and unemployment low, thus providing the fiscal room necessary for manoeuvre in difficult times.

The country-specific MTO, that is, the cyclically-adjusted balance net of one-off and other temporary measures, of a balanced budget, is calculated using the potential output of the Cyprus economy as estimated by the Ministry of Finance, which differs from the commonly agreed methodology. In our view, the agreed methodology leads to questionable results of the potential output, as it fluctuates considerably, especially during upturns, as well as downturns.

The structural balance in 2010 is estimated to have exhibited a decrease falling to a deficit of 5.6% of GDP, net of one-off measures, compared with a deficit of 6.3% of GDP the year before, thus exhibiting an improvement of the order of 0.7 percentage points of GDP. This is mainly due to the improvement of the nominal balance, while output gap turn negative reaching 0.5% of GDP.

According to the central reform scenario of this Programme, the structural budgetary position is projected to improve further from an estimated deficit of 3.7% of GDP in 2011 to a projected deficit of 2.4% in 2012 exhibiting a structural improvement of the order of 1.3 percentage points of GDP. This trend is sustained over the remainder of the programming period falling at 1.6% of GDP by the end of programming period, as the output gap closes. The total adjustment over the period 2011-2014 is estimated at 4.0 percentage points of GDP, with an average annual adjustment of the order of about 1 percentage point of GDP. This estimated annual adjustment exceeds the minimum requirement prescribed by the Stability and Growth Pact.

Over the programming period 2011-2014 expenditure is forecast to decrease by some 4 percentage points of GDP. This is due to a contained rate of growth of compensation of employees below nominal GDP growth, as a result of the decision of the government to reduce the number of government employees by 1.000 annually over the period of 2011-12, as well as to a contained rate of growth of other current transfers, mainly associated with better targeting of social welfare benefits and imposed restrictions on grants for local authorities and semi-governmental organisations.

Table XII: Components of Fiscal Adjustment and the Medium-term Objective

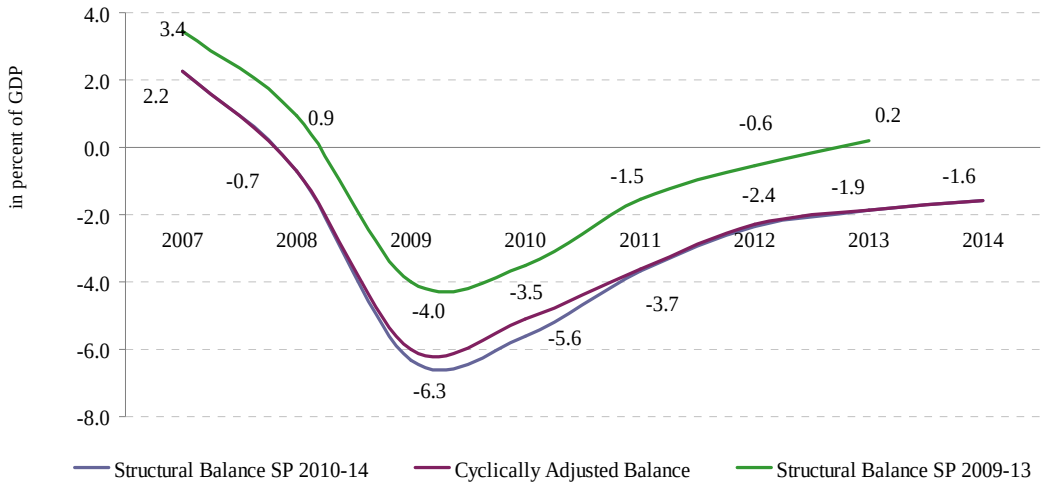
in per cent of GDP	2008	2009	2010	2011	2012	2013	2014	Total Adjustment 2011-2014
Expenditure developments[5]	0.5	4.1	0.9	-0.6	-1.7	-1.0	-0.5	*-3.8*
Revenue developments[6]	-2.0	-2.8	1.6	0.7	-0.3	-0.4	-0.1	*-0.1*
General Government Balance	**0.9**	**-6.0**	**-5.3**	**-4.0**	**-2.6**	**-2.0**	**-1.6**	**-3.7**
Cyclical Component	1.6	0.0	-0.2	-0.4	-0.3	-0.2	0.0	
Cyclically Adjusted Balance	**-0.7**	**-6.0**	**-5.1**	**-3.6**	**-2.3**	**-1.9**	**-1.6**	**-3.5**
One-off revenue measures	-	0.3	0.5	0.1	0.1	-	-	
Cyclically Adjusted Structural Balance	**-0.7**	**-6.3**	**-5.6**	**-3.7**	**-2.4**	**-1.9**	**-1.6**	**-4.0**

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

Following an estimated cumulative decline of revenues by around 4¾ percentage points of GDP in 2008-09, mainly owing to a decline in current taxes on income and wealth (mainly related to the downturn of the real estate and construction sector), as well as, in taxes on production and imports, associated with subdued consumption growth, revenue is estimated to have rebounded and risen by about 1.6 percentage points of GDP in 2010. It is then forecast to further rise by approximately 0.7 percentage points of GDP in 2011, due to discretionary measures introduced and then projected to decline on average by approximately 0.3 percentage points of GDP annually over the period 2012-2014, due to the projected less favourable, in terms of tax revenue, composition of growth.

[5] The figures represent the difference from one year to the next as a percentage to GDP.
[6] The figures represent the difference from one year to the next as a percentage to GDP.

Figure 18: Cyclically Adjusted and Structural Balance



Note: The structural balance and cyclically adjusted balance lines coincide over the period 2007-2010

Nominal Fiscal Balance in 2010

Public finances improved considerably in 2010 in the midst of a benign economic activity, not favourable to tax revenue, mainly due to revenue-enhancing measures to some extent one-off; the general government balance is estimated to have improved, as the deficit declined to some 5.3% of GDP compared to a deficit of 6% the year before.

On account of a primary budget deficit of some 3.1% of GDP – compared to a deficit of 3.4% of GDP in 2009 − the general government gross debt is estimated to have reached 60.9% of GDP at the end of 2010, compared with 58% at the end of 2009.

The fiscal performance in 2010 reflects significant developments in both the expenditure and revenue sides. Total expenditure is estimated to have increased by 0.9 percentage points, to 46.7% of GDP in 2010, while revenue has increased by about 1½ percentage points, to 41.4% of GDP.

On the expenditure side, the gradual withdrawal of the measures introduced in line with the European Economic Recovery Plan led to a decline, as a percentage to GDP, in compensation of employees, as well as, gross fixed capital formation by about 0.4 and 0.5 per cent of GDP in 2010 respectively. Interest expenditure contributed further to the containment of the rate of growth of total expenditure by an estimated decrease of 0.3 per cent of GDP.

Concurrently, social transfers have risen by around 1.5 percentage points of GDP, owing to the implementation of social measures for enhancing social cohesion,

namely the introduction of a targeted scheme and increased social welfare benefits associated with higher number of migrant recipients and increased unemployment.

Intermediate consumption contributed to the rise of expenditures, as a percentage to GDP, attributed mainly to increased defence imports.

Table XIII: General Government Consolidated Accounts

in per cent of GDP	2009	2010	2011 est.	2012 proj.	2013 proj.	2014 proj.
Current Revenue	39.8	41.4	42.1	41.8	41.4	41.3
Current Expenditure	41.7	43.1	42.5	40.8	39.9	39.4
Interest Payments	*2.5*	*2.2*	*2.4*	*2.5*	*2.6*	*2.6*
Current Balance	-1.9	-1.7	-0.4	1.0	1.5	1.9
Capital Expenditure	4.1	3.6	3.6	3.6	3.5	3.5
General Government Balance	**-6.0**	**-5.3**	**-4.0**	**-2.6**	**-2.0**	**-1.6**
Primary Balance	-3.4	-3.1	-1.6	0.0	0.6	1.0
Government Gross Debt	**58.0**	**60.9**	**61.6**	**62.0**	**61.3**	**60.1**

The performance on the revenue side continued to be negatively affected by a decline in the activity of the construction sector and the significant deceleration in the growth of corporate profits of the financial sector, following the exceptionally buoyant activity of the pre-crisis period. In particular, depressed activity in the construction sector led to significantly lower receipts from VAT, which amounted to just 1.5% of GDP in 2010 compared with 1.8% the year before; corporate tax receipts exhibited a similar pattern and continued to contract falling by approximately 0.4 percentage points of GDP in 2010 compared with the year before.

Overall, taxes on production and imports exhibited a marginal increase, owing to the increase of the excise duty rates levied on petroleum products, that somewhat compensated the impact of the unfavourable composition of growth.

Revenue

Overall, in 2010 total revenue is estimated to have exhibited an increase by about 7% rising to 41.4% of GDP compared with 39.8% the year before.

More analytically, total taxes are estimated to have remained roughly stable at 26.4% of GDP in 2010.

Taxes on production and imports are estimated to have increased marginally by 0.2 percentage points of GDP rising to 15.3% of GDP. This is mainly attributed to an accelerated rate of growth of excise duty receipts, brought by the higher rates on petroleum products, introduced in mid-June 2010. More specifically, the excise duty rate for petrol was increased from 30 cent per litre to 36 cent per litre, while the excise duty for gas oil was increased from 25 cent per litre to 33 cent per litre.

This was partly offset by the negative growth of excise duty receipts on motor vehicles, as demand for motor vehicles continued to contract for the second year in a row. More specifically, registration of motor vehicles fell by 12.5% during 2010 following a decrease of 25.7% in 2009 thus leading to a fall in excise duty receipts by some 28% in 2010, equivalent to 0.2% of GDP.

This was amplified by a sharp decline in the demand for intermediate inputs for the construction sector.

The activity in the real estate sector continued to be subdued. Values adjusted more in the coastal areas, as foreign demand for holiday homes remained at low levels. Total transactions in immovable property increased at a rate of 19.7% in 2010 compared with the year before, while sale agreements submitted at the Land and Survey Department increased at a rate of 5.2% in 2010. Growth emanated from domestic demand activity. Land and survey fees are estimated to have risen only marginally in 2010, by around 0.2% of GDP in 2010.

Taxes on income and wealth are estimated to have exhibited a marginal increase of some 2% for the year, down to 11.1% of GDP compared with 11.2% in 2009. The decline by 0.1 percentage points of GDP is solely attributed to lower receipts derived from corporate taxation, which declined by some 8%, owing largely to lower profits of financial corporations, as well as, tourist and construction sector corporations, falling to 3.9% of GDP in 2010 compared with 4.3% the year before.

In contrast, capital gain taxes on the sale of immovable property increased at a rate of 16%, as the number of properties sold rose by about 5.2% in 2010. More specifically, capital gains tax receipts in 2010 are estimated to have reached, as a percentage to GDP, 0.5% compared to 0.4% in 2009.

Furthermore, income tax receipts from physical persons in 2010 are estimated to have accelerated and increased marginally, as a percentage to GDP, to 3% in 2010 compared with 2.9% the year before.

Deemed dividend distribution, exhibited a robust growth rate reaching 45% in 2010 compared with the year before, rising as a percentage to GDP by 0.4 percentage points to 1.2%, as pre crisis undistributed profits of 2008 were on the rise. While,

withholding tax on interest exhibited a decline falling at a rate of 13% in 2010 declining, as a percentage of GDP, by 0.2 percentage points to 0.9%.

Social security contributions exhibited an increase of 14% in 2010 compared with the year before rising, as a percentage of GDP, by 1 percentage point reaching 9.6% in 2010 as the increased contribution rates introduced in April 2009 impacted on a full year basis.

Property income is estimated to have shown an accelerated rate of growth reaching some 60% in 2010 compared with the year before rising to 1.5% of GDP from around 1% in 2009. This is attributed to an exceptionally high dividend income of one-off nature from the Central Bank of Cyprus, due to the termination of the period of changeover of pound coins to euro coins, leading to the realisation of profits, as well as the allocation of higher profits associated with the extensive operations of the European Central Bank in money markets.

Expenditure

Total public expenditure is estimated to have exhibited an increase of approximately 6.2% in 2010 reaching 46.7% of GDP compared with 45.8% the year before. The increase in total expenditure in 2010 can be attributed, mainly, to higher than targeted social payments.

