FISCAL COUNCIL PRESS RELEASE
Autumn Report
November 2020

In a session held on 6/11/2020 the Fiscal Council approved the Autumn Report for 2020. The report was compiled with data available to the Council up to the 20/10/2020.

The full text of the Report has been uploaded to the Council's website, at www.fiscalcouncil.gov.cy. A copy may also be requested by phone by dialing 22606627, or via email at info@fiscalcouncil.gov.cy.

Amid the measures to contain the spread of Covid-19, the Council decided against holding the customary media gathering to present its Report.

The Council does remain at the disposal of the media and all stakeholders for clarifications, discussion and information relating to the Report.

Synopsis

Among others, the Report documents the following:

The macroeconomic environment

The macroeconomic environment during the first three quarters of 2020 deteriorated in relation to the same period of 2019.

Recent developments in connection with the current Citizenship-by-Investment programme, leading to the programme's termination, as well as the rise in coronavirus cases both in Cyprus and in major trading partners, will no doubt adversely impact the trajectory of the economy and thus public finances. At this stage quantifying these impacts is subject to a great deal of uncertainty.

Beyond the baseline scenario ('Endorsement', Table 1) that was based on the Ministry of Finance forecasts, as assessed on 9/10/2020, the Council generated two supplementary scenarios: Scenario 1, assuming further mild impacts on the economy; and Scenario 2, assuming further more severe impacts. It is noted that neither supplementary scenario stipulates measures tantamount to a total economic shutdown, equivalent to that occurring during the second quarter of the year.

The three scenarios are presented in Table 1 ('Macroeconomic forecasts') below:

Table 1

Macroeconomic projections				
	2020	2021	2022	2023
	GDP growth rate			
Endorsement *	-5.5	4.5	3.5	2.8
Outcome 1	-5.8	3.8	3.6	3.0
Outcome 2	-6.2	3.3	3.7	3.1
	Inflation			
Endorsement *	-0.6	1.0	1.5	2.0
Outcome 1	-0.8	0.9	1.4	1.8
Outcome 2	-1.0	0.8	1.3	1.6
	Unemployment			
Endorsement *	8.0	7.0	6.0	5.2
Outcome 1	8.2	7.7	6.9	5.7
Outcome 2	8.4	7.9	7.1	5.9
* Ministry of Finance Projections endorsed by the Council on 9/10/2020				

Fiscal forecasts

Like other European Union member states, in order to deal with the coronavirus crisis Cyprus has activated the General Escape Clause, allowing for a temporary deviation from the fiscal rules. The Council notes that this clause has been activated temporarily, and that any plans to tackle the pandemic should take into account the future sustainability of public finances.

Broadly, assessments for the next three-year period are subject to a significant degree of uncertainty due to difficulties in predicting the trajectory of the pandemic. The actual impact will depend on when and to what extent the pandemic will be contained and on whether there will be a permanent and significant impact on consumer habits and behaviours. **The Council reiterates that given the high level of uncertainty there should be frequent revisions of macro and fiscal forecasts and when necessary fiscal plans should be revised and modified so as to reflect the trajectory of the pandemic and its impact on the economy**.

In the meantime, and until there is a clearer picture as to trajectory of the pandemic, budgetary funds should be disbursed sparingly. Government support measures should cover only viable corporate entities facing temporary cashflow issues as well as households in dire need of assistance. **The state should continue to maintain a buffer that it can tap into should the need present to intervene anew going forward. Moreover, authorities are encouraged to never lose sight of the possibility of the public debt becoming unsustainable, either due to additional increases in the debt or to a possible reduced capacity to generate sufficient fiscal surpluses.** A potential decline in the productive capacity, coupled with a rise in interest rates, would adversely impact the ability to service the public debt, and for this reason debt should be kept as low as possible.

Drawing on the aforementioned modified macroeconomic scenarios, presented in Table 1, the Council notes in Table 2 the corresponding modifications to fiscal forecasts and the public debt.

