STABILITY PROGRAMME

OF THE

REPUBLIC OF CYPRUS

2007-2011

Ministry of Finance

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OF THE
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CONTENTS

INTRODUCTION

On the 22nd June 2007, and in accordance with Article 122(2) of the Treaty of the European Union, the ECOFIN Council abrogated the derogation for adoption of the euro in the Republic of Cyprus on the 1st January 2008. The Council, based on the recommendation by the European Commission and the European Central Bank (ECB), determined that Cyprus had achieved a high degree of sustainable convergence, meeting all the criteria, as laid down in Article 121 of the Treaty.[1]

The favourable assessment of Cyprus followed two years of participation inside the Exchange Rate Mechanism II (ERM II), and a period of fiscal consolidation, which begun in 2004. The fiscal deficit, which had reached 6.5% of GDP in 2003, was reduced gradually and turned into a surplus, estimated at 1.5% of GDP in 2007.

This is the first Stability Programme (SP), which Cyprus is required to submit in accordance with the Council's Regulation (EC) 1055/2005. It 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 (2005 Code of Conduct)". Since last year there have been no institutional developments pertaining to national budgetary rules and procedures, thus the current SP does not include a separate chapter covering in depth these issues.

As of 1st January, 2008, monetary policy in Cyprus will be determined by the ECB, taking into consideration conditions prevailing in the euro area as a whole. Hence, fiscal policy will have to play a decisive role, through the operation of automatic stabilizers, in steering the economy, especially during periods of asymmetric shocks affecting Cyprus.

The principal challenge inside the euro area is to consolidate the public finances, while, at the same time, strengthening the social safety net, re-directing resources towards growth-enhancing expenditure categories and improving physical infrastructure in various sectors of the economy. To achieve an enduring consolidation of public finances, especially in view of the prospective ageing of the population, a series of fiscal structural reforms are being undertaken, centred around the gradual introduction of a Medium-Term Budgetary Framework, using a programme and performance based budgeting method.

Following the strong fiscal performance observed during 2007—and conscious of the need to safeguard the important achievements thus far—, this first SP sets a more ambitious Medium-Term Objective for the period 2007-2011. The medium term objective, set in the last Convergence Programme, of a small deficit of ½% of GDP is now revised to a balanced budget. This cautious approach is warranted, given the

[1] Convergence report 2007 prepared by the European Commission and ECB, respectively: http://ec.europa.eu/economy_finance/publications/european_economy/2007/ee0607_en.pdf and http://www.ecb.int/pub/pdf/conrep/cr200705en.pdf .

considerable uncertainties pertaining to the "permanent" nature of the windfall revenue gains in 2007.

Overall, policies will have to support investment and private sector development, and to contribute towards the further enhancement of productivity and competitiveness of the economy. In this respect, the Government must play a special role in reducing the administrative burden of regulations, promote R&D and investment and play a role in determining wages in the economy, through public sector wage setting.

In order to gain broad political support the views of the political parties and other social partners were taken into account during the preparation of the SP. This SP has been approved by the Council of Ministers on the 5th December, 2007, and will be submitted to the House of Representatives for discussion.

The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as feasible and credible. Although a safety margin has been incorporated in the design of the fiscal consolidation programme, the Government stands ready to introduce additional corrective measures, should this be warranted by adverse developments. The Ministry of Finance will be monitoring closely the timely implementation of the Programme.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The overriding objective of economic policy is to enhance long-term growth and the standard of living of all citizens, maintain macroeconomic stability, implement structural reforms, which improve the functioning of the market mechanism, and ensure that the government sector provides, adequately and efficiently, services to the public. Within the overall government finance constraints and targets, fiscal policy will focus more on growth, through the 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.

Despite the relatively satisfactory performance of the economy—as exemplified by real convergence and the fulfilment of several key Lisbon targets—efforts to reform further labour, product and financial markets, in line with the country-specific Broad Economic Policy Guidelines' (BEPGs') and Cyprus' National Reform Programme, will be intensified, taking into account the recommendations made at the EPC's country review working group meeting in November 2007.

Fiscal Policy

Fiscal policy is geared towards consolidating the improved public finances, with a view to reducing public debt and thus addressing the long-term sustainability of public finances. Particular emphasis is placed on the need to curtail current expenditure and restructure public spending, in favour of capital expenditure, research and education, which can boost the economy's growth potential. Emphasis is also attached to targeted social spending. The policy is based on four key pillars:

- The introduction of a Medium-Term Budgetary Framework (MTBF), which will institutionalise expenditure rules, give more independence to spending ministries and, at the same time, increase their accountability for achieving important quantifiable targets;
- The reform of the social welfare system, in favour of those who are in greater need. Targeted social expenditure is key in curtailing wasteful spending;
- The modernisation of the public sector, which will result in leaner and more productive public services. Such a policy will limit expenditure growth and raise overall productivity. Particular attention will be placed on wage policy for public sector employees, given its impact on overall wage developments and hence the competitiveness of the economy (Box 1);
- Improve further tax collection, within the present system, by focusing on tackling tax evasion and improving tax administration.

Following the strong fiscal performance observed during 2007—and conscious of the need to safeguard the important achievements thus far—, this, first, SP sets a more ambitious medium-term objective for the period 2007-2011. The medium term, set in the last Convergence Programme, objective of a small deficit of ½% of GDP is now revised to a balanced budget. This cautious approach is warranted, given the considerable uncertainties pertaining to the "permanent" nature of the windfall revenue gains in 2007.

Monetary and Exchange Rate Policy

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, mainly through the pegging the Cyprus pound to an anchor currency, be it a basket of currencies until 1992 or a single currency, the ECU since 1992 and the euro since 1999. As suggested by the overall positive economic performance of the country, where high growth, low unemployment and relatively low inflation rates were recorded, the policy of using the exchange rate as a means to contain inflation and anchor inflationary expectations has served the economy well, not only in terms of safeguarding price stability, but also by providing a stable macroeconomic environment, which is conducive to long-term growth.

With the adoption of the euro, monetary policy remains effectively unchanged, though the possibility of any fluctuation of the exchange rate vis-à-vis the euro is completely removed. The fact that the Cyprus pound has been pegged to the ECU during 1992-98, and subsequently to the euro, without any tensions, suggests that the economy can cope with a fixed exchange rate regime, provided policies remain prudent and focused on the objectives stated in this Programme.