Social payments are estimated to have risen, as a percentage to GDP, to 14.9% compared with 13.4% the year before, due to an increased emphasis on social cohesion, in line with the objectives of the National Reform Programme. Specifically, social security payments are estimated to have exhibited an increase by some 10%, or about 0.5 percentage points of GDP, due to an increase in the level of pensions, as well as an increase in unemployment benefits.

An important component of the policies aimed at strengthening social cohesion was the introduction of an increased supplementary allowance to low income households with at least one pensioner. The fiscal impact of this measure is estimated to be of the order of 0.2 percentage points of GDP.

Furthermore, in mid-2009 the Government approved an increase of some 6½% on monetary allowances provided to social assistance recipients. This category of expenditure in conjunction with increases in the number of beneficiaries exhibited an overall increase of 12%, rising, as a percentage of GDP, to 1.4 per cent in 2010 compared with 1.3 per cent the year before.

The rate of growth of compensation of employees decelerated in 2010 and is estimated to have increased at a rate of 0.6%, decreasing as a percentage to GDP to 15.4% in 2010 from 15.8% the year before. This decelerated rate of growth is

attributed, on the one hand, to a lower inflation rate that feeds in through the automatic indexation mechanism, also known as the Cost of Living Allowance, and on the other hand, to a decrease in employment of the central government.

Owing to a lower cost of borrowing, interest expenditure is anticipated to have been reduced to 2.2% of GDP in 2010, falling by 0.3 percentage points, compared with the previous year.

In line with the Council's Recommendation on the withdrawal of the support measures introduced in accordance with the European Economic Recovery Plan, the Government has decided to gradually withdraw part of these measures that boosted investment expenditure in 2009, thus leading to decreased investment expenditure. This is estimated to have led to a decrease in government gross fixed capital formation, at a rate of 8%, and a fall, as a percentage to GDP to 3.6% in 2010, compared with 4.1% the year before

Excessive Deficit Procedure

On the 13th of July 2010, the Council decided to initiate the Excessive Deficit Procedure for the Republic of Cyprus, given that the fiscal deficit in 2009 exceeded the threshold of 3%. The Council established the deadline of 13 January 2011 for the Government of the Republic of Cyprus to take effective action to specify the measures that will be required to progress towards the correction of the excessive deficit.

At the same time, the Council issued a Recommendation postulating that the Cyprus Authorities should correct the excessive deficit - reduce deficit below the 3% threshold - by 2012 at the latest. The Recommendation specifies the need for credibility and sustainability in the deficit-reducing effort, in the context of a medium term budgetary framework, which should concentrate on an expenditure-driven fiscal strategy. In the event of more favourable economic conditions, the deficit reduction effort should be accelerated. The government debt ratio should be brought back to a declining path approaching the reference value. To this end, an average annual fiscal effort of at least 1½% over the period 2011-2012 should be ensured, but, at the same time, opportunities beyond the fiscal effort, as well as, more favourable economic conditions should be seized.

Finally, the Recommendation refers to the need for strengthening the binding nature of the medium-term budgetary framework and improvement in the monitoring of the budget execution throughout the year, as well as the need to improve the long-term sustainability of public finances by implementing reform measures to control pension and health care expenditure, in order to curb the projected increase in age-related expenditure.

Features of the 2011 Budget

The Budget for 2011 was prepared based on a three-year forecasting period taking into consideration the Medium Term Budgetary Framework of 2011-2013.

The Budget envisages the total withdrawal of the temporary support measures introduced in 2009 for the tourism sector. The Budget also places emphasis on the reallocation of government expenditures towards growth-enhancing activities and other policy priorities, established in the National Reform Programme for Cyprus.

More analytically, the main changes incorporated in the Budget for 2011 are:

- *Revenue enhancing:*
    - Application of a bank levy/tax on deposits (subject to a minimum profitability). Estimated fiscal impact of some 0.35 per cent of GDP.
    - Application of the reduced VAT rate of 5% on the consumption of foodstuffs and pharmaceuticals introduced on 10.1.2011. Estimated fiscal impact of some 0.4 per cent of GDP.
    - Application of increased excise duties on tobacco products introduced on 10th December 2010. Estimated fiscal impact of some 0.3 per cent of GDP.
    - Application of increased excise duties on petroleum products introduced on 17th June 2010. Estimated fiscal impact of some 0.2 per cent of GDP.
    - Application of the reduced VAT rate on hotel accommodation and restaurants of 8% instead of 5% introduced on January 1st 2011. Estimated fiscal impact of 0.2 per cent of GDP.
    - Reinstatement of overnight stay fees levied by local authorities on hoteliers introduced on January 1st 2011. Estimated fiscal impact of 0.05 per cent of GDP.
    - Reintroduction of airport taxes levied on airline companies introduced on January 1st 2011 onwards. Estimated fiscal impact of 0.1 per cent of GDP.
    - Termination of the practice of applying the minimum excise duty, prescribed by the acquis, on heating oil of 2 cent per litre during winter periods introduced in November 2010. Estimated fiscal impact of some 0.05 per cent of GDP.
    - Intensification of the procedure for the issuance of title deeds, through the approval of legislative measures that tackle issuance problems for buildings with minor irregularities (a measure that will substantially reduce the backlog of title deed issuances). Estimated fiscal impact of some 0.1 per cent of GDP.
    - Application of appropriate tariffs on the consumption of water (EU acquis). Envisaged introduction second half of the year. Estimated fiscal impact of some 0.05 per cent of GDP on an annual basis.

- *Revenue decreasing:*
    - Reduction of dividend income from Central Bank of Cyprus back to historical levels. Estimated fiscal impact of some 0.5 per cent of GDP.
    - Reduction of dividend income from semi-governmental organisations. Estimated fiscal impact of some 0.2 per cent of GDP.
    - No revenue related to interest rate swap. Estimated fiscal impact of some 0.2 per cent of GDP.

- *Expenditure increasing:*
    - Introduction of compensatory measures targeted towards low income households, in view of the application of the reduced VAT rate of 5% on foodstuffs. Estimated fiscal impact of 0.1 per cent of GDP.
    - Income support to Cyprus Airways. Estimated fiscal impact of 0.1 per cent of GDP.
    - Compensating scheme for Eurocypria employees made redundant. Estimated fiscal impact of 0.05 per cent of GDP.

- *Expenditure reducing:*
    - Reduction of the number of civil servants of central government by 1.000 per annum over the period 2011-2012. Estimated fiscal impact of 0.1 per cent of GDP.
    - Prohibition of the employment of additional personnel in the majority of departments of the central government

The Budget for 2011, which was prepared during the summer of 2010 and approved by the Council of Ministers on the 13th of September 2010, was based on a realistic macroeconomic scenario which is consistent with the macroeconomic projections included in this SP and which implies a GDP growth of 1½% in 2011 and inflation of some 3.4% for the year.

Revenue

In accordance with the central reform scenario, growth of total revenue is forecast to accelerate to 7.1%, that is, above nominal GDP growth, and thus rising, as a percentage to GDP, to 42.1% in 2011 compared with 41.4% the year before. The accelerated rate of growth is mainly attributed to the assumed application of the fiscal consolidation measures described in the Excessive Deficit Procedure section (Table XIV), as well as to the assumed reversal of the negative trend of revenues associated with consumption, as private consumption is forecast to grow in line with disposable incomes.

More specifically, taxes on production and imports are forecast to exhibit an increase of 11.5%, thus rising to 16.2% of GDP in 2011 compared with 15.3% the year before. The acceleration in the rate of growth of taxes on production and imports is mainly

attributed to the revenue enhancing measures that have been introduced, namely the increases in the excise duties of petroleum and tobacco products, as well as the application of the reduced VAT rate of 5% on foodstuffs and pharmaceuticals, in conjunction with the reintroduction of the reduced VAT rate of 8% on hotel and restaurant services.

Similarly, current taxes on income and wealth are forecast to exhibit an increase of 9.2%, thus rising to 11.5% of GDP in 2011 compared with 11.1% the year before. The accelerated rate of growth of taxes on income and wealth is attributed mainly to the anticipated introduction of a levy levy/tax on banks´ deposits.

Social security contributions are forecast to grow at a rate of 5.6%, in line with nominal earnings and employment growth, thus stabilising at 9.6% of GDP in 2011.

Property income is forecast to contract at rate of 40% as dividend income from Central Bank of Cyprus, as well as from semi-governmental organisations is expected to decline considerably. Thus, as a percentage of GDP, property income is forecast to fall to 0.8% in 2011 compared with 1.5% the year before.

Expenditure

Total government expenditure is projected to increase at a rate of 4%, considerably below nominal GDP growth, and fall, as percentage to GDP, to 46.1% in 2011 compared with 46.7% the year before.

In particular, compensation of employees and intermediate consumption is projected to rise at a rate of 1.9%, below nominal GDP growth, and fall, as a percentage to GDP, to 20% in 2011 compared with 20.6% the year before. This is mainly attributable to the decision of the government to reduce the number of employees in the central government by 1.000, partly offsetting the increases brought by the automatic indexation of wages and salaries and annual increments provided to public sector employees.

Concurrently, social payments are projected to decelerate at a rate of 4.5%, falling marginally to 14.8% of GDP in 2011 compared with 14.9% the year before. This is attributable to the anticipated deceleration in the rate of growth of pensions, redundancy entitlements and unemployment benefits, as well as to the anticipated reduction of vacation allowances.

Subsidies are projected to exhibit acceleration in 2011, as a result of the implementation of the new scheme of public transport, that is subsidised by the budget. As a percentage of GDP, subsidies are forecast to increase to 0.4% in 2011 compared with 0.2% the year before.

Similarly, the declining trend in interest payments is projected to be reversed in 2011, as interest rates and debt stock begun to climb. As a result, interest payments, as a percentage to GDP, are forecast to rise to 2.4% of GDP compared with 2.2% the year before.

Gross fixed capital formation is forecast to increase at a rate of 4%, in line with nominal GDP growth, thus stabilising at last years´ level of some 3.6% of GDP in 2011.

The budget balance is forecast to be contained at around 4% of GDP in 2011 compared with 5.3% the year before. During the first two months a divergence in the budget implementation has been observed.[7] The Ministry of Finance is monitoring the situation closely and stands ready to adopt further measures, if deemed necessary to achieve the fiscal targets set.

Plans for 2012 Budget and Medium Term

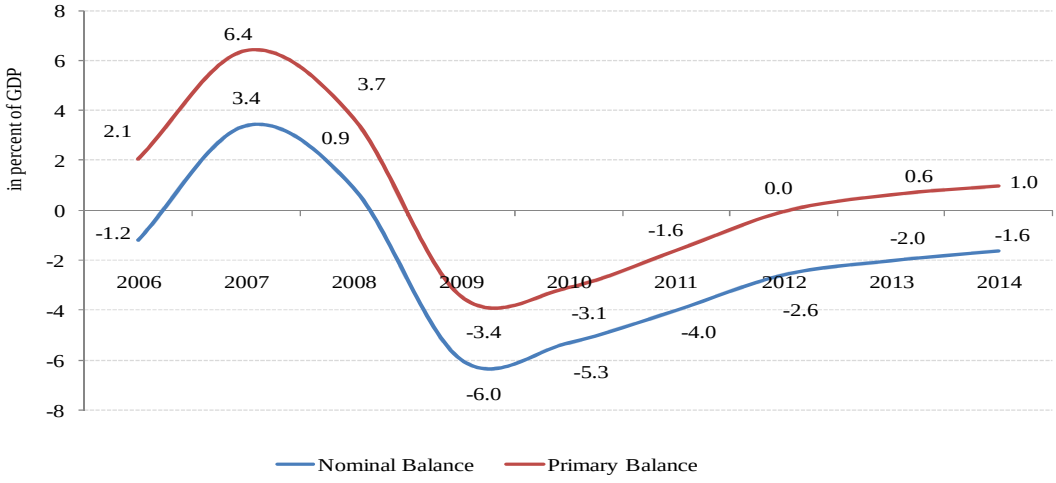
The Government is committed to meet its obligations stemming from the revised Stability and Growth Pact and which essentially require Member States to maintain sound public finances and address the issue of long-term fiscal sustainability.

