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ECONOMIC AND FINANCIAL AFFAIRS

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Assessment of the public debt sustainability of Cyprus

In compliance with Article 13.1 (b) of the ESM Treaty, this note has been prepared by the European Commission in liaison with the ECB.

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The economic and financial adjustment programme for Cyprus: Debt sustainability assessment

Introduction: the programme objectives support the sustainability of public debt

1. A positive assessment of the long-term sustainability of public debt is a sine qua non for granting financial assistance from the ESM and the IMF. In view of Cyprus' weak budgetary starting position, an already high government debt ratio, adverse macroeconomic circumstances and downside risks in the banking sector, the debt outlook is challenging for Cyprus. The financing needs of the government will be substantial, in a situation where the sovereign does not have access to international markets. The weak economic outlook may potentially also lead to additional financing requirements for re-capitalising banking institutions[1].

2. Pursuant to Article 13.1(b) of the ESM Treaty, the Chairperson of the Board of Governors of the ESM shall entrust the European Commission, in liaison with the ECB, with assessing whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF. This note by the Commission services, in liaison with the ECB, assesses whether public debt is sustainable under the macroeconomic adjustment programme agreed with the Cypriot authorities at staff level on 2 April 2013. The assessment has been [agreed/conducted/discussed] with IMF Staff.

3. An ambitious fiscal adjustment path over the medium-term is essential to contribute to the sustainability of Cyprus' public debt. With exception of short-term placements of treasury bills, the Cypriot government is unable to fund itself on the regular bond market. The loss of market access is a clear indication of investors' concerns about the sustainability of public debt. Assistance from the ESM, subject to strict conditionality laid down in the macroeconomic adjustment programme to continuous respect of pre-established eligibility conditions, will help to mitigate the impact of the adjustment process, undertake necessary reforms and contribute to rebuilding confidence, thereby paving the way for regaining market access.

[1] The Eurogroup statement of 25 March reconfirmed, as stated already on 16 March, that – in principle - financial assistance to Cyprus is warranted to safeguard financial stability in Cyprus and the euro area as a whole by providing financial assistance for an amount of up to EUR 10bn. The Eurogroup would welcome a contribution by the IMF to the financing of the programme. Together with the decisions taken by Cyprus, this results in a fully financed programme which will allow Cyprus' public debt to remain on a sustainable path. The Eurogroup also agreed that programme money will not be used to recapitalise Laiki and Bank of Cyprus.

4. A quick and sustainable solution to the banking crisis is of major importance to ensure debt sustainability. The programme measures aimed at restoring the soundness of the Cypriot banking sector, which in the longer term will support the aim of a sustainable debt trajectory. Thoroughly restructuring, resolving and downsizing financial institutions, strengthening of supervision, addressing expected capital shortfall and improving liquidity management are key steps in this regard. The gradual phasing-out of exceptional capital controls and other administrative measures will be conducive to better macroeconomic outcomes and thus contribute to improving the debt outlook.

5. A fundamental requirement for debt sustainability is that Cyprus can generate lasting growth. While the necessary medium-term deleveraging process of Cyprus' unsustainable internal and external imbalances will take a toll on medium-term growth performance, the programme will support a return to balanced growth. Addressing issues of a structural nature will also contribute to restore its growth potential over the long term thereby rebalancing the Cypriot economy, restoring its growth potential and strengthening competitiveness. These includes improving the functioning of labour, service and product markets, reinvigorating the performance of sectors where Cyprus has comparative advantages, reforming the public administration and carefully preparing for the exploitation of the Cyprus' offshore natural gas.

6. Programme ownership is a prerequisite for a successful adjustment programme. On 25 June 2012 Cyprus requested external financial assistance from euro area Member States as well as from the IMF with a view of the challenges that Cyprus is facing, in particular due to distress in the banking sector and the presence of macroeconomic imbalances. After unprecedentedly protracted programme discussions, Cyprus and the programme partners reached a provisional staff-level agreement on November 23 on the policy side of a draft Memorandum of Understanding (MoU), but did not conclude the financing side of the economic and financial adjustment programme. In December 2012, the Cypriot Parliament voted the large majority of fiscal measures for 2012-14 outlined in the draft MoU, as well as first important steps in relation to fiscal-structural reforms (e.g. pension system, health sector, budgetary framework, welfare benefits, COLA etc).

Macroeconomic developments and outlook

7. More than a decade of sustained and strong economic expansion in Cyprus came to an end in 2009. Economic activity in Cyprus fell by close to 2%, with weak domestic demand and an adverse external environment weighing strongly on growth. Economic activity recovered in 2010 with real GDP growth of around 1%. In 2011 the Cypriot economy grew by a modest 0.5%, with economic activity seriously affected by the accident in July 2011 that destroyed the Vasilico power station.

8. Since 2011, financial sector headwinds and growing uncertainty regarding the public finances position, including the impact of financial sector related contingent liabilities have had a negative impact on confidence and economic activity. These adverse developments related to the unwinding of very serious private and public sector imbalances in the Cypriot

economy as well as to the negative spill-overs from financial and economic turmoil in neighbouring economies and weak external demand. Financial sector deleveraging and fiscal consolidation weighed negatively on domestic demand, consumer and corporate sector confidence weakened, and unemployment rose.