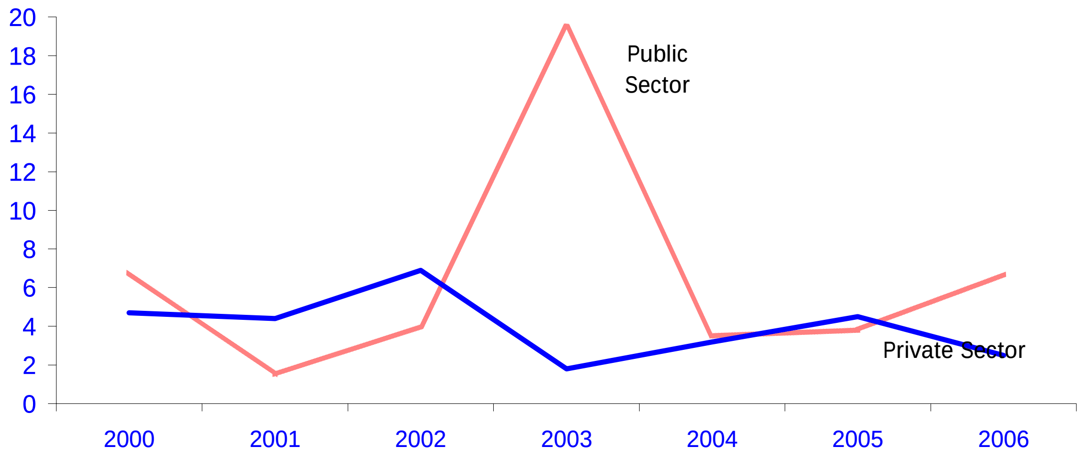
The requirement of keeping the exchange rate of the Cyprus pound against the euro relatively fixed inside ERM II meant that policies, which threatened exchange rate stability, would have been punished by the market. However, with prudent policies no longer “required” to stabilize the currency after euro adoption, it is nevertheless of key importance that fiscal, incomes, and other policies not be relaxed. Otherwise, competitiveness will be eroded and Cyprus will be punished by lower economic growth and a loss of potential output.

Box 1: The Role of the Public Sector

The public sector in Cyprus accounts for some 18% of the labour force. This is relatively high compared to many other EU countries: it compares, relatively, favourably, when measured against Scandinavian countries, where the employment share is around 20-25% of the labour force. However, it is high compared with other euro area countries, for example Austria, Germany, Ireland, and Netherlands, where the share is much lower, at around 10-12% of the labour force.

In terms of expenditure on wages and salaries, Cyprus ranks third highest among EU countries, with the share of wages and salaries (as a % of GDP) at around 17%.

Public and Private Sector Wage Increases (annual % change)



It is noted that, historically wages in the public sector have risen faster compared to wages in the private sector (Graph). Additionally, and notwithstanding the fact that public sector jobs are secure and offer other generous benefits, public sector employees enjoy wages, which are typically much higher compared to private sector wages, with the exception, perhaps, of top public sector employees. Finally, productivity of the public sector remains relatively low and scope for improvement is considerable.

What are the consequences for the economy, particularly in view of the prospective euro changeover, and the policy implications?

- Productivity and competitiveness are key inside a currency union. The relatively low productivity level in the pubic sector affects directly and indirectly the productivity of the whole economy. A reform of the public sector must address productivity by technological improvements, but also through training, promotion and hiring policies.
- The growth of the public sector limits the flexibility of fiscal policy to adjust in times of asymmetric shocks—since inelastic expenditure rises as a share of total expenditure—and to redirect resources to more growth enhancing areas. The restrictive hiring policy for the public sector must be the cornerstone of fiscal policy in the medium term.
- Public sector wage developments have an important impact on private sector wage determination. These spillovers from the public sector to private sector wages weigh heavily on external competitiveness. To bring public sector wages more into line with productivity wage settlements in the public sector should be based on performance, which can be differentiated across individuals and/or occupations.

Inside the single currency area, these considerations become crucial and policies must be undertaken to address these issues.

Structural Reforms

The promotion of structural reforms will enable Cyprus to develop a robust and flexible economy, exhibiting the desired resilience to external shocks, while enhancing the efficiency of the market mechanism and raising the production potential of the economy.

The programme of structural reforms, outlined in detail in the National Reform Programme, and updated in the recent Progress Report, aims at boosting productivity and competitiveness that will deliver high growth and living standards for the citizens of Cyprus. Although the Government is active in addressing these challenges, it considers the role of the private sector as key. The private sector identifies opportunities and invests in profitable areas. Macroeconomic stability and a friendly business environment are key ingredients underpinning this effort.

Ongoing reforms are addressing key challenges including the following areas:

1. *Reforms targeted at enhancing competition and improving the overall business climate*

Reforms are being carried out, aimed at enhancing competition and improving the overall business climate. Policies focus on enhancing competition, through the strengthening of the Office of the Commissioner for State Aid Control and the Commission for the Protection of Competition, removing regulatory barriers for the setting up of enterprises, inter alia, through the creation of one-stop-shops, and raising the efficiency of the public sector, through establishment of four Citizen Service Centres.

It has become increasingly recognized that better regulation can have a decisive positive impact on the business environment. A specialized unit for Better Regulation, setup in April 2007 within the Ministry of Finance, is responsible for promoting better regulation activities, including the reduction of administrative burdens of regulations.

2. *Promote R&D and innovation and facilitate ICT diffusion*

It is widely accepted that R&D and innovation and the wider utilisation of information technology are key in attracting foreign direct investment, boosting productivity and growth. The SP provides for increased expenditure on R&D, mainly through the Research Promotion Foundation (RPF). The increased expenditure is being accompanied by efforts to coordinate more effectively government-funded academic and private sector research programmes, so as to encourage innovation. EU structural funds will finance a large part of the budget for Research, Technological Development and Innovation, while the institutional framework for R & D and innovation will be enhanced, through the opening of the Cyprus University of Technology and the Research Centre for Energy, Environment and Water in 2007.