Taking into account the aforementioned measures, the general government balance in nominal terms is projected to be contained in 2011 at the level of 4% of GDP. The projected budgetary position implies a consolidation effort, against a no policy change scenario, of the order of 1¾ percentage points of GDP in structural terms.

The fiscal consolidation measures envisaged in 2011 rely on the containment of expenditure growth to levels below historical trends, as well as, on the application of discretionary revenue enhancing measures.

[7] According to data on cash basis for the first two months of 2011, there is a divergence in the monthly general government balance from what was originally forecast amounting to 0.6 per cent of GDP. The divergence is mainly attributed to a negative performance of revenue, which is more pronounced in the categories of corporate taxation, deemed dividend distribution and withholding tax on interest, as well as, VAT.

Figure 19: Overall Nominal and Primary Balance



There are considerable downside risks to this central reform scenario. These stem from the timely implementation of the fiscal consolidation measures as consensus building may prove challenging, especially for certain socially oriented measures. Risks also stem from the envisaged impact of the consolidation measures associated with the town planning amnesty on the issuance of title deeds for buildings or development projects constructed with minor irregularities, the containment in the rate of growth of the wage bill, particularly with regard to the reduction in employment, as well as the application of the appropriate tariffs on the consumption of water.

Additional risk factor to the achievement of deficit and debt targets is the practice of adopting supplementary budgets, especially in light of the fact that Cyprus has entered an electoral cycle. Last but not least, downside risks associated with the macroeconomic scenario, which are analysed in Chapter 5 of this Stability Programme, may also materialise.

The fiscal consolidation measures, envisaged to be implemented when consensus is reached among social partners include a systematic attempt to curtail current expenditures, public sector reforms, which will address the growing size of civil service, and a careful reform of the system of social transfers in order to target better benefits and help more those in greater need thus contributing to an improved social cohesion.

More analytically, the fiscal consolidation measures under review with the envisaged year of adoption and an estimated fiscal impact are presented in the table below. The said table includes, also the additional amounts that are required to be agreed in the on-going dialogue process with political parties and social partners in order to reach the fiscal targets set by the Government.

Table XIV: Fiscal Consolidation Measures

Measure	Planned year of adoption	Direct budgetary impact[8]			
		2011	2012	2013	2014
I. Public Sector Personnel Expenditure					
1. Reduction in the overall number of employees in the broad public sector (target 1000 per annum) through inter alia minimal creation of new posts in the civil service and termination of the practice of employing temporary personnel. The measure covers both permanent, as well as, hourly paid positions	2011-12	-0.1	-0.1	-0.05	-
2. Containment of the rate of growth of total wage bill in the public and broader public sectors	2010-13	-	-0.2	-0.2	0.2
3. Extension of the retirement age in Secondary Education and Police Service to 63 years of age	2010	-	-0.2	-	-
Impact of Public Sector Personnel Measures		***-0.1***	***-0.5***	***-0.25***	***0.2***
II. Targeting of Social Schemes					
1. Targeting social transfers to low income households	2011	0.1	-	-	-
2. Income support provided to Cyprus Airways	2011	0.1	-0.1	-	-
3. Compensating scheme for Eurocypria employees	2011	0.05	-0.05	-	-
Impact of targeting social schemes		***0.25***	***-0.15***	***-***	***-***
III. Other Expenditures					
1. Containment in the rate of growth current expenditure	2011-14	-0.1	-0.4	-0.2	-0.3
Impact of reduction of other expenditures		***-0.1***	***-0.4***	***-0.2***	***-0.3***
IV. Town Planning Amnesty					
Town planning amnesty for buildings constructed with minor irregularities and accelerating deed issuances from a	2011-12	-	0.1	0.05	0.05

[8] The direct budgetary impact presented is based on the additional impact, in percent of GDP, of each measure compared to the preceding year.

Measure	Planned year of adoption	Direct budgetary impact[8]			
		2011	2012	2013	2014
substantial backlog created over the years. Town planning amnesty is promoted through the amendment of five laws. The amendments intend to simplify and expedite the complex procedures, that begin from the licensing of the development and end-up with the issuance of title deeds for specific units or development projects and registering them to specific buyers or owners. Additionally, through the proposed amendments buyers unable to obtain a title deed for property purchased, mainly due to the fact that the development was completed with minor irregularities, will under certain provisions be able to do so.					
V. Revenue Measures					
1. Application of the minimum excise duties prescribed by the acquis on petroleum products	2010	0.2	-	-	-
2. Application of increased excised duty rates on tobacco products	2011	0.3	-	-	-
3. Application of the reduced VAT rate on foodstuffs and pharmaceuticals as prescribed by the acquis	2011	0.4	-	-	-
4. Reintroduction of the reduced VAT rate on hotel and restaurant services	2011	0.2	-	-	-
5. Application of a tax on bank deposits	2011	0.35	-	-	-
6. Reform of the pricing policy of water usage as prescribed by the acquis	2011	0.05	-	-	-
7. Dividend Income from various semi-governmental organisations	2011	-0.7	-	-	-
8. Interest rate swap	2011	-0.2	-	-	-
9. Fee on the issuance of a 3-year special government bond	2010	-	-	-0.1	-
10. Termination of the policy of reducing the excise duty on heating oil during the winter season	2010	0.05	-	-	-
Total Impact of Other Measures		***0.65***	***-***	***-0.1***	***-***
Subtotal as a percentage to GDP		***0.6***	***1.15***	***0.4***	***0.15***
Of which: *Revenue Measures* *Expenditure Measures*		*0.65* *0.05*	*0.1* *-1.05*	*-0.05* *-0.45*	*0.05* *-0.1*
VI. Additional Measures					
Additional measures to be agreed with stakeholders		-	*0.8*	-	-
Total Impact as a percentage to GDP		***0.6***	***1.95***	***0.4***	***0.15***

Medium Term Budgetary Framework

A Medium-Term Budgetary Framework (MTBF), which commenced in 2006, is intended to lead to a containment of expenditures by line ministries and, at the same time, promote the reallocation of expenditure in favour of growth - enhancing activities, consistent with the priorities set by the National Reform Programme.

More specifically, budgetary reforms require that ministries and other government spending agencies enter a process of redesigning their annual budgets, using new Medium-Term Budgetary Framework (MTBF) and Programme and Performance Budgeting (PPB) methods.

These new methods are being introduced progressively from 2007, with all spending agencies being required to prepare rolling over three-year budget of indicative nature. The first steps for introducing the new PPB framework were taken in 2007, with the implementation of pilot projects, covering three ministries. In 2008, the number of ministries and spending agencies, adopting this approach, increased and it is expected that all agencies will prepare their financial year (FY) 2013 budgets according to both the traditional (input-based) budget method and the new PPB/MTBF format. This will enable all spending agencies to have at least two "trial" years, in which the new methods can be developed, tested and refined.

During this trial period, the Treasury Department has been upgrading the accounting software Financial Management Accounting System (FIMAS) to a newer version that is capable of supporting the new budgetary methods and classifications. The new MTBF/PPB approach will become the official (and only) budget method from FY 2014 onwards.

Overall, the MTBF budgeting should enable managers to plan activities more effectively, by incorporating the amount of financing required to sustain a particular government policy, budget activity or expenditure project over several years.

The Budgetary framework described above as well as additional fiscal rules will be embedded in national legislation covering the preparation and implementation of forthcoming Budget Laws thus increasing its effectiveness and binding nature.

A detailed presentation on legislation, discussing its binding nature and the fiscal rules is provided in Chapter 6 – Quality of Public Finances.

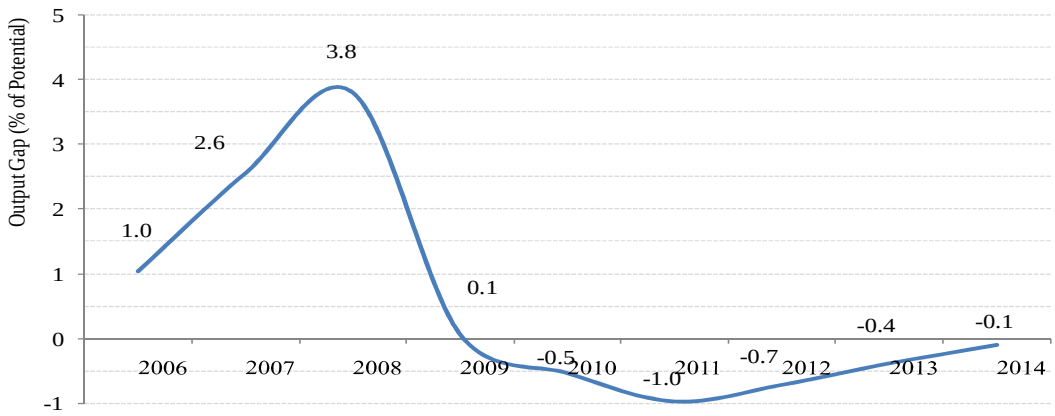
Structural Balance and Fiscal Stance

Following a period of robust economic activity, during which the output gap was positive peaking in 2008 to about 3¾% of GDP, the economy contracted in 2009 for the first time since 1974. The downturn led to a considerable fall in the capacity utilisation rate of the economy and to a fall in output gap, which is forecast to turn

negative in 2010. The medium-term scenario incorporated in the SP envisages a relative decrease of potential GDP growth at the beginning of the programming period following the economic crisis and subsequently a gradual acceleration towards closing of the output gap by the end of the programming period. Specifically, output gap is estimated to have turned negative reaching ½% of GDP in 2010 from a close to balance position in 2009 and is expected to widen further in 2011 reaching 1% of GDP. In 2012-14 the output gap, as a percentage of GDP, is forecast to be negative but gradually improve as economic activity intensifies, closing at 0.1% of GDP by the end of the programming period.

Based on this analysis of the cyclical position of the economy, and to provide a clear picture of the underlying fiscal position, the following analysis disentangles trend, cyclical, and one-off fiscal effects.

Figure 20: Output Gap



One-off measures

The substantial improvement in the fiscal position of Cyprus economy in nominal terms during 2006-2008 was achieved without the introduction of any one-off measures. However, during 2009 following a period of exceptional revenues, brought by the boom in the real estate sector during the period 2004-2008, construction and real estate activities contracted and capital gains tax receipts and land and survey fees exhibited sharp declines. The direct loss of revenue attributed to a slowdown in the real estate sector is estimated to amount to about 2½ per cent of GDP in 2009 on top of an estimated 2 per cent in 2008. In addition to this, one-off revenue measures in 2009 associated with the imposition of a fine to petroleum companies by the Competition Protection Authority amounted to 0.3% of GDP. In 2010 one-off measures associated with exceptional higher dividend by the Central Bank of Cyprus and a semi-governmental organisation, a profit realised from an interest rate swap, a fee on the sale of a 3-year special government bond, as well as to a capital injection to a state owned airline company, amounted to about 0.5% of GDP.

The Stability Programme relies on the implementation of measures of permanent nature over the programming period. Owing to the implementation of the fiscal consolidation measures, the tax buoyancy ratio (that is the change in the ratio of revenue to GDP) is forecast to fall to 1.8 in 2011 from 2.1 the year before and subsequently stabilising at about 1 over the remainder of the programming period, below historical levels.