9. The Commission services' Winter 2013 Forecast (published on 22 February 2013) incorporated the provisional staff-level agreement of 23 November 2012. Economic activity in Cyprus was expected to significantly weaken with real GDP contracting by close to 2½% in 2012. The deterioration was seen to be driven by a marked contraction of domestic consumption and private investment, as a result of the prolonged high economic uncertainty and the tightening credit conditions due to on-going deleveraging process, the significant deterioration in the labour market and the pass-through of fiscal consolidation measures implemented at the end of 2011. Projections of the economic outlook for 2013 and 2014 were pointing to a prolonged recession with a further cumulative loss in output of around 5%, due to further declines in domestic demand and investment activity resulting from fiscal consolidation and subdued credit growth. The external sector was set to provide a positive contribution to growth in both years as prospects for the export of goods and services were seen to remain favourable, particularly for tourism and business services.

10. Following political agreements in the Eurogroup on 16 and 25 March, the agreed economic and financial adjustment programme entails a frontloaded banking sector restructuring. In accordance with the Cypriot authorities policy plans, major financial institution will be downsized combined with extensive bail-in of uninsured depositors, and a set of wide-ranging temporary capital controls and administrative measures. The programme is envisaged to build the foundation for sustainable growth over the long run. Nevertheless, in the short run, the economic outlook remains challenging. Real GDP is projected to contract by 12½% cumulatively in 2013-14. Short-run economic activity will be negatively affected by the immediate restructuring of the banking sector, which will impact on net credit growth and by additional fiscal consolidation measures. Temporary restrictions required to safeguard financial stability will hamper international capital flows and reduce business volumes in both domestic and internationally oriented companies. The bail-in of uninsured depositors will cause a loss of wealth, which will reduce private consumption and business investment. This, compounded by the impact of fiscal consolidation already undertaken and new measures agreed, will result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector.

11. Having addressed the banking sector problems upfront, growth is projected to rebound in 2015-16 and attain close to 2% over the long run. The fiscal consolidation is expected to help restoring consumers and investors' confidence in the medium-term. The ongoing deleveraging of both household and corporate balance sheets will over time remove the impediment to a more balanced growth. At the same time, the restoration of a sound and well-capitalised banking system is expected to gradually loosen the tight credit conditions in

the economy. Also, in the outer years, investments projects related to the energy sector and the prospects of exploitation of natural gas could contribute increasingly to economic growth. The recent reform of Cyprus' wage-indexation mechanism will contribute to align public wages with developments in economic activity, improve competitiveness, and support the economic recovery. This is expected to have a positive impact on the external balance, with the current account deficit contracting over the programme period and external debt, in particular related to external liabilities of financial institutions, expected to decline.

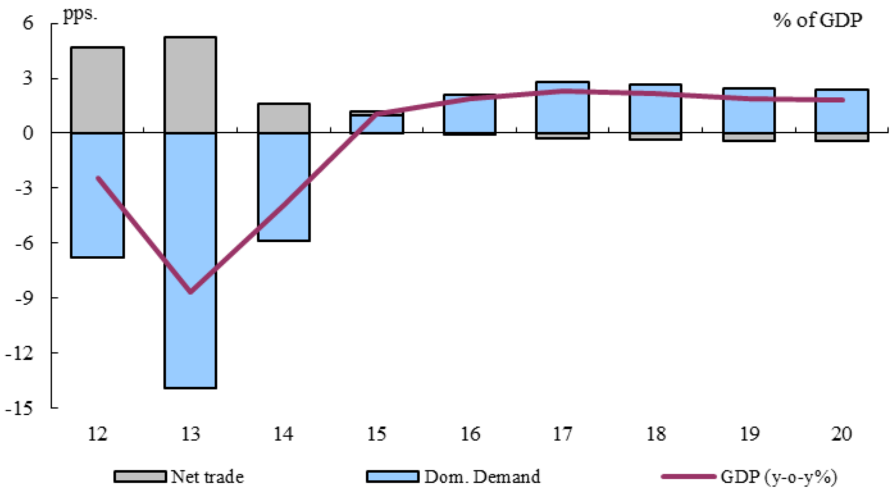
12. Macroeconomic risks remain important and tilted to the downside. On the domestic front, downside risks are associated with domestic credit conditions and further deterioration of confidence in the banking system. Moreover, there is a non-negligible risk of a cycle of household and corporate defaults propagating through the economy, leading to further banking sector losses, worsening of labour market conditions, stronger than expected fall in house price and a prolonged loss of business and consumer confidence. Also, the deep restructuring of the Cypriot banking sector could have strong spill-overs on related professional business services and financial services exports. More generally, the transition to a more varied growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and will require flexible factor and product markets. Upside risks for the Cypriot economy are limited, relating mainly to higher investment activity in the energy sector and possible improvements in the external outlook, should the euro area economic activity strengthen beyond expected.

Table 1: Macroeconomic projections, 2012-16

	2012	2013	2014	2015	2016
		Proj.			
Real Economy					
Real GDP	-2,4	-8,7	-3,9	1,1	1,9
Domestic demand	-6,8	-13,9	-5,9	1,0	2,1
Consumption	-2,7	-11,5	-5,1	0,8	1,9
Private consumption	-3,0	-12,2	-5,6	1,6	3,0
Public consumption	-1,7	-9,0	-3,7	-1,7	-1,5
Fixed investment	-23,0	-29,5	-12,0	2,3	3,5
Inventory accumulation 1/	-0,9	0,0	0,0	0,0	0,0
Foreign balance 1/	4,7	5,2	1,6	0,2	-0,1
Exports of goods and services	2,3	-5,0	-2,5	1,7	2,7
Imports of goods and services	-7,2	-16,0	-6,5	1,7	3,3

1/ Contribution to growth.