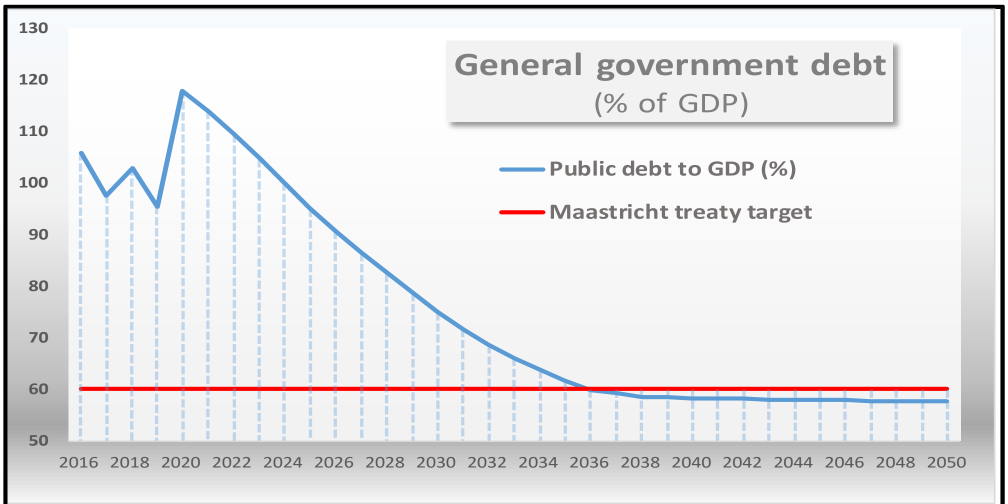
Table 2

Fiscal projections and debt to GDP				
	2020	**2021**	**2022**	**2023**
	Fiscal general balance			
Endorsement *	-4.5	-0.7	-0.6	-0.1
Outcome 1	-5.0	-1.4	-0.9	-0.3
Outcome 2	-5.7	-2.1	-1.3	-0.8
	Fiscal primary balance			
Endorsement *	-2.2	1.4	1.3	1.5
Outcome 1	-2.7	0.8	1.1	1.3
Outcome 2	-3.4	0.0	0.6	0.9
	Public debt to GDP			
Endorsement *	114.8	111.0	102.3	98.1
Outcome 1	117.4	114.0	110.0	106.0
Outcome 2	118.1	116.2	112.6	109.1

* Ministry of Finance Projections endorsed by the Council on 9/10/2020

Public debt

Based on the to-date data and underlying assumptions - which as noted are subject to a great deal of uncertainty - it is projected that Cyprus will remain able to service its public debt. This forecast is likewise documented in the most recent European Commission and International Monetary Fund assessments. The anticipated trajectory of the public debt is shown in the following diagram (General government debt - % of GDP'):



Notes

Source for actual data up to and including 2019 Ministry of Finance

Basic assumptions based on macroeconomic and fiscal projections by the International Monetary Fund 2020-25. (https://www.imf.org/en/Publications/WEO/weo-database/2020/October/select-countries?grp=995&sg=All-countries/Advanced-economies/Euro-area)

Assumption 1Q; The average interest rate will decline to 2.3% by 2023 and then gradually rise to 3.5%.

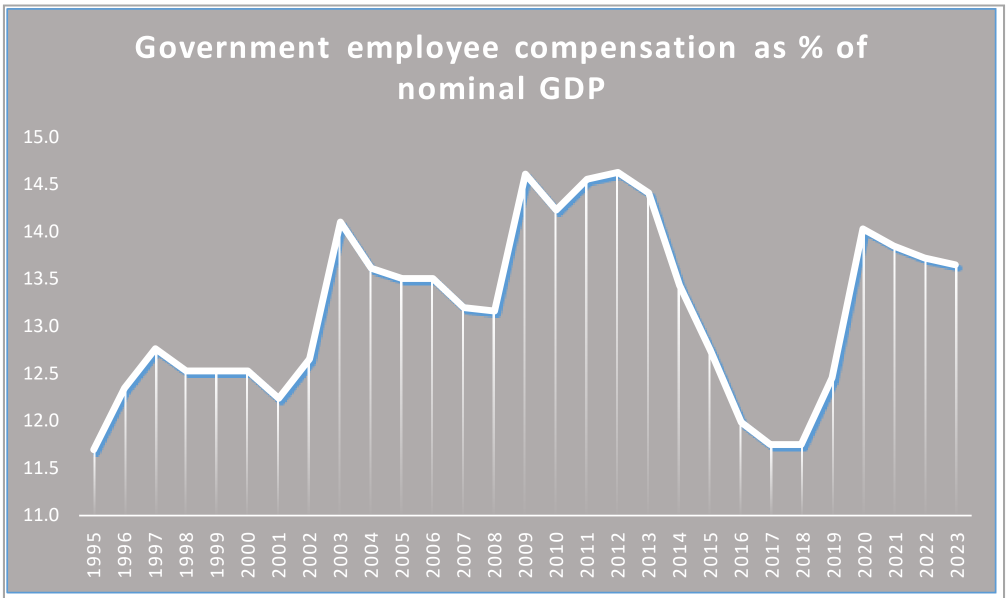
Assumption 2: All primary balances will be used for the repayment of public debt.