Table XV: Cyclical Developments and one-off measures

as a percentage of GDP	2009	2010	2011 est.	2012 proj.	2013 proj.	2014 proj.
GDP growth at constant prices	-1.7	0.9	1.5	2.5	2.7	3.0
General Government Balance	**-6.0**	**-5.3**	**-4.0**	**-2.6**	**-2.0**	**-1.6**
Net Interest payments	2.5	2.2	2.4	2.5	2.6	2.6
Potential GDP growth (% change)	2.0	1.5	2.0	2.3	2.5	2.8
GDP output gap[9]	0.1	-0.5	-1.0	-0.7	-0.4	-0.1
Cyclical budgetary component	0.0	-0.2	-0.4	-0.3	-0.2	0.0
Cyclically-adjusted balance	**-6.0**	**-5.1**	**-3.6**	**-2.3**	**-1.9**	**-1.6**
Cyclically-adjusted primary balance	-3.5	-2.9	-1.2	0.2	0.7	1.0
One-off measures	*0.3*	*0.5*	*0.1*	*0.1*	-	-
Cyclically-adjusted balance net of one-off and other temporary measures	**-6.3**	**-5.6**	**-3.7**	**-2.4**	**-1.9**	**-1.6**
Structural Change	-5.6	0.7	1.9	1.3	0.5	0.3
Cyclically-adjusted primary balance net of one-off and other temporary measures	-3.7	-3.4	-1.3	0.2	0.8	1.0

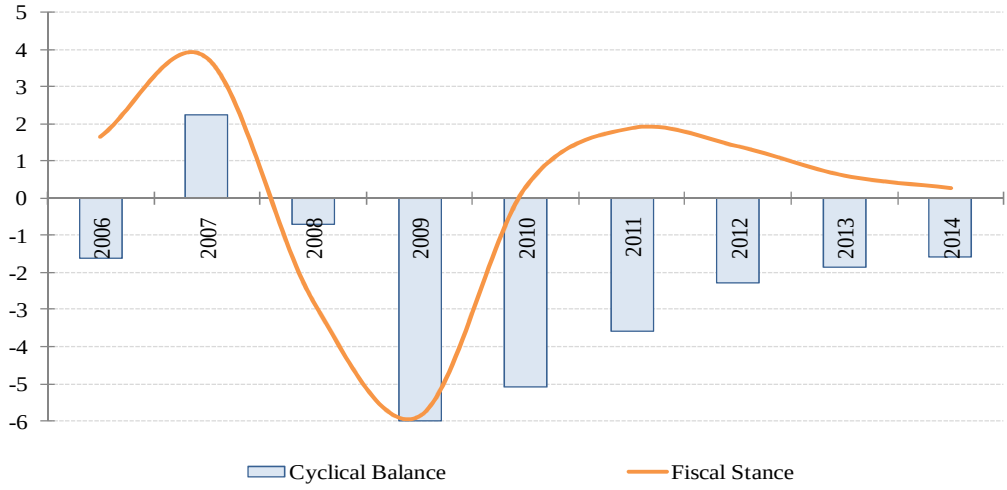
The cyclically-adjusted balance and structural balance

Similarly to last year's Stability Programme, indicators of cyclically-adjusted budget balances have been incorporated in the compilation of the Stability Programme 2010-2014, in order to take into account cyclical variations. The cyclically adjusted budget balance is estimated to have declined from a deficit of 6% of GDP in 2009 to a deficit of 5.1% in 2010, and is projected to exhibit a declining trend at the beginning of the programming period falling to a deficit of 2.3 per cent of GDP in 2012. This trend is projected to continue over the remainder of the programming period falling to 1.6 per cent of GDP by 2014.

[9]In percent of potential GDP.

Reflecting the conservative fiscal stance exhibited over the period 2004-2007 peaking at 3¾ per cent of GDP in 2007, fiscal stance turned negative in 2008 reaching 2.7% of GDP and rose further in 2009 reaching 5.9%. In 2010, fiscal stance is estimated to turn positive again reaching approximately 0.3 per cent of GDP. Subsequently, it is forecast to increase further in 2011 peaking at 1.9 per cent of GDP and fall to 1.4 per cent in 2012. Over the 2013-14 period, the fiscal stance is forecast to be close to ½per cent of GDP.

Figure 21: Cyclical Balance and Fiscal Stance
(in per cent of GDP)



A similar picture is also presented for the cyclically-adjusted balance, net of one-off measures (Table XV). The cyclically-adjusted balance net of one-off measures, as a percentage to GDP, declined sharply in 2009 falling to a deficit of 6.3% compared with a deficit of 0.7% the year before, due to the exceptional, and hence temporary, revenue, attributed to the real estate boom that began to dissipate in 2009, leading to a deterioration of the structural position by 5.6 percentage points. The structural balance in 2010 exhibited an improvement of about 0.7 percentage points of GDP, thus falling to a deficit of 5.6% of GDP. The structural adjustment effort is positive over the programming period, as the cyclically adjusted balance, net of one-off measures, is forecast to continue improving reaching a deficit position of 1.6 per cent of GDP in 2014. The implied annual fiscal effort is negative averaging 1 per cent of GDP over the programming period 2011-2014.

Debt Management

Debt Levels and Developments

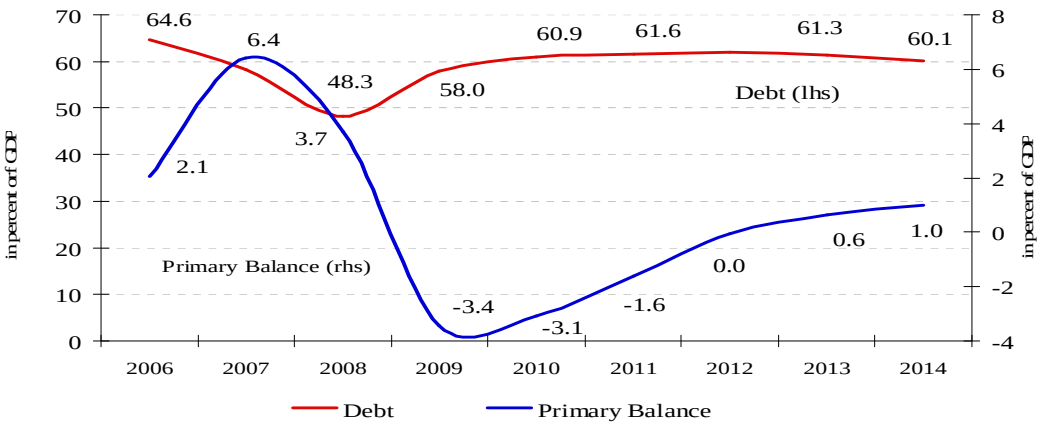
The revised Stability and Growth Pact (SGP) specifies that, in light of the increased economic and budgetary diversity in the EU, *"the medium-term budgetary objectives (MTOs) should be differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as the diversity of risks to the sustainability of public finances"*.

The European Council on the 20th of March, 2005 indicated that "*the long-term sustainability of public finances would be supported by the convergence of debt ratios towards prudent values*". The 'Code of Conduct' also stresses *"the need to ensure the convergence of debt ratios towards prudent levels, taking into account the economic and budgetary impact of ageing populations"*.

In light of the above, the evolution of public debt has been brought to the forefront of fiscal surveillance. Countries with higher-than-average debt levels are subject to stricter consolidation requirements, while low public debt countries are allowed to sustain small scale fiscal deficits and adopt accordingly their MTOs.

Following a period of debt consolidation the on-going economic downturn and the worsening fiscal position will inevitably reverse this positive development, at least until the fiscal situation stabilises by the end of the programming period. The debt-to-GDP ratio is estimated to have risen to 60.9% of GDP in 2010 compared to 58% the year before, or by some 3 percentage points of GDP. The increase of the debt-to-GDP ratio is largely attributed to the large primary deficit. The debt-to-GDP ratio is projected to continue its upward path and peak to around 62% of GDP in 2012 exhibiting a further increase of approximately 1 percentage point of GDP. It is then forecast that the debt-to-GDP ratio upward trend will be reversed and exhibit a decline falling to about 60% of GDP by the end of the programming period.

Figure 22: Government Gross Debt and Primary Balance



Stock-Flow Adjustment

The Stock-Flow Adjustment (SFA) analyses the factors contributing to changes in government debt, other than government deficits/surpluses. The main items include the accumulation or running down of financial assets and the so called "snow ball" effect. The positive stock flow adjustment in 2009, equivalent to 6.2% of GDP, reflect primarily the large positive "snow ball" effect brought by a stagnating growth of nominal GDP and secondarily the accumulation of liquid assets to meet maturing obligations of the government at the beginning of 2010. This was followed in 2010 by a marginally negative stock flow adjustment due to a deccumulation of government assets, equivalent to -0.2% of GDP.

The contribution of SFA is projected to remain broadly negative during the programming period peaking in 2011 at about -1% of GDP, turning positive in 2012 and then due to a negative "snow ball" effect fall close to balance and then rising to -0.3% in 2014.

Table XVI below presents the gross debt level, according to the central reform scenario, and the contribution to change in gross debt for the period of 2009-2010, and projections covering the period 2011-2014.

Table XVI: General Government – Debt Developments

as a percentage to GDP	**2009**	**2010**	**2011 est.**	**2012 proj.**	**2013 proj.**	**2014 Proj.**
Gross Debt Level	58.0	60.9	61.6	62.0	61.3	60.1
Change in Gross Debt	9.7	2.9	0.7	0.3	-0.6	-1.3
Contributions to Change in Gross Debt						
Primary Balance	-3.4	-3.1	-1.6	0.0	0.6	1.0
Interest Payments	2.5	2.2	2.4	2.5	2.6	2.6
Nominal GDP Growth	-2.0	2.9	5.2	4.6	5.3	5.7
Stock-flow adjustment[10]	6.2	-0.2	-0.9	0.3	0.0	-0.3
Net Financial debt	58.2	59.0	60.8	61.8	61.1	59.9
Implicit interest rate	5.2	3.9	4.1	4.3	4.5	4.5

[10] Including "snow-ball" effect.

Financing actions in 2010

The Public Debt Management Office of the Ministry of Finance has been following a low-risk public debt management strategy.

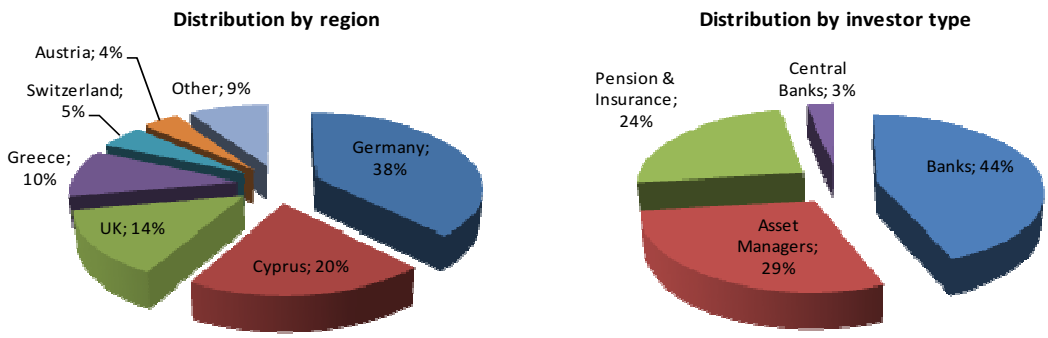
- Short-term public debt comprises only 5% of the total public debt;
- Weighted-average remaining maturity of public debt is estimated at 6 years;
- Amount denominated in euro constitutes almost 100% of public debt;
- Public debt with fixed interest rates is about 91% of total public debt.

Within this policy context, the financing in 2010 comprised of a good mixture of all financing instruments used by the Republic. Following a 2-year local bond issue of €116m in January, the Republic issued a new €1bn benchmark 10-year EMTN bond in February. Despite the challenging market conditions the bond was priced at a yield of 4.683% or a spread of 125 basis points over mid-swaps. The coupon was set at 4.650%. Due to the market volatility and adequate funding from the February issue, the government chose to proceed with short-term financing over the summer. Summer financing actions comprised of a €400m ECP and €250m TB.

As the decision was to return to the financial markets after the summer break, in November the second EMTN of the Republic within the year was launched, namely a 5-year benchmark bond. The bond was priced at a new issue spread of 172bps over mid-swaps (overall yield of 3.842%; coupon 3.75%).