Graph 1: Cyprus – GDP growth and contributions



Source: Commission services' calculation

The programme's fiscal consolidation strategy aims at achieving a sizeable primary surplus

13. An ambitious but achievable fiscal adjustment path over the medium-term is essential to contribute to the sustainability of Cyprus' public debt. For this reason, a key objective of the fiscal strategy and the agreed consolidation measures in the draft Memorandum of Understanding with Cyprus (MoU) is to achieve a continuous strengthening of the primary budget balance over the programme period, resulting in a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018, maintaining at least such a level thereafter. This constitutes an improvement in the primary balance of close to 4 p.p. of GDP over 2013-16 and close to 3 p.p. of GDP over 2017-18.

14. The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation and maintain a primary surplus at high level over the longer-term. The range of fiscal-structural and structural reforms agreed in the MoU include establishing a medium-term budgetary framework, undertaking pension system, health care and welfare system reform measures, enhancing revenue collection and tax administration and ensuring improvement to the public finance management and the functioning of the public sector.

15. Debt sustainability depends critically on determined programme implementation. The Cypriot authorities have legislated and implemented an important number of fiscal measures for 2012-2014, amounting to around 4½% of GDP of measures[2].

16. Following, the 25 March 2013 Eurogroup political agreement, additional fiscal consolidation measures of around 1.5% of GDP for 2013 will be legislated and implemented before disbursement of the first tranche of financial assistance, namely (i) increase in the statutory corporate income tax to 12.5%, (ii) increase in the interest income withholding tax to 30% and (iii) increase in the bank levy to 0.15%. The majority of the fiscal adjustment measures for 2013-14 agreed in November 2012, as well as the immediate consolidation measures for 2012, were already enacted in 2012. The remaining measures agreed in November 2012 but not yet implemented, notably the revision of the property tax and of the social housing schemes, will be legislated as prior actions. The total additional fiscal measures in 2013 therefore amount to around 2.1% of GDP.

17. The fiscal consolidation implies that the improvement in the primary balance over 2013-14 will contribute to reducing the debt ratio substantially within the programme period, in spite of the rather strong debt-increasing effects from interest expenditure and the projected recession (table 2). To safeguard the return to a sustainable debt trajectory, the measures prescribed in the MoU for the period 2015-2017 will be fully specified during the programme period and laid down in the adopted Medium-Term Budgetary Framework, accompanying the annual Budget Law. The 2015 and 2016 Budget Laws will be presented for review by the programme partners before submission to the House of Representatives. The Cypriot authorities will present programme partners in early-2016 with a provisional list of permanent measures to attain a primary surplus of 3% of GDP in 2017. The measures required will be included in the draft 2017 Budget Law.

18. In the event of underperformance of revenues or higher social spending needs, the Cypriot government has committed to stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains, will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

[2] The adopted measures amounted to consolidation measures of about 5.0% of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 2.3% of GDP in 2013, and 1.9% of GDP in 2014, and ½% of GDP in 2015-2016 based on the macro-economic projection underpinning the 23 November 2012 staff-level agreement.

Table 2: Public debt trajectory projections, 2012-2016

	2012	2013	2014	2015	2016
Gross debt ratio	**86.5**	**109.0**	**123.0**	**126.3**	**121.9**
Changes in the ratio	*15.4*	*22.4*	*14.0*	*3.3*	*-4.4*
(1) Primary balance	**1.9**	**2.4**	**4.3**	**2.1**	**-1.2**
(2) Snowball effect	**3.3**	**11.4**	**6.8**	**0.5**	**-0.9**
Interest expenditure	*2.9*	*3.6*	*3.6*	*3.6*	*3.7*
Growth effect	*1.8*	*8.3*	*4.4*	*-1.3*	*-2.4*
Inflation effect	*-1.4*	*-0.6*	*-1.2*	*-1.8*	*-2.2*
(3) Stock flow adjustment	**10.2**	**8.6**	**2.9**	**0.6**	**-2.4**

Source: Commission services

Table 3: Fiscal projections, 2012-2016

		2012	2013	2014	2015	2016
				Proj.		
General government balance	Nov. 2012 Draft MoU	-5.8	-4.3	-3.2	-1.9	-0.2
(% of GDP)	WF13	-5.5	-4.5	-3.8	n.a	n.a
	Mar. 2013 Draft MoU	-5.5*	-6.0	-7.9	-5.7	-2.5
Primary balance	Nov. 2012 Draft MoU	-2.2	-0.7	1.0	2.7	4.0
(% of GDP)	WF13	-1.9	0.2	1.2	n.a	n.a
	Mar. 2013 Draft MoU		-2.4	-4.3	-2.1	1.2
Interest payments 1/	Nov. 2012 Draft MoU	-3.6	-3.6	-4.2	-4.6	-4.2
(% of GDP)	WF13	-3.7	-4.6	-5.0	n.a	n.a
	Mar. 2013 Draft MoU		-3.6	-3.6	-3.6	-3.7
Government gross debt	Nov. 2012 Draft MoU	86.5	134.6	142.7	141.1	136.1
(% of GDP)	WF13	86.5	93.1	97.0	n.a	n.a
	Mar. 2013 Draft MoU		109.0	123.0	126.3	121.9

**: Pending validation of April 2013 EDP notification by ESTAT*
1/ final estimates of interest payments will depend on the agreed financing conditions under the ESM and IMF facilities.
Source: Commission services. Nov. 2012 Draft MoU: Based on the draft MoU, as of end-November 2012. WF13: Data from the Commission services' Winter 2013 Forecast. March 2013 Draft MoU: Data from the draft MoU, as of end-March 2012.