Progress in diffusing ICT has improved, by the completion of important e-Government projects, such as the Government Portal, the upgrading of the social insurance system, and the first phase of the roll-out of the Office Automation System.

Further measures promoting e-health have been introduced including an integrated health care system in the general hospitals of Nicosia and Famagusta and the development of a national Health Monitoring System.

Also, in primary and secondary schools measures promoting e-learning, including improved ICT infrastructure, training of teachers in basic ICT skills and use of multimedia instruction in class are being implemented.

3. Upgrading basic infrastructures and improving the functioning of network industries

Implementation of policies aimed at upgrading the physical infrastructure and improving the functioning of network industries are proceeding, taking into account environmental concerns.

Conditions of competition have improved in the utilities sectors (telecommunications and energy), in which there was, until recently, only one provider. In the telecommunications sector there has been a significant increase of the share of other providers, beyond the Cyprus Telecommunications Authority (CYTA), in the provision of communication services. In the energy sector, 35% of the electricity market was opened to competition, after Cyprus´s accession to the EU in 2004. Until now, the Electricity Authority of Cyprus (EAC) remains, virtually, the only supplier, but a number of private suppliers have expressed interest to enter the market. Additionally, the Framework for a Natural Gas Market has been regulated, in line with the relevant EU Directive. Moreover, the Council of Ministers has recently granted the legal authority for the establishment of an entity to manage the transmission and distribution of energy, thus contributing to separate distribution from production in the electricity network.

The air transport sector was fully liberalised as from April 2004, enhancing significantly the conditions of competition. In this sector infrastructure is being upgraded, with the signing of the final concession agreement between the Government and Hermes Airports Ltd, launching the redevelopment of the two airports in Cyprus, using the BOT method. The selected consortium took over the operation of the two existing airports as from May 2006, while the construction works for the redevelopment of the two airports started in June 2006 and is being implemented in advance of plan.

4. Further human capital development and raising the employment rate

Enhancing physical and human capital is key in raising productivity and boosting the economy’s potential growth. Increasing employability and labour force adaptabilíty and raising the employment rate will boost potential growth. Development of human capital is especially important in an economy, dominated by the services sector. Rapid changes in the communication and information-technology sectors and structures of production as well as the organisation of work and the labour market require constant upgrading of the educational and training systems, as well as more emphasis on lifelong learning.

To achieve these objectives the following measures and reforms are being implemented:

- a strategic plan on educational reform, including the quality of education, teacher training and assessment, and the curriculum up to the lyceum level, has been submitted in September 2007 by the Minister of Education and Culture, to teacher organizations and other stakeholders, with a view to reaching a consensus and arriving at policy decisions, within the next few months;

- there have been significant developments in the tertiary education sector, with a Technological University and three private universities (previously tertiary colleges) commencing operation during 2007, thus increasing both study opportunities and human capital development;

- the final draft of a study, focusing on the organization of Secondary Technical and Vocational Education (STVE) was completed last August. External evaluations of both technical/vocational education programmes in general as well as the existing apprenticeship scheme are in progress, with a view to improving curricula and other aspects of the systems;

- a life long learning strategy was approved by the Council of Ministers in November 2008, and for the management of the strategy a non profit organization, the European Life Long Learning Programmes Management Foundation, was established; and

- schemes to increase employability have been developed, including one for inactive women, one for young people and one for the unemployed. Measures to upgrade child care services and help balancing family needs with employment are being undertaken, while a national action plan on gender equality was adopted.

These latter set of measures have contributed to raising the total employment rate to 69.6% in 2006 from 65.7% in 2000, the female employment rate to 60.3% from 53.5% in 2000, and the rate for older workers to 53.6% from 49.4% in 2000.

5. *Reform of social security and health care systems in light of the prospective population ageing*

This vital issue has been widely discussed both at the national and EU level. The Government is working with social partners on possible parametric reforms to the social security system and for a fundamental systemic reform of the health care system. In addition to these plans, which are discussed at a greater length in Chapter 6, other policies are promoted, including schemes to encourage the participation of females in the labour market, the more active participation of older workers and the more effective management of economic migration.

2. ECONOMIC OUTLOOK

World Economy/Technical Assumptions

Despite a challenging macroeconomic environment following the crisis in the sub-prime mortgage market in the United States, the world economy continues to expand at a relatively brisk rate and is expected, largely, to maintain its momentum in 2008. World growth is projected to reach just over 5% in 2007 and 4¾ % in 2008, mainly supported by buoyant economic activity across all continents and by the robust expansion of world trade.

The recovery of the EU economy has firmed in 2007, aided by solid performance in the larger economies—France, Germany, Spain, Poland, and the United Kingdom—but also in the periphery countries, particularly Finland, Ireland, and Greece. GDP is forecast to expand by 2.9% in the EU and 2.6% in the euro area in 2007. The growth performance of the new EU members is particularly satisfactory, especially of Poland, Slovakia, the Czech Republic and the Baltics, although signs of overheating are evident in a number of countries. Recent structural reforms in a number of countries appear to have paid off and encouraging developments in the labour markets—including higher employment rates— have paved the way for a more sustained expansion during this cycle.

The UK economy—the most important economic partner of Cyprus—has displayed renewed dynamism and is currently expanding at a healthy rate, forecast to reach some 3.1% in 2007. Growth in other emerging European, Middle Eastern and CIS countries will remain robust owing to increased oil revenues, thus providing a boost to Cyprus' merchandise and non-tourist services exports, including outlays on business services. In particular, Russia, which is emerging as an important trading partner of Cyprus, is expected to expand by 7% in 2007.

The uncertainty surrounding the macroeconomic impact of the sub-prime mortgage lending crisis in the United States remains large, but these events appear to have mainly affected appreciably, thus far, the balance of risks for 2008. Thus while overall growth prospects for the world economy have not changed materially for 2008, the balance of risks has clearly tilted towards the downside.

In 2008, GDP is forecast to expand by some 2½% in the EU and around 2% in the euro area, thus displaying some deceleration compared to 2007. The economies expected to experience the most visible growth deceleration include the United Kingdom, where growth is forecast to decelerate to 2.2% in 2008, and other rapidly expanding economies, especially Finland, Ireland, Spain and the Baltics. On the other hand, growth in France and Russia is forecast to remain at around similar levels compared to 2007 (around 2 % for France and 7% for Russia).