The November issue showed an increased placement among international investors (80%) vs. the February bond (62%). The geographical and industry distribution of investors is depicted below:

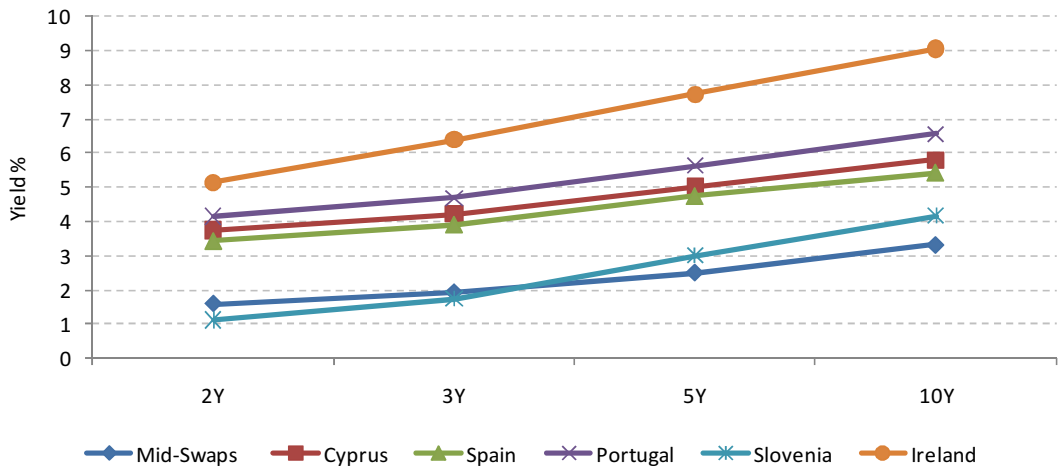
Figure 23: Republic of Cyprus €1bn, 5-yr EMTN - investor distribution



Overall, yield development for Cypriot benchmark bonds throughout 2010 was in line with peer eurozone countries (rating wise). Cyprus benchmark bonds have been

affected particularly in April-May but normalised after the announcement of the EMU/IMF financial support for Greece. Despite the decline in spreads after the summer, the EMTN bond in November was priced at a relatively higher premium compared to previous issues of the Republic. An increase in the secondary market yields in the last 2 months of the year had effectively little impact on the government financing as the bulk of borrowing needs had been covered for the year. The following chart constitutes a static picture of secondary market yields as at 31st Dec. 2010:

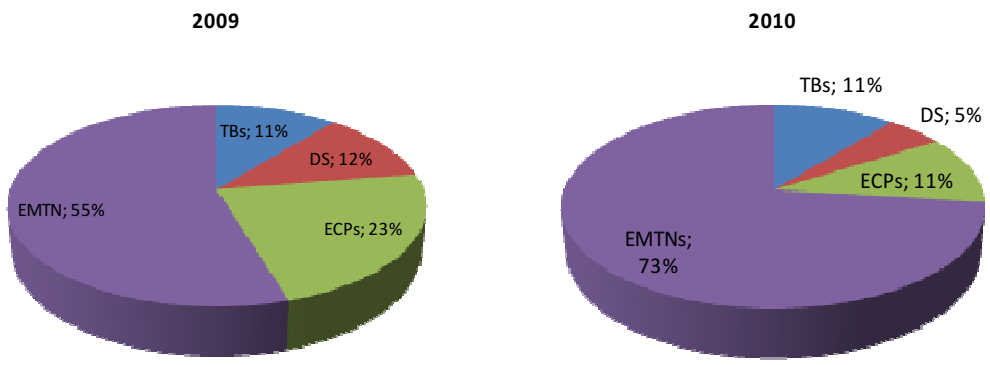
Figure 24: Bond Yields – Cyprus and other Sovereigns as at 31-12-2010



Net debt issuance in 2010 followed the issuance pattern of the previous year by concentrating on EMTN issues. The issue of €2bn EMTN bonds covered 73% of net issuance for the year.

As mentioned above, the rest of net issuance was in the form of €116m long term domestic bond, and €495m short term bills and papers:

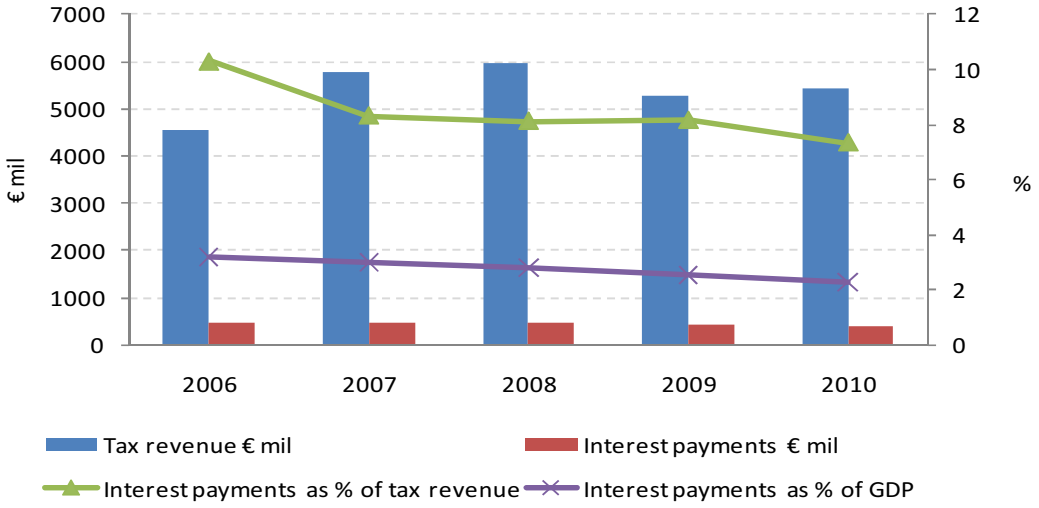
Figure 25: Public Debt Securities Issuance by the Republic of Cyprus



The EMTN issues increased visibility of the Republic of Cyprus as a euro issuer, and helped in the creation of a sovereign yield curve for the country. Short term debt was reduced to 4% of outstanding debt by the year end, down from 9.4% at the beginning of the year. Furthermore, the policy of low risk in the debt portfolio has been followed by hedging any debt positions in foreign currency.

As indicated in the relevant chart below, the interest rate burden has fallen during the year due to low base rates that affected short term borrowing and floating rate indexed debt, and due to the debt consolidation of previous years.

Figure 26: Servicing the Public debt



As already described, the Cyprus debt portfolio carries low market risk. Only around 9% of debt is indexed to floating interest rates whereas securities and loans denominated in currencies other than the euro make up less than 1% of outstanding debt.

PDM policy

The MoF focus is to modernize the current debt management framework and practices. Under this context, work will be undertaken in the following areas:

- Modernize legislation to account for institutional arrangements and better reflect today's financial markets;
- Set up primary dealers system for the government bond market. In 2010 the electronic trading platform for Government Treasury Bills has been successfully launched. Regular auctions are planned to take place during 2011;
- Enhance public debt management infrastructure;

Financing 2011

Gross financing needs for 2011 are projected to be close to EUR 2.0 bn. The following options are available for the financing of the year:

- Medium/ long-term EMTN (available amount exceeding EUR 4.0 bn) through syndication, auction or private placement;
- Short-term ECP (available amount of up to EUR 2.5 bn) through private placement in the over-the-counter market;
- Short-term TBs (unlimited) through auction in the domestic market;
- Domestic Government Bonds (unlimited) through auction in the domestic market;
- Schuldschein in the German market;
- Institutional loans for project financing.

Subject to market conditions, the dominating option is the issuance of a new 5-year or 10-year EMTN bond in the euro market. In February 2011 the Republic issued a 5-year EMTN bond by private placement, of a nominal amount of €170m and a yield of 4.75%. The target is to maintain short term debt below 10% of outstanding debt, and retain presence in the euro debt market.

Financing 2012 – 2014

The following are projections of the annual refinancing needs for the period 2012 – 2014, as at 31 Dec. 2010:

Table XVII: Refinancing needs for the period 2012 – 2014

Year	**2012**	**2013**	**2014**
EUR bn	1.2	1.7	1.0

The Government will pursuit the same borrowing policy and low-risk public debt management strategy in the near future, placing also emphasis on reducing borrowing costs, through the further development and more efficient functioning of the secondary market.

Balance by Sub-Sector of General Government

The General Government sector in Cyprus comprises of the central government, the local authorities and the social security funds. The central government accounts for the bulk of the general government deficit, with the local authorities responsible for a small share of some 0.1% of GDP, as a substantial part of their operations and investment programmes are financed by transfers from the central government (Table XVIII).

The Central Government deficit is estimated to have declined from a deficit of the order of 8.7% of GDP in 2009 into a deficit amounting to 7.7% in 2010. While, Social Security Funds balance, which is based on a pay-as-you-go system, exhibited a smaller surplus, from 2.8% of GDP in 2009 to 2.4% in 2010, thus impacting on the overall budget balance. [11]

During 2011, it is projected that the Central Government budget balance will continue to exhibit a downward trend as a percentage to GDP and fall to 6.3%. The surplus of the Social Security Fund is projected in 2011 to stabilise at last year's level of 2.4% of GDP, bringing the overall balance of the General Government to a deficit of around 4% of GDP.

The sizeable surplus of the Social Security Funds is linked to the newly introduced parametric reforms and the still-favourable demographics, but also is due to the fact that the Social Security System will continue its maturing phase for another few years, after which the people who are entitled to full benefits will start to retire.

The projected fall in the surplus of the Social Security Fund is mainly due to increases in pension entitlements, as well as, the number of beneficiaries, and an unchanged social security contribution rate over the period 2011-13. Specifically, the surplus of the social security funds is projected to decline from a forecast of 2.4% of GDP in 2010 gradually to 2.1% by 2014.

[11] The Government as an employer and as a contributory party to the whole scheme contributes annually approximately 3 percent of GDP.

Table XVIII: General Government Budgetary Developments by Sub-Sector

in per cent of GDP	2009	2010	2011	2012 est.	2013 proj.	2014 proj.
			Net lending by sub-sectors			
General Government	**-6.0**	**-5.3**	**-4.0**	**-2.6**	**-2.0**	**-1.6**
Central Government	-8.7	-7.7	-6.3	-4.7	-4.0	-3.7
Local Government	-0.1	0.0	0.0	0.0	0.0	0.0
Social Security Funds	2.8	2.4	2.4	2.1	2.1	2.1

Euro Plus Pact

In the framework of the Euro Plus Pact, the Government of the Republic of Cyprus commits to engaging in dialogue with all relevant stakeholders, addressing competitiveness issues and implement specific measures concerning competitiveness, sustainability of public finances and financial stability, as presented below.

Fostering competitiveness

The containment of public sector wages is one of the measures that are being discussed with stakeholders with a view to address competitiveness challenges. Possible policy options include zero contractual salary increases in the public sector during the next year, the initiation of a public dialogue with trade unions for a containment of public sector payroll in the medium term and the re-designing of the system of Cost of Living Allowance (COLA) in order to limit increases in higher income groups, thus making it more equitable.

Meanwhile, concerning corporate taxation, Cyprus intends to maintain its current system which is characterized by low tax rates and a broad tax base, in line with broadly accepted principles of effective and fair taxation systems.

Contributing further to the sustainability of public finances

A dialogue on the restructuring of the public pension system is currently under discussion, which will be concluded by the end of 2011. The dialogue is based on concrete proposals including the gradual introduction of contributions of civil servants towards pensions, changes in the calculation method of pension level and a change in the indexation of pensions.

Furthermore, a Budgetary Framework (BF) is being gradually established. Towards this end a Bill is being prepared. The BF, among others, includes the introduction of

national fiscal rules and the application of a binding MTBF as described above. The national fiscal rules include an expenditure rule. The BF is envisaged to be approved by the Council of Ministers during autumn of 2011 and subsequently adopted by Parliament by the end of the year. A more detailed description of the BF, as this is defined in the prepared Bill, is given in Chapter 6.

Reinforcing Financial Stability

The Cypriot financial sector is sound; the overall position of the banking sector is considered healthy, with a strong liquidity position and a comfortable capital adequacy as well as sufficient profitability. There is a continuous and close monitoring of the liquidity and capital adequacy position of financial institutions by the supervisory authorities. Moreover, an ad hoc committee has been set up, with the participation of the Central Bank, in its capacity as supervisor of banks and responsible for the overall financial stability, as well as with the other supervisors, which monitors closely the developments of the financial sector.

A framework draft law for dealing with financial crisis has been prepared, to enable the Cypriot Council of Ministers, following a proposal of the Minister of Finance and taking into account the opinion of the Governor of the Central Bank of Cyprus (CBC) after approval of these measures by the House of Representatives, to take, 'in a period of a financial crisis', measures intended to address liquidity or insolvency problems affecting financial institutions, in full compliance with the relevant acquis framework.