The programme's banking sector restructuring reduces the needs for public support

19. The Cyprus-domestic banking sector, including the cooperative credit institutions, was oversized and represented until recently 550% of GDP. The two main banks of Cyprus, Bank of Cyprus (BoC) and Cyprus Popular Bank (Laiki), were insolvent. The necessary downsizing and restructuring of the banking sector is already under way. The Parliament has adopted on 22 March 2013, legislation establishing a comprehensive framework for the recovery and resolution of credit institutions. Under the terms of that legislation, the Central Bank of Cyprus (CBC) is the single resolution authority for banks and cooperative credit institutions alike. Using this new framework the authorities have proceeded with:

(i) the carve-out of the Greek operations of the largest Cypriot banks: The Greek assets and liabilities of the largest Cypriot banks were disposed of to a Greek core bank[3] at the end-of March 2013 and thus reduced the size of the Cypriot banking sector by 120 per cent of GDP. It also reduced any potential spill overs between the Greek and the Cypriot banking system going forward.

(ii) the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus: Laiki entered resolution on the 25 March 2013 and its performing assets along with the insured deposits and the ELA were transferred to the BoC.

(iii) the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without use of public money: The Bank of Cyprus has been fully recapitalised in order to regain its eligible counterparty status for the purpose of participation in regular Eurosystem monetary policy operations and it was transformed into a conventional lender, active mainly in Cyprus. By granting only limited new lending, this bank would be dramatically downsized overtime.

20. As a result of these actions the Cypriot banking sector has been downsized immediately and significantly to [350]% of GDP. Hellenic Bank, which has a limited capital need, may find this from private sources. Further downsizing will be achieved through the restructuring of the cooperative credit institutions. To preserve the liquidity of the Cypriot banking sector administrative measures have also been imposed.

21. The Cooperative banking sector, which needs a significant amount of recapitalisation aid, would be rationalised through mergers of its member institutions, and would also have to downsize significantly.

22. Recapitalisation needs arise from expected losses estimated by PIMCO in an adverse scenario and to ensure that the banks remain sufficiently capitalised at 9% core tier one. In response to the results of the due diligence exercise, Bank of Cyprus and Cyprus Popular

[3] On 26/03/2013, Piraeus Bank of Greece signed an agreement to acquire all of the Greek deposits, loans and branches of Bank of Cyprus, Cyprus Popular Bank (CPB) and Hellenic Bank, including loans and deposits of their Greek subsidiaries (leasing, factoring and the Investment Bank of Greece (IBG)).

Bank have been intervened and restructured and thus programme money will not be used to recapitalise Laiki and BoC. Against this background, the recapitalisation of the remainder of the restructured banking sector amount to around EUR [2.5] bn over the programme period, taking into account that further recapitalisation needs may arise in the case of higher-than-projected loan loss provisions. The recapitalisation bond injected in Laiki in June 2012 is not replaced by ESM financing.

Financing needs and sources

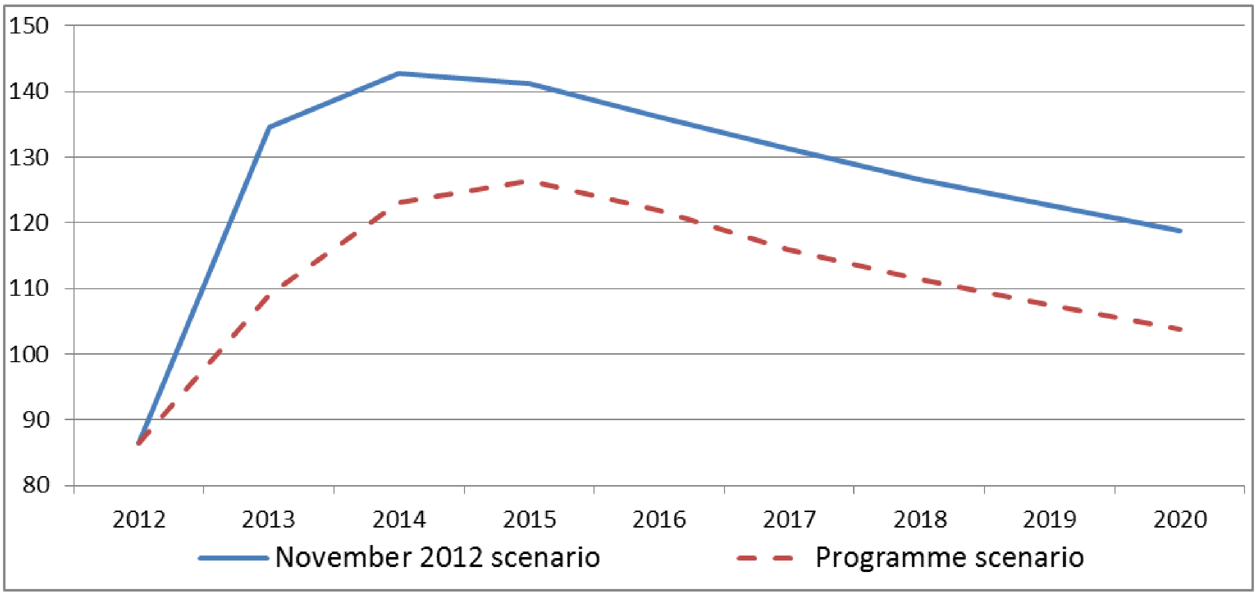
23. The Eurogroup meeting of 16 March 2013 approved financial assistance to Cyprus – in principle – for a total amount of up to EUR 10bn, i.e. the remaining financing needs over the programme period 2013-2016 after inclusion of proceeds from burden-sharing measures adopted by the Cypriot government. This programme envelope has been reconfirmed in the Eurogroup meeting of 25 March 2013. This amount will cover financing needs arising from the recapitalisation of the remainder of the restructured banking sector (around EUR [2.5] bn), redemption of maturing medium- and long-term debt including loans (around EUR [4.1] bn), and net fiscal needs after measures taken (up to EUR [3.4] bn) over a three-year programme horizon, i.e. 2013-2016.