In contrast, the US economy is facing a visible slowdown which, if it were to prove deeper or more persistent than currently anticipated, could have further significant repercussions for world economic growth. Recent indicators point to a significant slowdown of the housing market, and signs of weaker consumer and business sentiment. The Federal Reserve has already lowered interest rates by 100 basis points since September 2007 and is ready to act again if growth prospects deteriorate further.

The vulnerability of the world economy is coupled with emerging inflationary pressures, due to rising food and oil prices. Both forces are presenting a real challenge to central bankers. These uncertainties are further reflected in increased volatility in equity and bond prices, which are further impacting growth prospects in the medium term.

The projections for the macroeconomic outlook for Cyprus are based on the assumption of an unchanged exchange rate of the euro and Cyprus pound against major currencies from the average level of October 2007. It is assumed that the price of crude oil (Brent crude) will average $71 per barrel in 2007, and will rise to $79 per barrel in 2008. In subsequent years, crude oil prices are assumed to remain at just under $76 per barrel. As regards interest rates, the Stability Programme assumes that they will converge towards the lower levels prevailing in the Eurozone. Given these projections for the world economy and the related technical assumptions, the external economic environment for Cyprus is envisaged to remain favourable over the coming year and into the medium term.

Cyclical Developments and Current Prospects in Cyprus

The economy of Cyprus has continued to perform well in 2007, after a solid performance in 2006. GDP growth reached 3.8% in 2006 and is expected to accelerate to 4.2% this year. Overall, growth performance during the past few years has been robust, thus facilitating real convergence with the EU (Box 2).

On the supply side, the economy is performing well particularly in the secondary sectors due to continued buoyancy of the construction sector, despite expectations for a cooling off this year and, more importantly, in the services sector. From the demand side, continued strong private consumption and a further expansion of export activity are providing the impetus to growth. The satisfactory growth performance is being facilitated by strong employment growth, supported by considerable inflows of foreign workers in key sectors of the economy.

From a sectoral view point, the tertiary sectors have continued to outpace the primary and secondary sectors. Strong demand for financial and other business services, health and education, as well as real estate related activities has heightened growth, offsetting the continuous below potential expansion of the tourism sector. At the same time, buoyant demand for agricultural exports and dwellings has sustained growth in these key sectors of the economy, resulting in a more balanced growth pattern. Foreign demand for real estate in Cyprus rose fast in 2007, with bank loans to non-residents to finance house purchases reaching historically high levels. The tourism industry, which has been operating below potential for a number of years, staged a recovery in 2007 with tourist revenues rising by 7% in the first nine months of this year, even though the volume of tourist arrivals has tended to stagnate.

Table I: Selected Economic Indicators 2005-2007

annual % change	2005	2006	2007
Real GDP growth rate	3.9	3.8	4.2
HICP	2.0	2.2	2.2
Unemployment rate (Labour Force Survey)	5.3	4.5	4.2
Current account balance (% of GDP)	-4.7	-5.9	-6.6

Private consumption continued to expand rapidly compared to 2006. The strong growth of consumption, which is forecast to reach 4.9% in constant prices in 2007, is attributed to further employment and real wage gains as well as to the rapid growth of consumer credit. Public consumption is expected to grow by a relatively moderate rate, around 2.2% in 2007, reflecting the prudent fiscal policy followed by the Government of the Republic of Cyprus, primarily in the area of public wages. Investment is set to expand to 7.9% in 2007, and will continue to be driven by construction and investment in machinery and equipment.

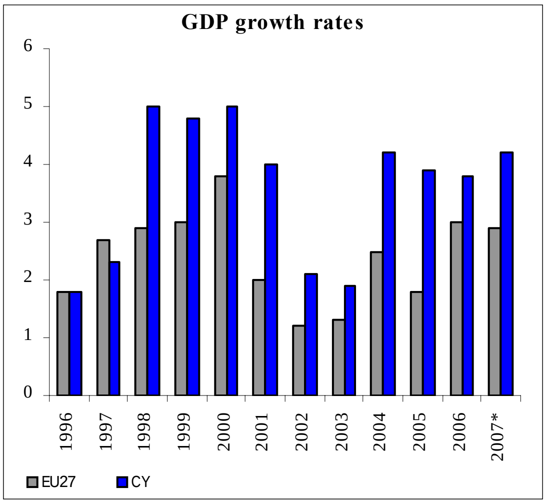
Export growth for goods has moderated somewhat to 1.6% in 2007, mainly as a result of a fall in re-exports, which have declined (in terms of levels) following a decrease by some 19% in 2006. However, domestic exports have risen rapidly, even at a time of increased competition in world markets. Specifically, domestic exports increased by 25.1% during the first eight months of 2007, and are forecast to rise by 17.5% for the year. Exports of services have continued to expand at a satisfactory pace driven, primarily, by financial and other business services and a continued modest pick-up in tourist arrivals and further rises in per capita spending. Tourist arrivals have remained low during the first half of the year, but have displayed a modest recovery in the latter half, being expected to increase by 0.5% in 2007 compared to last year.

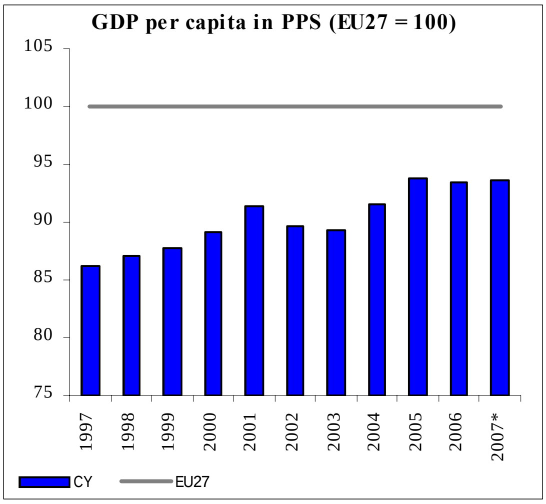
Labour market conditions remain tight with the unemployment rate declining to 4.2% of the labour force in 2007. Employment has continued to expand strongly, at around 2% in 2007, sustained by a continued inward immigration and the employment of Turkish Cypriots. The rapid growth of the working age population and employment in several sectors, have been instrumental in supporting strong demand and curbing wage growth. At the same time, these changes have increased, markedly, the de facto flexibility in the labour market.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), decelerated significantly in the first months of the year, falling to 1.7% in August 2007, but has picked up subsequently, on the back of rising food and oil prices. Based on the current estimates, it is forecast to average 2.2% in 2007 (Appendix I provides a detailed forecast for inflation over the programme period). Excluding energy costs and prices of other volatile items, such as seasonal fruits, inflation remains subdued. Restrictive fiscal policies, the credible peg of the Cyprus pound to the euro, as well as declining prices in several categories—most notably of clothing and telecommunications—and intense competition in other key retail segments of the market are exerting a significant downward pressure on core inflation.