In relation to banks and cooperative credit institutions, the imposition of a special tax has been decided, of the order of around €60m per annum for the next 2 years, with the establishment of a fully independent Financial Stability Fund, within the next 6 months. Part of the generated revenues (25/60) from the above tax will constitute part of the said Fund. The Independent Financial Stability Fund will be set up, with a view to supporting and facilitating the resolution of distressed credit institutions.

5. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

During 2010, the world economy has shown firm signs of recovery, although there are significant divergences in performance across different regions and countries. Differences exist not only across continents but also within, especially the euro area. The sovereign debt crisis in the euro area, rising commodity prices, and geopolitical tensions in some parts of the world are casting a shadow over the ongoing recovery and uncertainties remain elevated. The return to potential growth is therefore characterized by uncertainty, which can also affect Cyprus, given its small and open nature.

The economy of Cyprus rebounded in 2010 exhibiting a modest positive growth. As in the previous SP 2009-2012, the current SP envisages a gradual recovery towards a lower, compared to pre-financial crisis period, potential GDP growth. In the short term, the scenario takes a conservative stance with regards to the growth prospects of 2011, envisaging moderate growth, stemming particularly from exports of services. Construction and tourist activities are forecast to remain subdued, whereas financial intermediation activities are expected to follow a moderate growth path over the programming period.

Risks to the projections are associated with the uncertainties in relation to the external environment of Cyprus. The shock emanating from the global crisis still casts its shadow over the global economy and the prospects for the near and medium term. Important determinants for the eventual recovery will be the unwinding of stimulus measures from the fiscal and monetary side, exchange rate and oil price developments, the situation in labour markets, and financial sector developments.

Tensions in euro area sovereign debt markets are also key. Future developments in the euro area will be critical for the economy as a whole as they influence the economy of Cyprus both directly and indirectly, especially through confidence effects and volatility of spreads.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

To address the sensitivity of the projected general government balance and debt ratios, alternative assumptions for real GDP growth rates and interest rates have been incorporated in two distinct scenarios. All simulations assume unchanged policies but free operation of automatic stabilizers.

Assumption 1: *Higher oil prices and more pronounced losses in tourism that could lead to lower annual growth by 1.5 percentage points of GDP over the programming period of the central reform scenario.*

Other things being equal, the budget balance is projected to deteriorate by some 0.3 per cent of GDP at the beginning of the programming period to a deficit of 4.3 per cent of GDP in 2011. The resulting deficit path follows an upward trend up to 2013 reaching 2.8 per cent of GDP, falling to 2.6 per cent of GDP at the end of the programming period. The public debt-to-GDP ratio is projected to follow an ascending path peaking to 64.1 per cent to GDP in 2013, falling thereafter to 63.7 per cent to GDP, 3.6 percentage points of GDP higher than the central reform scenario.

Table XIX: Scenarios for Public Finances

in per cent of GDP	**2011**	**2012**	**2013**	**2014**	**2011-2014 4-year average**
Central Scenario					
GDP	1.5	2.5	2.7	3.0	2.4
General Government Balance	-4.0	-2.6	-2.0	-1.6	
General Government Debt	61.6	62.0	61.3	60.1	
Sluggish external recovery					
GDP	0.0	1.0	1.2	1.5	0.9
General Government Balance	-4.3	-3.1	-2.8	-2.6	
General Government Debt	62.5	63.8	64.1	63.7	

Assumption 2: *Interest rates remain 100 basis points above baseline each year during 2011-2014.*

Under this scenario, the government deficit would be 1 per cent of GDP higher at the end of the programming period, and the government debt-to-GDP ratio would be higher by about 2½ percentage points of GDP at the end of the programming period.

Table XX: Scenarios for Higher Interest Rates Cumulative Differential

in per cent of GDP	**2011**	**2012**	**2013**	**2014**
Central Scenario				
GDP	1.5	2.5	2.7	3.0
General Government Balance	-4.0	-2.6	-2.0	-1.6
General Government Debt	61.6	62.0	61.3	60.1
Higher interest rates				
GDP	1.5	2.5	2.7	3.0
General Government Balance	-4.3	-3.1	-2.7	-2.6
General Government Debt	61.9	62.8	62.9	62.9

The analysis presented here underlines the sensitivity of deficit and debt dynamics on alternative growth paths, and underscores the crucial role of reforms in maintaining strong potential growth in the medium term. Additionally, borrowing costs are also key, especially during periods of moderate growth of the economy.

Comparison with Previous Update

Compared with the forecast presented in the Stability Programme 2009-2013, GDP growth forecast for 2011 has remained unchanged while forecast for the outer years of the programming period have been revised downwards, taking upon a more conservative stance, amid conditions in the construction and tourism sectors, along with uncertainties surrounding world economic conditions, such as the developments in the oil market. The general government balance, as a percentage of GDP, and the debt-to-GDP ratio are projected to exhibit an improvement, in accordance to the Councils' recommendations issued under the Excessive Deficit Procedure initiated for Cyprus, whereby the correction of the excessive deficit should be reached by 2012 the latest.

The general government balance, as a percentage of GDP, is estimated to have reached a deficit of 5.3% in 2010, some 0.7 percentage points lower than what was anticipated in the last update. The difference is mainly attributed to the modest recovery witnessed in 2010, in combination with the introduction of concrete policy measures and a tight control over current expenditures. The general government balance is projected to fall to a deficit of 4% in 2011 and a deficit of 2.6% in 2012 in accordance to the Councils' recommendations. Because of the initiation of the Excessive Deficit Procedure for Cyprus, the forecast for the general government budget balance is better than the one projected in the last update. At the end of the programming period, the general government balance is projected to be at a deficit of 1.6% of GDP.

The general government debt-to-GDP ratio is projected to rise to 60.9% in 2010 and subsequently increase further, peaking at 62% in 2012. At the end of the programming period, debt-to-GDP ratio falls to 61.3%. These projections are lower in comparison to the previous update. This is attributed, on the one hand, to the lower primary deficits at the beginning of the programming period, which turn to surpluses by the end of the programming period, and, on the other hand, to the revised forecast of nominal GDP levels.

Table XXI: Divergence from previous update

in per cent of GDP	2009	2010	2011	2012	2013	2014
			GDP Growth			
Previous Update	-1.7	0.5	1.5	3.0	3.2	n/a
Latest Update	-1.7	0.9	1.5	2.5	2.7	3.0
Difference	0.0	0.4	0.0	-0.5	-0.5	
			General Government Balance			
Previous Update	-6.1	-6.0	-4.5	-3.4	-2.6	n/a
Latest Update	-6.0	-5.3	-4.0	-2.6	-2.0	-1.6
Difference	0.1	0.7	0.5	0.8	0.6	
			Debt-to-GDP Ratio			
Previous Update	56.2	61.0	63.2	63.1	62.3	n/a
Latest Update	58.0	60.9	61.6	62.0	61.3	60.1
Difference	1.8	-0.1	-1.6	-1.1	-1.0	

Box 4. Main features of the Social Security System

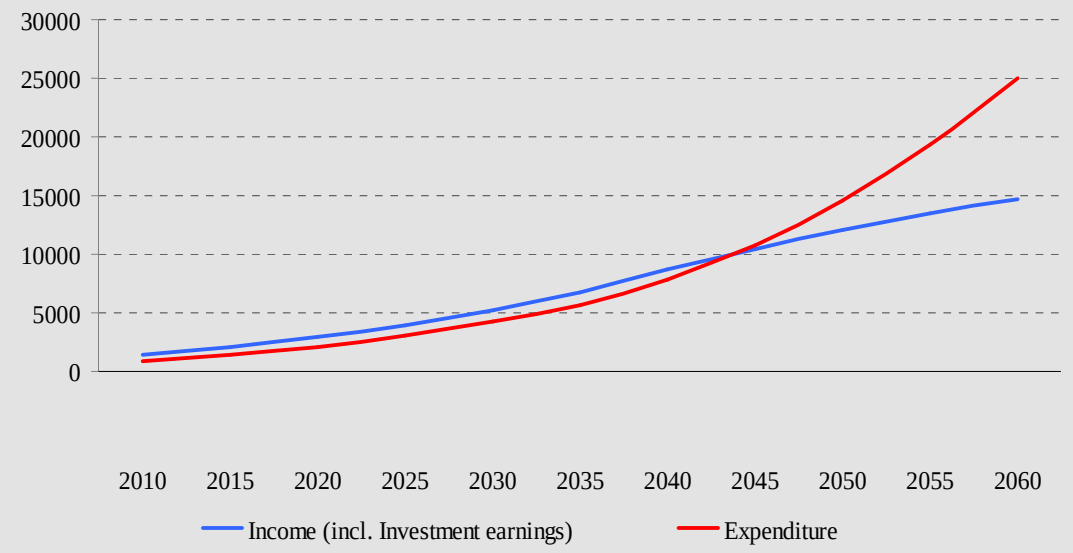
The Social Security System (SSS) in Cyprus covers pensions and other payments, such as unemployment, redundancy, holiday and disability benefits. It is designed as a "partially-funded" system, with the annual surplus deposited to a special reserve of the Social Security Fund (SSF).

The Law stipulates that, a reserve of a certain size is maintained to cover current and future obligations. In other words, the size of the Fund is determined as a multiple of the total annual obligations, taking into consideration the gradual maturity of the system and demographic factors, i.e. ageing, which are projected to cause a huge increase in pension obligations.

Essentially, given the projected increase in pension obligations, the establishment of a reserve fund is destined to ameliorate the effects of ageing on future generations and, thus, improve intergenerational equity. To this end, contributions are set at higher levels than required to cover current pension and other obligations, leading to the creation of a relative significant financial reserve. The "reserve" is almost exclusively invested in government paper. As such it does not create a liability, in economic terms, but, rather, a conditional future commitment obligation of the Government to meet future shortfalls of the SSS, when they arise. The size of the future Government commitments vis-à-vis the SSS will depend on economic and demographic developments, as well as, further policy reforms. In 2010, the total reserve of SSS amounted to about €7 billion, of which, 93% was invested in non-tradable government paper.

Sustainability

Currently, the SSS is characterized by comparatively high effective age and replacement rates (60% by 2020) and benefit ratio. As it stands today, it maintains a surplus up to 2045. This will gradually decline and will turn into a deficit. Viability is secured until 2048.



6. QUALITY OF PUBLIC FINANCES

Policy Strategy

Improvement in the quality of public finances is an important element of fiscal policy for realizing the growth potential and, at the same time, countering the spending pressures that arise from an ageing population, as well as ensuring of long-term sustainability of public finances. Considerable attention is paid to the quality aspects of public expenditure to ensure that growth enhancing budgetary items are not squeezed out by uncontrolled expenditure costs or by growth in inefficient expenditure categories.

The spending priorities include infrastructural investment, IT-development, research, education and health. On the revenue side, Government policies aim at preserving the current system, characterized by low marginal tax rates and a wide tax base. These are important elements of the Lisbon Strategy for promoting growth and jobs, while simultaneously meeting the objectives of the Stability and Growth Pact.

Policy Framework and Structural Reforms

A number of structural reforms will assist in the development of strong and flexible public finances, in order to resist any external shocks. Following the adoption of Council Directive on the requirements for budgetary frameworks of the Member States, as well as the agreement on the Pact for the Euro Plus for Stronger Economic Policy Coordination for Competitiveness and Convergence, whereby euro area Member States are committed into translating EU fiscal rules as set out in the Stability and Growth Pact into national legislation, the Ministry of Finance of the Republic has initiated the procedure involving all stakeholders, in order to amend the relevant framework law to incorporate these new principles.