Assumption 3: The primary balance policy will be maintained up until the reduction of public debt to 60% of GDP.

Reforms and fiscal risks

Other than the foregoing, maintaining fiscal stability and improving the conditions necessary for the well-being for the population at large, may be achieved as follows:

- **By immediately pushing forward the necessary reforms** highlighted by relevant agencies and organisations and as repeatedly described in successive Council reports. These reforms aim to boost the competitiveness of the Cyprus economy and to render the island more attractive to productive investment projects generating long-term well-paying jobs.
- **By avoiding reliance on quick-fix policies that run the risk of being unexpectedly terminated** and adversely impacting other sectors of the economy, as well as households, while at the same time leading to additional permanent state expenditures.
- **By keeping in check state expenditures, particularly the government payroll** which - as shown in the diagram below - had begun increasing at a rate beyond GDP growth even prior to the onset of the pandemic. Specifically, and as part of a broader drive to reform the civil service, **there should be put in place a transparent and rational performance assessment and remuneration system which, among others, would factor in the trajectory of the economy, budgetary allocations, productivity, a civil servant's duties and responsibilities, as well as corresponding pay in the private sector and in the rest of the EU**.



Source for the period 1995-2018: Cyprus Statistical Office

Government employee compensation: Table "ESA 2010 Questionnaire 1100- General Government Expenditure by Function"

GDP: Table "National Accounts".

Source for the period 2019-2023: Explanatory notes to the 2021 Annual Budget

- **By keeping in check expenditures of the National Health Scheme**. Healthcare systems around the world - including those in operation for decades and are regarded as exemplary - are under strain due to the pandemic. The Council believes that spending on the NHS should be monitored on an ongoing basis, thus ensuring the scheme's sustainability and without jeopardising public finances. Abuse and mismanagement within the healthcare system should be dealt with swiftly and forcefully. Failure to do so will adversely impact total costs but also the quality of the service provided. Recurring abuses could throw the system into a vicious circle, leading patients and healthcare professionals alike to seek alternatives elsewhere; this could bring about a further depletion in the quality of service and drive up operating costs to the point of rendering the system itself unsustainable.

- **By safeguarding the stability of the financial system through a drastic reduction in Non-Performing Loans (NPLs) that remain within and outside the banking sector.** Although lately some progress has been achieved in tackling NPLs, the problem remains a serious one, posing one of the gravest challenges to public finances and the economy at large. Subdued interest in the 'Estia' mortgage relief scheme offered to households, and the decline in unemployment up until March 2020, point both to a reluctance to meet obligations as well as to weak enforcement.
  The Council is of the view that all necessary changes should be immediately pushed forward so as to create the appropriate framework and conditions to reduce NPLs, including via drastic steps such as foreclosures if need be. The Council acknowledges that this might place certain households and businesses in a precarious position. In such cases, government support can and should be provided through current or new schemes. **A blanket freeze on foreclosures will give rise to instability, placing in jeopardy the financial system and therefore public finances as well, restrict financing opportunities and raise financing costs for other households and businesses, and encourage and foster a disregard for meeting one's financial obligations; more significantly, new households and prospective professionals and entrepreneurs who own no other property, will be denied access to financing for the purpose of acquiring a permanent residence or business premises**.
  The Council notes that the NPL ratios across the Eurozone are in the single digits. Given the EU's plans to move forward with a full banking union and a common deposit guarantee system, provided that NPL decline further, it is expected that considerable pressure will be brought to bear on this point.
- **By encouraging household savings. - This will stave off the existing risk of pension inadequacy and also it will improve the conditions for new investments into the economy**.
  There still remains the need to create a viable pension system - ensuring adequate retirement benefits, and averting the possibility of the state having to tap its resources to support future pensioners. Efforts should be made to encourage household saving, which throughout the years has remained at very low levels. To this end, incentives to save, reforms to the institutional framework, and enhanced oversight, are all necessary preconditions. It should be stressed that, other than the benefits to the participants, **a robust and properly regulated pension system provides a source of sound financing and a mechanism that plays a positive role in the rational operation of businesses**.

Cyprus Fiscal Council

Nicosia 11/11/2020