24. The ESM is expected to provide EUR [9.0] bn of external financial assistance. This amount would fully cover needs identified for the recapitalisation of the banking sector (EUR [2.5] bn) in a cashless transaction and EUR [6.5] bn for debt redemption and fiscal purposes. The IMF has signalled its willingness to participate in the programme financing (except for financial sector recapitalisations) under the "normal access" procedure. This would imply an IMF contribution of up to [EUR 1.0bn]. In line with the Eurogroup decision of 25 March 2013, Cyprus will contribute itself a total of around EUR [13.0] bn to the financing of the adjustment programme. For a detailed analysis please see the note on the assessment of financing needs put forward by the Commission services under Art. 13.1 of the ESM Treaty.

Assessment of the sustainability of public debt

25. The total programme envelope is estimated at EUR 10 bn ([56]% of 2012 GDP). Taking into account the programme's macroeconomic projection and under the assumption that fiscal targets are met, the debt ratio under the "programme scenario" is expected to peak at [126]% of GDP in 2015. Compared to the debt trajectory implied by the November 2012 provisional staff-level agreement ("Nov. 2012 scenario"), the peak in the debt ratio is around 15 p.p. lower (chart 2). In the "programme" scenario, the front-loaded fiscal consolidation measures will not be able to offset the impact on debt of the significant decline in GDP and the recapitalisation of the banking sector. From 2015 onwards, a growing primary surplus and the return to positive GDP growth will bring the debt ratio on a declining path, reaching around [122%] of GDP at the end of 2016 and around [104%] of GDP in 2020 (Graph 2).

Graph 2: Debt trajectories under the "programme" scenario and the "November 2012 scenario"



Source: Commission services

Note: The Nov. 2012 scenario is based on the Commission services' winter 2013 forecast including EUR 10 bn re-capitalisation of the Cypriot banking system, while the "programme" scenario is based on the agreed draft MoU (March 2013).

26. The programme partners have identified total re-capitalisation needs for banking sector institutions in the order of EUR [2.5] bn, incorporating the effect of (i) the resolution of Laiki bank and the bail-in of the uninsured depositors; (ii) the deposit-to-equity swap of the uninsured depositors in Bank of Cyprus; (iii) the carve-out of the Greek assets of Laiki Bank, Bank of Cyprus and Hellenic Bank. A possible unforeseen deterioration in non-performing loans, stemming from worse-than-expected adverse macroeconomic developments, would lead to additional banking sector needs over the programme period.

27. The "programme" scenario takes into account a number of policy measures to strengthen debt sustainability, in particular (i) proceeds generated by privatisation of state-owned assets; (ii) the proceeds from the sale of excess gold reserves owned by the Cypriot Republic; and (iii) an asset swap in order to repay in kind part of the loan that the Central Bank of Cyprus extended to the Republic prior to the euro accession.

28. Privatisation receipts: The Cypriot authorities have committed to initiating a privatisation programme, which improves the debt outlook. Privatisation proceeds of at least EUR 1.0 bn within the programme period and additional EUR 0.4 bn in the outer years from the sale of state-owned companies and other state assets appears feasible. The establishment of a complete inventory of assets owned by central government, the municipalities and the regional administration should provide a basis for the sale of additional public real estate and land assets.

29. Sale of excess gold reserves: The Cypriot authorities have committed to sell the excess amount of gold reserves owned by the Republic. This is estimated to generate one-off revenues to the state of EUR 0.4 bn via an extraordinary pay-out of central bank profits.

30. Asset swap of part of the outstanding loan by the Central Bank of Cyprus: Prior to the accession to the Eurozone, CBC had provided a loan to the Republic. The current outstanding amount is approx. EUR 1.4 bn. It is estimated that real estate or other fixed assets valued at EUR 1.0 bn will be swapped for an equal value loan portion.