More specifically, the Ministry of Finance intends to amend the Law for the Management of Revenues and Expenditure and of the Accounting System of the Republic and Other Related Matters and incorporate provisions:

- Accounting and Statistics
  - Should cover all sectors of general government
  - Timely and regular availability of public data (monthly for central government, quarterly for local government)

- Forecasts
  - Based on most likely macro scenario or more prudent scenario
  - Significant differences between our forecasts and commissions forecasts shall be described
  - All budgetary forecasts including methodologies, assumptions shall be made public
- Numerical fiscal rules
  - Should promote compliance with reference values on deficit (3%) and on public debt (60%) in accordance with the Treaty
  - Multi-annual fiscal horizon
  - Fiscal policy to ensure the achievement over the medium term of a balanced budget
- Medium – term budgetary frameworks
  - Multiannual fiscal planning horizon (3 years)
  - Multiannual transparent budgetary objectives in terms of general government deficit and debt
  - Description of medium term policies showing how the M.T.O is achieved

The amendments incorporated in the framework Law will be discussed with stakeholders. It is envisaged that, the new Bill will be submitted to the Council of Ministers for approval in autumn 2011 and by the end of 2011 it will then be tabled before the House of Representatives for discussion and final adoption.

Reallocation of Expenditures

It is noted that, the budgetary process for 2011, required line ministries to provide forecasts of their expenditure needs for 2012 and 2013. These forecasts were split between current obligations and future needs. The additional available resources were allocated to the high priority areas, such as research and technology, education and health all in line with the objective of redirecting public expenditure to growth-enhancing categories. The areas with marginal or no growth are those of agriculture, security and defence and road transportation.

The policy for reallocation of government expenditure evidently leads to the containment in absolute terms of expenditures functions such as Defence, Public

Order and Safety, Economic Affairs and Recreation Culture and Religion, while high priority functions such as Education, Housing and Community Amenities, Health and Social Protection exhibit a rising trend.

Table XXII: Functional Classification of Expenditure

in per cent of GDP	2004	2005	2006	2007	2008	2009
1. General public services	9.9	10.5	10.3	10.6	10.3	12.0
2. Defence	1.8	1.9	2.0	1.8	1.7	1.9
3. Public order and safety	2.1	2.1	2.1	2.1	2.1	2.3
4. Economic affairs	4.7	4.3	4.2	3.6	3.5	3.5
5. Environmental protection	0.3	0.3	0.3	0.3	0.3	0.3
6. Housing and community amenities	2.5	2.5	2.5	2.8	2.9	3.2
7. Health	3.1	3.1	3.1	2.9	3.0	3.3
8. Recreation, culture and religion	1.2	1.3	1.3	1.4	1.3	1.3
9. Education	6.5	6.4	6.4	6.3	6.7	7.1
10. Social protection	9.9	10.6	10.3	9.5	9.7	10.9
11. Total expenditure	**42.0**	**42.9**	**42.6**	**41.2**	**41.7**	**45.8**

High priority areas

Total expenditure for *infrastructure*, in the Budget for 2011 and in projects financed through Private Public Partnership agreements, exceed 4% of GDP. Considerable progress has been achieved in the expanding and upgrading of basic infrastructure including the completion of important projects in the area of health, education and transport. Newer priorities in the area of education and health are reflected in the Council of Ministers approving a programme of action for the enhancement of tertiary education through the operation of the newly founded Technological University of Cyprus, as well as the establishment of a faculty of Medicine in the University of Cyprus and the adoption of concession agreements with private entities to provide high value added health care services.

Total expenditure on ***education*** is budgeted to increase by approximately 5% in 2011 compared to 2010, reaching approximately 7.5% of GDP. Expenditure on education is focused mainly on the continuation of computerisation of all primary and secondary schools and upgrading of new research and academic institutions (University of Cyprus, Cyprus University of Technology, Open University). Progress in improving the quality and extension of education in these areas in 2010 was considered satisfactory.

Total expenditure on ***health*** is budgeted to increase by approximately 5% in 2011 compared to 2010, reaching 3.5% of GDP. The Budget for 2011, allocates considerable funds for the operation of two new general hospitals and for the promotion of private health care services. The improvement of the quality of the health care system and the effective tackling of the anticipated increases in public health expenditure constitutes a significant challenge.

As in the annual Budget for 2010, the Budget for 2011, shows negligible increases or even decreases in certain cases in the areas of agriculture, security and defence and public administration.

Revenue Side

Improving the quality of public finances from the revenue side has represented an important challenge to the Cyprus authorities covering different aspects. As levels of government revenue and tax structures have macroeconomic and microeconomic consequences, their impact will shape many aspects of the Cyprus economy.

Firstly, the macroeconomic consequences of taxation are materialized by its stabilization, redistribution and (dis)incentive effects. Tax systems must contribute to ensuring budgetary discipline. With the adoption of a fiscal consolidation plan the authorities have identified the less distortionary categories of taxes with respect to growth and employment and have introduced them to address the fiscal imbalances that have emerged. A better functioning product, labour and capital markets, as well as, the enhanced automatic stabilization potential of fiscal policy have been required. Moreover, with tax policy impacting on both, the authorities are closely monitoring the macroeconomic effects of the tax system.

Secondly, taxes – by altering relative prices – distort economic choices. In this connection, the Cyprus authorities are constantly monitoring the tax/benefit system to ensure that “work pays”, without jeopardizing needed support to vulnerable groups in society, in the process enhancing the flexicurity system in this direction. Also, in view of the challenge of globalization consideration is also being given to the equitable taxation of immobile tax bases, while limiting taxation of mobile tax bases within the confines of the EU acquis and tax directives.

7. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

This chapter illustrates the overall situation concerning the sustainability of public finances, looking in more depth at the projections on the evolution of the SSF and other age-related expenditures, and the evolution of the general government expenditures and revenues. For the purposes of this analysis, it is assumed that the budgetary situation evolves in line with the Stability Programme targets for 2011-14. Thereafter, the projected changes in age-related expenditure and revenue are cumulated to the 2013 general government expenditure and revenue ratios to obtain the projected long-term paths for the general government deficit.

The projections incorporate the recent reform of the social security system, which took place in 2009. Specifically, on March 6, 2009 the House of Representatives adopted a package of reform measures aimed at addressing the long-term sustainability of the Social Insurance Fund (SSF). The new law, which came to effect on April 1st, 2009, includes a set of parametric reforms that are to be phased in gradually, but also a set of principles to be followed by the Government concerning the investment policy of the SSF. These reforms include a progressive increase of social security contributions – seven increases by 1.3 percentage points every five years, first increase in April 2009 and last increase in January 2039 – and other reforms on the expenditure side that aim at tightening eligibility criteria; these reforms, and their impact were described in more detail in last year's Stability Programme.

Table 7 in the Appendix includes an analysis of the long-term fiscal sustainability taking into account the impact of age-related changes in expenditure over the period 2011-2060. The main elements of the analysis are the long-term projections for social security pensions, health and education expenditures. The base year for the projections is 2009 and therefore, the figure for the subsequent years are projections, including that for 2010.

Total social security expenditures are projected to increase from 5.4% of GDP in 2010 to 9% of GDP in 2030 and 15% of GDP in 2060, with the benefit ratio rising over the period from 45.7 to 48.1 due to the maturing of the system (Table XXIII) At the same time contributions increase from 7% of GDP to 9% of GDP in 2030 and 10% GDP in 2060. The reserve of the SIF which is in surplus equivalent to some 42% of GDP is projected to remain in positive territory until 2050 and turn to a deficit of 24% of GDP by 2060. The aforementioned significant increase in pension expenditure in Cyprus over the period 2007-60 is explained almost entirely by the change of the dependency ratio, and to a much lesser extent by the increased coverage ratio. The latter, is due to the expected increase in the percentage of female insured persons who meet the qualifying conditions for receiving an old-age pension at the age of 63. The dependency ratio is projected to decline from 5.2 in 2010 to 2.1 in 2060, implying that

for every pensioner there will be only 2.2 working persons subscribing the SIF, instead of almost 6 currently (Table 7).

Table XXIII: Current baseline scenario, % GDP

in percent of GDP	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**
Total Expenditure	5.4	7.0	8.9	10.6	13.1	14.9
Total Amount of Contributions	6.9	7.9	9.0	10.0	9.9	10.0
Reserves	41.7	40.5	39.1	34.1	15.5	-24.0
Benefit Ratio (%)	45.7	48.7	50.0	49.1	48.5	48.1
Interest rate	1.5%	3.5%	3.5%	3.5%	3.5%	3.5%

The results presented concerning the financial status of the Social Insurance Fund (SIF) (base year 2009) differ from those previously projected (last Stability Programme, base year 2006) because of the following factors:

- The recent experience since 2006 has led to improvements in the modeling methodology, which now reflects more accurately the current state of affairs.
- The number of contributors over the last three years has been much higher than anticipated (resulting to higher contributions), and that had a positive impact of the financial position of the SIF.
- There is a notable downward revision of net migration throughout the period, which is the result of the recent crisis, and which is expected to affect all EU countries in a symmetric way.
- A second important revision in the opposite direction is the upward revision of the 2010 fertility rate to 1.5, from 1.46 expected before.
- Participation rates have also been somewhat revised, with male participation rate higher, in contract to female participation rates, which appear to have remained lower than had been anticipated before.
- Finally, another important change that is affecting negatively the results is the assumed interest rate, which is used as a proxy for the return on the social security's reserves. Specifically, the interest rate has been lowered significantly, especially in the first years, thus leading to a bigger financing gap by 2060.

Table XXIV: Basic Demographics 2010-2060

SP 2010-14						
	2010	**2020**	**2030**	**2040**	**2050**	**2060**
Total Fertility Rate	1.50	1.54	1.58	1.60	1.60	1.60
Life Expectancy at birth						
- Males	78.3	79.9	81.3	82.7	83.9	85.1
- Females	82.8	84.2	85.4	86.7	87.9	89.0
Participation Rates	73.9	78.1	79.4	79.2	80.9	81.4
- Males	79.8	82.1	82.4	81.8	82.0	81.8
- Females	65.6	70.2	71.9	72.1	74.1	75.6
Migration	2.220	5.955	5.497	5.039	4.705	4.127
SP 2009-13						
	2010	**2020**	**2030**	**2040**	**2050**	**2060**
Total Fertility Rate	1.46	1.49	1.52	1.54	1.57	1.60
Life Expectancy at birth						
- Males	78.5	80.0	81.5	82.8	84.0	85.2
- Females	82.0	83.5	84.9	86.2	87.5	88.7
Participation Rates	74.6	79.3	79.3	79.1	79.2	79.1
- Males	81.8	84.2	83.4	83.0	83.0	82.9
- Females	67.5	74.4	75.2	75.1	75.2	75.2
Migration	9.151	8.498	7.844	7.190	6.554	5.883

In total, all age-related expenditure including spending on healthcare and education – which are based on the projections of the Aging Working Group Report 2009 – are projected to rise from around 19.3% of GDP in 2010 to 28.7% in 2060.

As a result total general government expenditure is set to increase from 46.7% of GDP in 2007 to 53.2% in 2060. General government revenue, which is estimated to have declined significantly between 2007-10 is forecast to increase from 41.4% of GDP in 2010 to 43.3% in 2060.

The results of this analysis clearly reveal that while the problem is contained broadly through 2030-35, when the adverse demographics kick in the deterioration in the financial position of the SIF and, in turn, that of the general government worsens markedly.

APPENDIX

Table 1a: Macroeconomic prospects

	ESA Code	**Year 2010**	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	15,149	0.9	1.5	2.5	2.7	3.0
2. Nominal GDP	B1*g	17,434	2.9	5.2	4.6	5.2	5.7
Components of real GDP							
3. Private consumption expenditure	P.3	10,201	-1.5	0.5	2.3	2.3	2.3
4. Government consumption expenditure	P.3	2,950	0.5	-0.5	0.0	0.0	0.0
5. Gross fixed capital formation	P.51	2,961	-5.5	-0.5	2.0	2.5	3.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-137	-0.9	0.2	0.2	0.2	0.2
7. Exports of goods and services	P.6	6,448	2.2	2.6	3.5	4.5	4.6
8. Imports of goods and services	P.7	7,274	0.7	1.8	2.0	2.5	2.5
Contributions to real GDP growth*							
9. Final domestic demand		16,112	-2.0	0.1	1.9	2.0	2.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-137	2.4	1.1	0.0	0.0	0.0
11. External balance of goods and services	B.11	-826	0.6	0.2	0.5	0.7	0.8

*Any differences from real GDP rate of change are due to rounding.