Box 2. Real Convergence with the EU, 1996-2007: Some remaining challenges

During the past 10 years the Cyprus economy expanded at an average rate of 3.6%, compared with 2.4% in the EU27. Consequently, its per capita GDP has increased to over 90% of the equivalent average EU level; in other words, the economy has almost completed its real convergence vis-à-vis the rest of the Union.





Source: ESTAT

This impressive performance masks, however, a number of challenges, which must be addressed in the coming years:

- Productivity improvements have been less impressive, with the productivity level estimated to be around 80% relative to the EU. This suggest that pressures on competitiveness have emerged, particularly in certain sectors;
- Structural reforms have also advanced at a slower pace compared to the notable growth performance. Important challenges remain in the areas of regulation, improving further the business environment and cutting red tape, reforming labour markets, and reforms of the health care and pension systems;
- Progress in enhancing infrastructure has been uneven, with insufficient consideration given to environmental concerns:
    - The efforts of successive governments focused on providing decent housing for refugees in the 1970s and 80s, constructing water dams in the 1980 and 90s to tackle water shortages, and improving the road network in the 1980s and 90s.
    - With limited resources available, deficiencies in other areas have emerged, particularly owing to the rapid progress and growth of the economy.
    - The public transportation system remains basic and bottleneck problems are emerging in several cities. The overall cost for introducing a clean and efficient public transport system could be significant.
    - Furthermore, more investment needs to be undertaken to provide clean water for drinking and agricultural purposes.
    - Infrastructure deficits are also evident in other areas related to the growth of quality/high-value added rural tourism, and the protection of the environment.

The challenge over the next decade is to tackle some of these problems, thereby supporting long term growth.

The banking sector has continued to display dynamism and profits for nine months of 2007 have increased to record levels for the three largest banks. Monetary and credit aggregates have risen sharply over the past year, with borrowing and lending in foreign currencies soaring in response to strong demand for consumer goods and real estate (Box 3) . In October 2007, Narrow Money (M1) registered an annual growth rate of 16.7%, while M2 expanded at an annual rate of 18.5% compared with 14.5% in the corresponding period of 2006. Bank credit to the private sector expanded by 26.2% in the same period. It is noteworthy that the share of foreign currency borrowing by residents— mainly euro—out of total credit has increased from 9½% in 2003 to 27% in October of 2007. Also, bank loans to non-residents more than quadrupled in the ten months to October 2007 compared with the corresponding period of 2006, as foreign purchases of Cyprus real estate rose sharply.

Official interest rate differentials have narrowed vis-à-vis the euro area, following the monetary tightening by the ECB in 2007 (by 75 basis points since the last Convergence Report was finalised). The narrowing of differentials contributed to some deceleration of capital inflows compared to the very high levels, which had been realised in 2006, and, which had contributed to the to excess liquidity conditions in the banking system.

With credit expansion accelerating during 2007, the Central Bank of Cyprus (CBC) sought to tighten monetary conditions, without raising the interest rate differentials with ECB rates[2]. Liquidity absorbing operations involving the acceptance of bank deposits at higher interest rates were expanded. Yields on Government Treasury bills and long-term bonds have also been driven up during 2007, despite the much lower financing needs of the Government. The yield on the latest issue of 10-year Development Stock at end-September was 4.6% compared with a yield of 4.26% on similar stock one year earlier.

The current account is expected to register a deficit of some 6.6% of GDP in 2007. Despite a strong export performance for goods, and to a lesser extent exports of services, lower transfers from the EU and markedly higher imports are behind the deterioration of the current account. The rather persistent deficit masks a number of transitory factors including soaring oil prices and income outflows by foreign firms.

[2] As a large part of the credit was increasingly concentrated in the construction sector, the CBC, to constrain prudential risks, issued circulars to all banks on 12th July and 22nd August 2007, restricting the maximum percentage of financing allowed for the purchase or construction of property from 70% to 60% of the value of the property funded. The maximum funding allowed for the purchase/construction of primary permanent residence remained at 80%. In this regard, the CBC opted to limit the share of the particular type of loans in banks´ portfolios, to make loans more secure and, at the same time, to slow credit expansion to the construction sector.

Box 3. Causes and Consequences of Rapid Credit Growth

During 2007, rapid credit growth has continued and even accelerated, as banks and credit co-operatives operating in Cyprus, increasingly extended credit to finance purchases of consumer goods and real estate. This consumer credit expansion enabled very high increases in private consumption at a time, when growth of real incomes was being somewhat dampened, by rising energy and food prices.

In the period January to October 2007 bank credit to the private sector increased at an annual rate of 26%, compared with 16% in the same period of 2006. Similarly, the 12 monthly rate of increase of credit extended by credit co-operatives to October 2007 was 16%, which compared with 10% one year earlier. Credit expansion has been increasingly channelled into "building and construction" and for "professional and personal loans", with the latter category including financing for household purchases of consumer goods and real estate; these two categories accounted for 83% of total bank credit expansion to the private sector in the first ten months of 2007.

The rapid growth of credit has reflected both supply and demand factors, that partly reflect historically low interest rates:

- Generally, banks have been quite active in promoting loans to finance housing construction by developers as well as house purchases by both residents and non-residents. Credit has been used also to promote and, indeed, help fund purchases of cars and consumer durables.