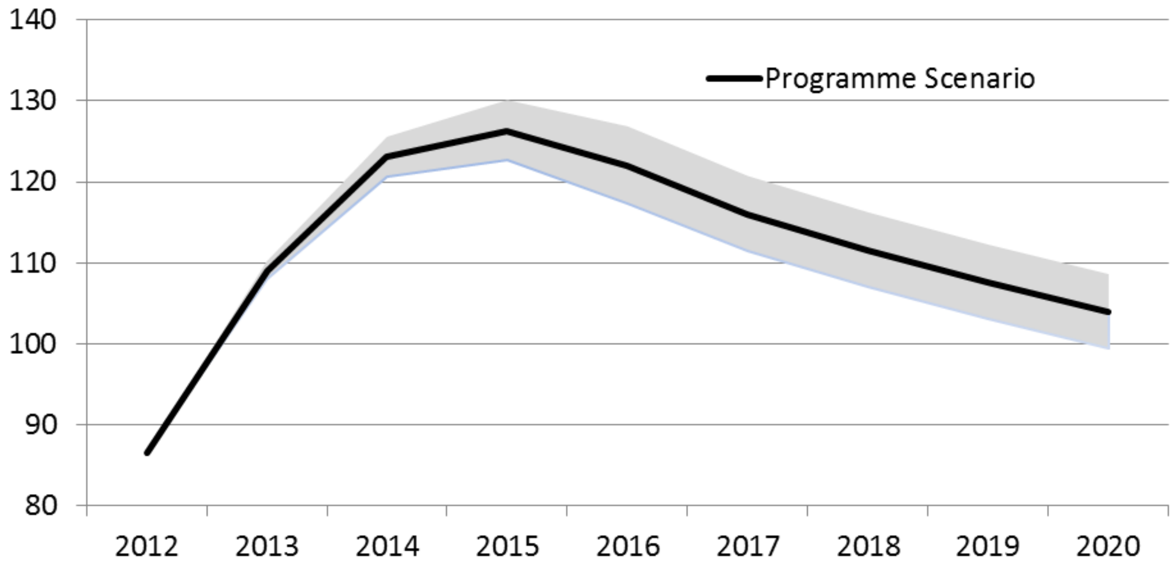
31. A number of other policy steps will alleviate financing needs over the programme period, but with limited or no impact on the public debt trajectory: i) the Cypriot authorities will endeavour the roll-over of up to EUR [1.0] bn domestic law long-term debt maturing during the programme period. In order to implement this, the Cypriot authorities intend to undertake a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The maturing bonds will be exchanged for new longer dated sovereign bonds with maturities between 5 and 10 years; ii) reschedule the Russian loan falling due in 2016 to be repaid in 5 equal instalments starting in 2018 and lower the interest rate; iii) rolling over the EUR 1.9 bn CPB recapitalization bond[4].

32. Debt projections are sensitive to macroeconomic developments, in particular deviations in the projected nominal GDP path and the fiscal balance. Graphs 3-5 show a sensitivity analysis of the programme scenario. The charts depicts, respectively, the impact of a 1 p.p. lower annual GDP growth each year during 2013-16, the impact of a 1 p.p. worse primary fiscal balance each year during 2013-16 and the impact of a 2 p.p. higher interest rate during 2013-2020. Chart 6 shows the impact on the projected debt ratio of a combined shock.

33. In spite of the sound foundations of the programme, downside risks to the projected debt developments during and after the programme period exist and are linked in particular to: (i) a possible stronger contraction of the economy, steeper drop in real estate prices, and further worsening of the labour market outlook, especially if the banking sector downsizing and administrative restrictions will result in a more protracted period of low confidence and credit contraction (graph 3); (ii) non-attainment of the agreed primary surplus targets established in the programme (graph 4); (iii) insufficient implementation of fiscal-structural measures to underpin the attainment of continued high primary surpluses; (iv) lower-than-expected privatisation proceeds; (v) a less tax-rich composition of growth and possibly stronger sensitivity of revenues to the structural adjustment of the Cypriot economy; (vi) a worsening of the economic situation in trade-partner economies and (vii) lack of success in regaining market access at a reasonable borrowing cost after the programme period (graph 5).

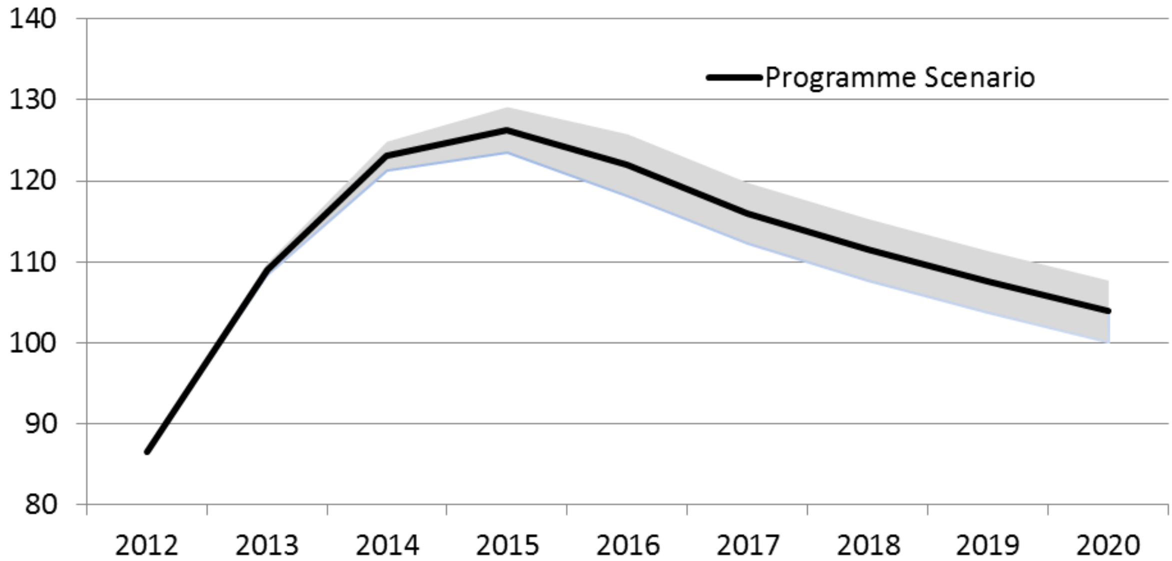
[4] The statistical treatment of the CPB recapitalisation bond is currently subject to assessment by Eurostat in context of Cyprus' April 2013 fiscal notification.