Table 1b: Price developments

	ESA Code	**Year 2010**	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		115.1	2.0	3.7	2.1	2.4	2.6
2. Private consumption deflator		114.5	2.7	3.2	1.9	2.1	2.3
3. HICP[1]		112.0	2.6	3.4	2.1	2.3	2.5
4. Public consumption deflator		117.5	2.5	3.8	3.1	3.1	3.1
5. Investment deflator		115.0	3.4	4.4	2.6	2.9	3.2
5a. Gross Fixed Capital Formation Deflator		115.0	3.3	4.5	2.6	2.9	3.2
6. Export price deflator (goods and services)		110.2	1.9	2.5	1.5	1.6	1.8
7. Import price deflator (goods and services)		110.9	3.8	2.2	1.8	1.6	1.6

[1] Optional for stability programmes.

Table 1c: Labour market developments

	ESA Code	**Year 2010**	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1] (000´s)		377,3	0.5	0.5	0.8	1.0	1.0
2. Employment, hours worked[2] (thousands)		724,1	0.3	0.5	0.8	1.0	1.0
3. Unemployment rate (%)[3]		25.4	6.2	6.0	5.8	5.5	5.3
4. Labour productivity, persons[4] (€, 2005 prices)			0.4	1.0	1.7	1.7	2.0
5. Labour productivity, hours worked[5](€, 2005 prices)			0.5	1.0	1.7	1.7	2.0
6. Compensation of employees (€ million)	D.1	7992,7	2.8	3.7	3.1	3.3	3.7
7. Compensation per employee (€)		20,270	2.3	3.2	2.3	2.3	2.7

[1]Persons with occupation, domestic concept, national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d: Sectoral balances

% of GDP	ESA Code	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-7.8	-7.3	-6.8	-6.0	-5.2
of which:						
- Balance on goods and services		-5.1	-5.1	-4.5	-3.7	-2.9
- Balance of primary incomes and transfers		-2.7	-2.3	-2.3	-2.3	-2.3
2. Net lending/borrowing of the private sector	B.9	-2.5	-3.3	-4.2	-4.0	-3.6
3. Net lending/borrowing of general government	EDP B.9	-5.3	-4.0	-2.6	-2.0	-1.6
4. Statistical discrepancy						

Table 2: General government budgetary prospects

	ESA Code	**Year 2010**	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-926.1	-5.3	-4.0	-2.6	-2.0	-1.6
2. Central government	S.1311	-1,341.1	-7.7	-6.3	-4.7	-4.0	-3.7
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	-6.5	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	421.5	2.4	2.4	2.1	2.1	2.1
General government (S13)							
6. Total revenue	TR	7,213.0	41.4	42.1	41.8	41.4	41.3
7. Total expenditure	TE[1]	8,139.1	46.7	46.1	44.4	43.4	42.9
8. Net lending/borrowing	EDP B.9	-926.1	-5.3	-4.0	-2.6	-2.0	-1.6
9. Interest expenditure	EDP D.41	387.9	2.2	2.4	2.5	2.6	2.6
10. Primary balance[2]		-538.2	-3.1	-1.6	0.0	0.6	1.0
11. One-off and other temporary measures[3]		79.0	0.5	0.1	0.1	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		4,601.9	26.4	27.7	27.7	27.3	27.2
12a. Taxes on production and imports	D.2	2,671.1	15.3	16.2	16.1	16.0	15.8
12b. Current taxes on income, wealth, etc	D.5	1,930.3	11.1	11.5	11.5	11.3	11.4
12c. Capital taxes	D.91	0.5	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	1,670.0	9.6	9.6	9.6	9.6	9.6
14. Property income	D.4	260.9	1.5	0.8	0.6	0.6	0.5
15. Other[4]		680.2	3.9	3.9	3.8	3.9	3.9
16=6. Total revenue	TR	7,213.0	41.4	42.1	41.8	41.4	41.3
p.m.: Tax burden		6,271.4	36.0	37.3	37.3	36.9	36.8

(D.2+D.5+D.61+D.91-D.995)[5]							
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	3,596.3	20.6	20.0	19.3	18.6	18.4
17a. Compensation of employees	D.1	2,686.7	15.4	15.0	14.5	14.0	13.9
17b. Intermediate consumption	P.2	909.6	5.2	4.9	4.8	4.6	4.5
18. Social payments (18=18a+18b)		2,591.7	14.9	14.8	14.9	14.8	14.7
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	21.4	0.1	0.2	0.2	0.1	0.1
18b. Social transfers other than in kind	D.62	2,570.3	14.7	14.6	14.8	14.7	14.5
19=9. Interest expenditure	EDP D.41	387.9	2.2	2.4	2.5	2.6	2.6
20. Subsidies	D.3	36.8	0.2	0.4	0.3	0.2	0.1
21. Gross fixed capital formation	P.51	635.4	3.6	3.6	3.6	3.5	3.5
22. Other[6]		891.0	5.1	5.0	3.7	3.5	3.6
23=7. Total expenditure	TE1	8,139.1	46.7	46.1	44.4	43.4	42.9
p.m.: Government consumption (nominal)	P.3	3,367.2	19.3	18.7	18.1	17.4	17.2

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

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

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

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

[6] D.29+D4 (other than D.41) + D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3: General government expenditure by function

% of GDP	COFOG Code	**Year 2008**	**Year 2013**
1. General public services	1	10.3	9.1
2. Defence	2	1.7	1.7
3. Public order and safety	3	2.1	2.1
4. Economic affairs	4	3.5	4.3
5. Environmental protection	5	0.3	0.5
6. Housing and community amenities	6	2.9	3.0
7. Health	7	3.0	3.3
8. Recreation, culture and religion	8	1.3	1.4
9. Education	9	6.7	8.0
10. Social protection	10	9.7	10.0
11. Total expenditure (=item 7=23 in Table 2)	**TE**	**41.7**	**43.4**

Table 4: General government debt developments

% of GDP	ESA Code	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
1. Gross debt[1]		60.9	61.6	62.0	61.3	60.1
2. Change in gross debt ratio		2.9	0.7	0.3	-0.6	-1.3
Contributions to changes in gross debt						
3. Primary balance[2]		-3.1	-1.6	0.0	0.6	1.0
4. Interest expenditure[3]	EDP D.41	2.2	2.4	2.5	2.6	2.6
5. Stock-flow adjustment		-0.2	-0.9	0.3	0.0	-0.3
of which:						
- Differences between cash and accruals[4]		0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		-0.7	0.5	0.5	0.5	0.5
of which:						
- privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other[6]		0.0	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt[7]		3.9	4.1	4.3	4.5	4.5
Other relevant variables						
6. Liquid financial assets[8]		1.9	0.8	0.2	0.2	0.2
7. Net financial debt (7=1-6)		59.0	60.8	61.8	61.1	59.9

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5: Cyclical developments

% of GDP	ESA Code	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
1. Real GDP growth (%)		0.9	1.5	2.5	2.7	3.0
2. Net lending/borrowing of general government	EDP B.9	-5.3	-4.0	-2.6	-2.0	-1.6
3. Interest expenditure	EDP D.41	2.2	2.4	2.5	2.6	2.6
4. One-off and other temporary measures[1]		0.5	0.1	0.1	0.0	0.0
5. Potential GDP growth (%)		1.5	2.0	2.3	2.5	2.8
contributions:						
- labour		0.2	0.3	0.5	0.7	0.8
- capital		0.6	0.8	0.8	0.8	0.9
- total factor productivity		0.7	0.9	1.0	1.0	1.1
6. Output gap		-0.5	-1.0	-0.7	-0.4	-0.1
7. Cyclical budgetary component		-0.2	-0.4	-0.3	-0.2	0.0
8. Cyclically-adjusted balance (2 - 7)		-5.1	-3.6	-2.3	-1.9	-1.6
9. Cyclically-adjusted primary balance (8 + 3)		-2.9	-1.2	0.3	0.8	1.0
10. Structural balance (8 - 4)		-5.6	-3.7	-2.4	-1.9	-1.6

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

Table 6: Divergence from previous update

	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
Real GDP growth (%)						
Previous update		0.5	1.5	3.0	3.2	n/a
Current update		0.9	1.5	2.5	2.7	3.0
Difference		0.4	0.0	-0.5	-0.5	
General government net lending (% of GDP) EDP B.9						
Previous update		-6.0	-4.5	-3.4	-2.5	n/a
Current update		-5.3	-4.0	-2.6	-2.0	-1.6
Difference		0.7	0.5	0.8	0.5	
General government gross debt (% of GDP)						
Previous update		61.0	63.2	63.1	62.3	n/a
Current update		60.9	61.6	62.0	61.3	60.1
Difference		-0.1	-1.6	-1.1	-1.0	

Table 7: Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	**41.2**	**46.7**	**45.1**	**47.1**	**48.7**	**51.1**	**53.2**
Of which: age-related expenditures (1-5)	**18.2**	**20.7**	**21.3**	**23.3**	**24.9**	**27.3**	**29.4**
1.Pension expenditure	7.5	8.3	9.7	11.3	12.9	15.2	16.8
1.1 Social security pension	4.6	5.4	7.0	8.9	10.6	13.1	14.9
Old-age and early pensions (A)	3.3	4.1	5.2	6.6	7.9	10.1	11.5
Other pensions (disability survivors) (B) *	1.3	1.3	1.9	2.3	2.7	3.0	3.3
1.2 Occupational pensions (if in general government) [1]	2.9	2.9	2.6	2.5	2.3	2.1	1.9
2. Health care [2]	2.9	3.3	3.4	3.6	3.7	3.9	4.1
3. Long-term care *(this was earlier included in the health care)* [2]	0.006	0.006	0.006	0.007	0.008	0.010	0.011
4. Education expenditure [2]	7.0	8.1	6.8	7.0	6.8	6.7	7.0
5. Other age-related expenditures	0.8	1.0	1.4	1.4	1.5	1.5	1.5
Interest expenditure	…	…	…	…	…	…	…
Total revenue	**44.6**	**41.4**	**41.7**	**42.6**	**43.4**	**43.3**	**43.3**
Of which: property income	0.7	1.5	0.7	0.7	0.7	0.7	0.7
Of which: from pensions contributions (or social contributions if appropriate)	5.9	6.9	7.9	9.0	10.0	9.9	10.0
Pension reserve fund assets	36.2	41.7	40.5	39.1	34.1	15.5	-24.0
Of which: consolidated public pension fund assets (assets other than government liabilities)	-	-	-	-	-	-	-
Labour productivity growth (hours)	1.7	2.3	2.1	2.1	2.1	1.9	1.8
Real GDP growth	3.6	2.3	3.4	2.6	2.4	1.8	1.8
Participation rate males (aged 15-64)	81.2	79.8	82.1	82.4	81.8	82.0	81.8
Participation rates females (aged 15-64)	64.7	65.6	70.2	71.9	72.1	74.1	75.6
Total participation rates (aged 15-64)	72.9	73.9	78.1	79.4	79.2	80.9	81.4
Unemployment rate	4.5	6.2	5.2	4.8	4.7	4.6	4.6
Dependency Ratio[3]	5.6	5.2	3.9	3.2	2.9	2.4	2.1

[1] Occupational Pension forecast are extrapolated from a reform based scenario of an Expert Study. The reform scenario incorporates the following assumptions for the period up to 2060: (i) annual inflation 2.5%, (ii) reduction during the beginning of the programming period and then stabilization of employment, (iii) general contractual annual salary increase of 0.5% for employees and (iii) pension increases is limited to inflation only and excludes wage growth.
[2] Ageing Working Group calculations.
[3] Population 15-64 / Population 65+.
*Other benefits: For the purposes of projections the invalidity pension is assumed to be paid for life, instead of converting to old-age pension at 63.

Table 8: Basic assumptions

	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
Short-term interest rate (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average)	1.33	1.40	1.41	1.41	1.41
Nominal effective exchange rate					
World growth excluding EU					
EU GDP growth	1.8	1.7	2.0	2.2	2.2
Growth of relevant foreign markets [UK]	1.3	2.2	2.5	2.4	2.5
World import volumes. excluding EU					
Oil prices (Brent. USD/barrel)	79.6	112.8	112	110	110