- However, the burgeoning demand for credit has been an equally strong factor, contributing to rapid credit expansion. In fact, with consumer purchasing power being affected by sharp rises in energy and food prices stemming from climbing international oil and cereal prices, credit has been increasingly needed to sustain the brisk growth of private consumption. The rise in the ratio of household debt to income appears to have broadly coincided, with higher oil prices in terms of Cyprus pounds.

What are the implications? One consequence of the strong increase in consumer credit as well as the acceleration in loans extended for purchases of real estate has been the large rise in the demand for consumer goods imports and for materials, supplies and equipment required to sustain the construction boom. This, in turn has increased pressures on the current account of the balance of payments and on the level of housing prices as well as generally on prices of locally produced goods and services. Thus, through the credit mechanism, there have been further effects on goods and services prices, adding to the direct impact of higher international energy and food prices on inflationary pressures in Cyprus.

It is unlikely that the current rate of expansion of consumer credit can be maintained at such levels in the coming year. There was a huge increase in credit-financed motor car purchases in 2007 and this is unlikely to be repeated over the coming year. Furthermore, with housing prices reaching high levels relative to incomes it will be increasingly difficult for new borrowers (local and foreign) to adequately service related housing loans, thus making the extension of new housing loans more risky for lending institutions. Moreover, with the ratio of household debt to income rising over the last two years, demand and supply factors are likely to interact to curb the rapid growth of credit.

Medium-term Scenario 2008-2011

The Stability Programme is based on a medium-term macroeconomic scenario that takes into account the positive effects stemming from the implementation of fiscal and structural reforms and other policies included in the National Reform Programme. The following key assumptions are made for 2008-11:

- Tourist arrivals will increase by 2%, and per capita tourist spending by around 1% in real terms annually over 2008-11[3].
- The value of exports of services other than tourism will rise at an annual average rate of 7.6% over the period 2008-11.
- Nominal earnings will rise by 4.6% per annum and real earnings by 2.4% during 2008-2011, in line with prospective productivity gains. Hence, real unit labour costs will rise by 2.4% per annum over the same period.
- Employment will expand by 1.7% per annum, as a result of an increasing inflow of foreign and Turkish Cypriot workers.
- Public sector employment will expand by some 1% annually.

Based on these assumptions, and notwithstanding some risks to this scenario, it is forecast that GDP will expand at an average rate of 4%—slightly above the estimated potential growth rate of 3¾%—thus closing the output gap by the end of the programming period. With growth at or somewhat above potential, the unemployment rate will decline to 3.6% by 2011.

Table II: Selected Economic Indicators 2008-2011

annual % change	2008	2009	2010	2011
Real GDP growth rate	4.1	4.0	4.0	4.0
HICP	2.5	2.0	2.0	2.0
Unemployment rate (% of Labour Force) (Labour Force Survey)	4.0	3.9	3.7	3.6
Current account balance (% of GDP)	-6.5	-6.3	-5.9	-5.6

It is envisaged that domestic demand,—reflecting mainly buoyant investment activity and strong growth of private consumption,—and to a lesser extent exports will be the main drivers of growth in the medium term. Private consumption will continue to grow at around 4% per annum on account of wage and employment gains and low interest rates. Investment will expand by about 3.6% per annum—compared with an average increase of 8.2% in 2003-07. Low interest rates and a stable macroeconomic environment, prospective euro adoption in 2008, liberalisation in a number of sectors (e.g., energy and communications), and plans to upgrade physical infrastructure in

[3] This implies that the total number of tourist arrivals will reach 2.5 million by 2009 and total receipts from tourism will amount to some 11.6% of GDP, compared with 12.8% in 2005 and 17.6% in 2002.

various segments of the economy (including in transport and energy), will keep investment activity strong in the near to medium term.

In contrast, public consumption growth will remain moderate, as a result of the implementation of the MTBF which, inter alia, envisages stricter controls on public sector employment growth, as well as the containment of other current expenditures. More specifically, government final consumption is expected to increase at an annual rate of around 3.9% in real terms over the period 2008-11.

Exports of goods and services are forecast to rise by around 3.4% per annum in constant prices on the back of considerable tourist demand and improvements in the quality of the tourist product, which will boost revenues and profit margins. Exports of services, other than tourism, are expected to continue to perform well, expanding at an annual rate of some 5.5-6% in real terms over 2008–11.

From the sectoral viewpoint, the private tertiary sectors will continue to be the main engine of growth, given that the comparative advantages of Cyprus favour the development of these types of activities. The share of the services sector as a whole to GDP is anticipated to grow further and reach 79.6% in 2011, as compared with 78.4% in 2006, whereas the share of both the primary and secondary sectors would correspondingly decline from 3.1% and 18.5% in 2007 to 2.8% and 17.6% respectively in 2011. Within the services sector, continuing restructuring and diversification are expected, with an increased shift towards export-oriented private services in the areas of communications, financial intermediation, business services, private education and health. These will continue to benefit from the abolition of all restrictions on direct and portfolio investment, not only for EU residents but also for residents of third countries, implemented as from the last quarter of 2004, the conditions of enhanced competition in the utilities sectors, the opening up of new universities in Cyprus, and the utilisation of the comparative advantages of Cyprus.

Box 4. Risks to medium-term forecasts

Overall, the risks to the outlook seem to be fairly well balanced over the medium term.

On the downside, there are the risks of:
- Further escalation of, and unfavourable repercussions from, the sub-prime crisis in the US;
- Disorderly further depreciation of the dollar leading to a significant real effective appreciation of the euro;
- Increasing inflationary pressures arising from further increases in energy and food prices;
- Geopolitical tensions in the Middle East.

On the upside:
- The effects of fiscal and other structural reforms, and the positive impact from EU and euro-area membership, may be underestimated, implying a higher growth potential of the economy in the medium term.
- Underestimation of growth and import potential of important trading partners in Middle East, Asia and the CIS.

In the labour market the medium-term scenario envisages further employment gains, mainly resulting from increased participation of foreign workers, and a gradual increase in the participation rate of female Cypriots and old aged. With the gainfully employed population increasing by 1½% per annum, the unemployment rate will fall to 3.6% in 2011 from 4.2% in 2007. In general, labour market conditions are expected to remain tight, but the projected increase of foreign and Turkish Cypriot workers will help ameliorate shortages in various sectors, in particular in low skilled occupations.