Graph 3: Programme scenario: sensitivity to lower/higher growth



Source: Commission services

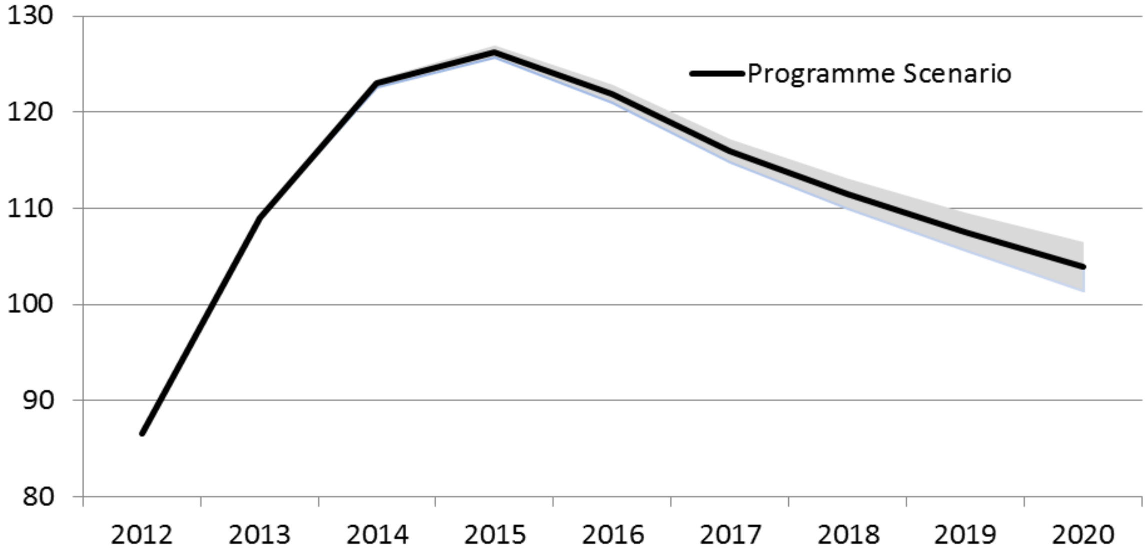
Graph 4: Programme scenario: sensitivity to 1 p.p. worse/better primary balance



Source: Commission services

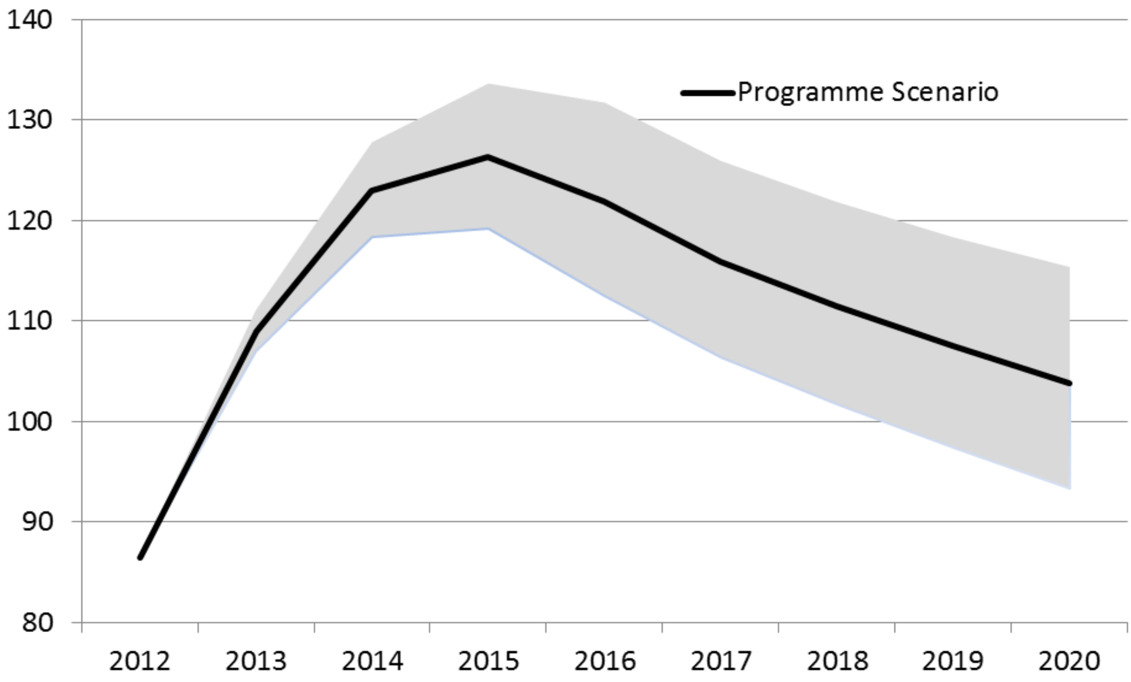
34. The low financing needs and the fact that a majority of the debt will be to the ESM after the end of the programme period imply that debt dynamics are less sensitive to market interest rate changes until 2020. This is confirmed by assuming higher market interest rates of 2 p.p. , on new and rolled-over debt, which has a limited impact on debt dynamics up to 2020 (graph 5).