Productivity growth is expected to accelerate to 2.2% per annum over the medium term, as a result of the strong investment undertaken in recent years, which will bring about greater utilisation of new technologies. Real earnings are forecast to rise in line with productivity growth, and real unit labour costs will increase by 2.4% over the same period.

The current account deficit is expected to narrow over the medium term to around 5.6% of GDP in 2011 from 6.6% in 2007. Gross domestic savings are forecast to decrease marginally from 16.5% of GDP in 2007 to 16.4% of GDP in 2011, with higher public savings contributing 1¾ % of GDP. Gross national investment will also marginally increase, mainly as a result of higher private sector investment as a share of GDP. The upward revision for the medium-term current account deficit compared to previous forecasts reflects primarily the assumption for higher oil prices, which has a bearing on the level of imports of fuels and lubricants, as well as an expectation for further widening of the income balance as a result of improvements in profitability of foreign firms and an equivalent further increase of the inward FDI, which are expected to continue to finance, to a large extent, the current account deficit, thereby allowing official foreign exchange reserves to remain at very comfortable levels.

Despite these underlying factors affecting the size of the current account, the large nominal appreciation of the euro-linked Cyprus pound has led to a loss of external price and cost competitiveness. As a result export shares in tourism and goods markets have fallen, while import penetration has increased considerably. Overall, the effective appreciation of the Cyprus pound has induced the restructuring of the economy in favour of less labour intensive activities, where Cyprus has a comparative advantage. Indeed, this process has brought about diversification of the economy through expansion of alternative businesses within the services sector (e.g., tourism, banking, other financial services, real estate services etc), rather than across more traditional sectors.

3. GENERAL GOVERNMENT BALANCE AND DEBT 2007-2011

Policy Strategy

The Government's main policy objective is to support economic stability and ensure sustainable public finances in a medium- and long-term perspective, in the spirit of the revised Stability and Growth Pact. The robustness of public finances will contribute to addressing implicit liabilities related to increasing expenditures, in light of population ageing. A sustainable fiscal policy requires, among other things, a marked reduction in public debt in the forthcoming years of the programme period, before public expenditure associated with the ageing of the population sets in.

Taking into account the turnaround in public finances and the improved prospects, the country specific Medium-Term Objective (MTO) has been revised and set at a more ambitious level, namely, a balanced budget.

The MTO target set will allow scope for the automatic stabilizers to play, thus helping to dampen cyclical fluctuations. The target requires prudent fiscal policies when cyclical conditions are favourable and unemployment low, and provides fiscal room for manoeuvre, in case of severe downturns with evident imbalances.

Fiscal policy will continue to rely on the following three pronged strategy:

- Containment of expenditure growth below nominal GDP growth.
- Enhancement of the effectiveness of the revenue collecting departments.
- Improvement of the quality of public finances.

The MTBF, currently being put in place will ensure the containment of government expenditure growth below nominal GDP growth.

The improvement in the quality of public finances will contribute to the fiscal consolidation process and play an important role in creating a growth-enhancing environment in the medium- term, while supporting structural reforms, in line with the Lisbon Agenda and national objectives.

In the same context, the further, steady, reduction of public debt as a percentage of GDP to significantly below the reference value is important for fiscal consolidation and the long-term sustainability of public finances.

With Cyprus' accession to the euro area and the related loss, from a national perspective, of monetary and exchange rate policy instruments, the application of sound policies, especially in the area of public finances and incomes policies, becomes even more important. The responsibility of Cyprus as a euro area member state is to make the right strategic choices and take advantage of the merits of monetary union. The impressive results in the area of public finances should be locked-in and the focus be on achieving progress with the planned institutional and structural reforms.

Medium-Term Objective

The general government nominal budget balance exhibited a marked turnaround in 2007 and is currently estimated to record a surplus of around 1.5% of GDP, compared with a deficit of 1.2% in 2006. The turnaround is attributed to both permanent and temporary factors, including the high levels of corporate profits especially of the financial institutions and the real estate boom that can be assessed as being, to a large extent, of a temporary nature. The turnaround is projected to ease-off over the programming period, with the nominal budget balance gradually moving to a slight surplus nominal position.

As already pointed out, the country-specific MTO, that is, the structural budget position has been revised, to a balanced budget. The final outturn for 2006 indicates that the country-specific MTO, set in the last Convergence Programme, has been achieved in the said year, following a structural improvement of the order of 2.1 percentage points of GDP, with the structural deficit falling to 0.3% in 2006 compared with 2.4% the year before. The structural position in 2007, excluding all factors that are considered to be of temporary nature, continues to improve and is currently estimated that it will exhibit a surplus of the order of 0.7% of GDP.

In line with the spirit of the revised Stability and Growth Pact, windfall unexpected revenues were used, to a great extent, for deficit and debt reduction, while at the same time pro-cyclical fiscal policies were avoided.

As the output gap slowly closes, during the remainder of the programming period, and eliminated by 2011, the structural position is projected to gradually improve at the beginning reaching a surplus of 0.9% of GDP in 2008 and exhibit a marginal decline over the programming period, falling to a surplus of 0.8% of GDP during 2009-10 and subsequently marginally declining to a surplus of 0.7% by the end of the programming period. The projected trend of the structural balance is significantly affected by the gradual deterioration in the balance of the Social Security Funds, due to the gradual impact of population ageing.

The revised MTO though, set in the Stability Programme 2007-2011, is projected to be respected throughout the programming period.