Graph 5: Programme scenario: sensitivity to higher/lower interest rate



Source: Commission services

Graph 6: Programme scenario: combined sensitivity to growth, primary balance and interest rate



Note: Combines the effect of a lower/higher growth, worse/better primary balance and higher/lower interest rates, respectively.
Source: Commission services

35. There are, however, also upside risks to be taken into account, albeit difficult to quantify, including: i) the macroeconomic scenario underpinning the programme assumes a pronounced short-term impact of fiscal consolidation on economic activity. However, the Cypriot economy is a small open economy, implying that the impact on growth from consolidation could be comparatively small, while the benefits of confidence-enhancing fiscal and structural reform measures may be comparatively large; ii) the future exploitation of Cyprus' offshore gas fields is expected to increase government revenues both directly and via increased economic activity. These effects are excluded from the current debt projections as the size of these natural resource revenues remains uncertain. Overall, although both the timing and size of the revenues remain uncertain, exploitation of Cyprus' natural resources constitute a significant upside risk to debt sustainability; iii) the agreed and planned structural reforms will lead to a fall in long-term expenditures especially in the area of pensions. The agreed increases in retirement ages and other parametric changes to the pension system and health care system will yield significant savings in public finances.

Conclusions

36. The projections carried out by the Commission services, in liaison with the ECB, on the basis of the financial, fiscal and macroeconomic parameters of the draft MoU, suggest that Cyprus' debt outlook is challenging, but will allow Cyprus’ public debt to remain on a sustainable path, provided that there is strong implementation of the adjustment programme. The assessment has been [agreed/conducted/discussed] with IMF Staff.

37. A number of downside and upside risks to the debt projections may impact on the actual debt trajectory. Although difficult to quantify, downside risks appear dominant.

Annex 1: Main technical assumptions underpinning the debt projections

Description of scenarios in the DSA

- The **November 2012 scenario** is based on the Commission's services 2013 Winter Forecast which builds on no-policy-change, apart from the fiscal measures already adopted and implemented in December 2012 in line with the draft Memorandum of Understanding agreed in November 2012, and includes the costs for the recapitalisation of the banking system amounting to EUR 10.0 bn.
- The **Programme Scenario** is based on the commonly agreed macroeconomic forecast and the fiscal consolidation measures incorporated in the MoU agreed between the Cypriot authorities and the Troika on 2 April 2013, including, inter alia, privatisation receipts for state-owned and semi-public companies of EUR 1.4 bn over 2013-2018, roll-over of domestic-law long-term debt of EUR 1.0 bn, CBC loan asset swap of EUR 1.0 bn and sale of excess gold reserves of EUR 0.4 bn.

Macroeconomic and fiscal assumptions

- The projections under the November 2012 scenario are based on the Commission services' 2013 Winter Forecast, which incorporated the provisional MoU agreed at staff level. Projection of the programme scenario is based on the commonly agreed programme partners' macro-fiscal forecast for 2013-2016.
- The scenarios assume a rescheduling of the redemption of the loan by the Russian Federation of EUR 2.5 bn so that repayment takes place as from 2018 in 5 equal instalments and an interest rate reduction. For technical purposes and pending finalisation of the agreement between the Russian Federation and the Republic of Cyprus, an interest rate of 2½% was used.
- The GDP deflator is assumed to be 1.9% between 2017-2019, reaching 2.0% by 2020 and remain stable thereafter.

Interest rate assumptions

- The ESM interest rate reflects the expected path of 10-year Bunds, plus a margin, ranging from 2.27% in 2013 to 3.80% in 2025.
- The IMF interest rate increases from 2% in 2013 to 3.4% in 2017. It declines gradually to 3.2% until 2020 and remains stable at that level thereafter.
- The nominal long-term interest rate on new/rolled over debt is assumed to be at 5%. The nominal short-term interest rate on new/rolled over debt is assumed to decline linearly from 5% in 2013 to 3% by 2015.

Debt profile and loan assumptions

- The ESM loan of EUR 9bn has a maximum average maturity of 15 years with a maximum maturity of 20 years - in practice this implies that half of the outstanding ESM loan has been paid back by [2028 and the ESM loan will be repaid by 2033];
- The IMF loan of EUR 1bn is granted under the Extended Fund Facility. Repayment starts after 4.5 years.
- Cyprus continues to roll-over outstanding T-Bills at programme start on the market, i.e. programme funds are not used for the redemption of T-Bills.