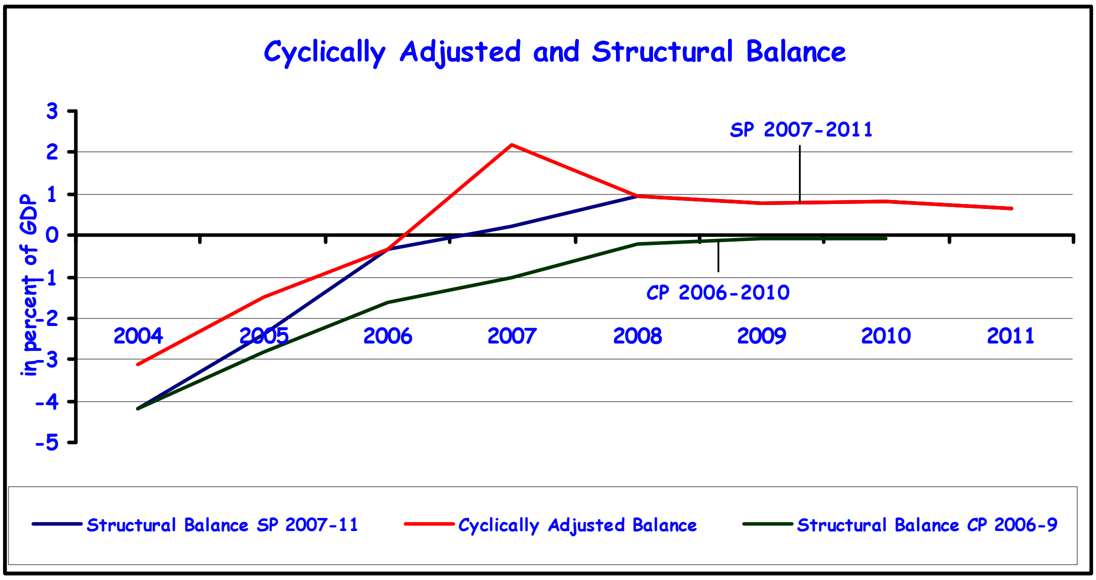
Table III: Components of Fiscal Adjustment and the Medium-term Objective

in percentage points of GDP	2005	2006	2007	2008	2009	2010	2011	Total Adjustment 2008-2011
Expenditure developments	*0.8*	*0.2*	*0.6*	*-0.6*	*0.2*	*0.0*	*0.1*	*-0.3*
Revenue developments	*2.4*	*1.4*	*3.3*	*-1.6*	*0.2*	*0.1*	*0.1*	*-1.2*
General Government Balance	**-2.4**	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**	**0.2**
Cyclically Budgetary Component	*-0.9*	*-0.8*	*-0.6*	*-0.4*	*-0.3*	*-0.1*	*0.0*	
Cyclically Adjusted Balance	**-1.5**	**-0.3**	**2.2**	**0.9**	**0.8**	**0.8**	**0.7**	**-0.2**
One-off revenue measures	0.9	-	*1.5*	-	-	-	-	
Cyclically Adjusted Structural Balance	**-2.4**	**-0.3**	**0.7**	**0.9**	**0.8**	**0.8**	**0.7**	**-0.2**

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

Expenditure developments over the programming period 2008-2011 are projected to impact positively on the budget balance as they are anticipated to decline as a percentage to GDP by 0.3 percentage points. This development is projected to be the result of the decline in interest expenditure and compensation of employees by about 1.0 and 0.2 percentage points of GDP, respectively, amid rising pension expenditures due to population ageing and the wearing off of the gradual increase of the retirement age to 63 years of age in the public sector that was introduced in 2005.

The extremely large rise in government revenues in 2007, especially the unexpectedly high receipts brought by the boom in the real estate, can be ascribed largely to temporary factors. Consequently, revenue developments are projected to return to historical levels and impact negatively on the nominal budget balance, as they are forecast to decline by approximately 1.6 percentage points of GDP in the first year of the programming period.



Actual Balances in 2007

The considerable improvement in government finances of 2006 continued throughout 2007. During the first nine months of the year, the general government balance was in surplus, reaching 3.4% of GDP. For the year as a whole, it is estimated that the budget balance will recede to a surplus of 1.5% of GDP, from a deficit of 1.2% in 2006 and 2.4% in 2005. On account of a primary surplus for a second consecutive year and the use of accumulated financial assets to repay maturing debt, general government gross debt is estimated to decline to 60.0% of GDP, compared to 65.2% in 2006.

The improvement of fiscal performance in 2007 is primarily based on revenues, as they are forecast to rise to 45.9% of GDP, compared with 42.6% the year before. Concurrently, taking advantage of good revenue performance, expenditure as a percentage to GDP is anticipated to rise by around ½ of a percentage point to 44.4%, owing to the accelerated expropriation of land for development projects in conjunction with the advanced implementation of the Agricultural Development Scheme 2004-06, that is co-financed through the EU Budget.

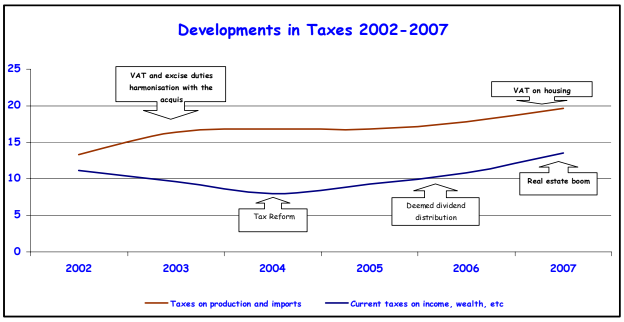
Table IV: General Government Consolidated Accounts

in percent of GDP	2006	2007 est.	2008 proj.	2009 proj.	2010 proj.	2011 proj.
Current Revenue	42.6	45.9	44.3	44.5	44.6	44.7
Current Expenditure	40.8	41.4	40.8	41.1	41.1	41.2
Interest Payments	*3.3*	*3.2*	*2.9*	*2.4*	*2.3*	*2.2*
Current Balance	1.8	4.5	3.5	3.4	3.5	3.5
Capital Expenditure	3.0	3.0	3.0	2.9	2.9	2.9
General Government Net Borrowing	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**
Primary Balance	2.1	4.7	3.4	2.9	2.9	2.8
Government Gross Debt	**65.2**	**60.0**	**48.5**	**45.3**	**43.8**	**40.5**

The improved performance on the revenue side is, mainly, attributed to a further improvement of the performance of the tax collecting departments, a composition of growth favourable to generating high tax revenue, as well as to the real estate and the financial sector boom. In particular, the continued surge in construction and real estate activity contributed significantly to higher tax receipts (3% of GDP). Furthermore, the increased profitability of the corporate sector, primarily of financial corporations, led to a much higher profit-based taxes (1% of GDP) (see Box 5 for details).

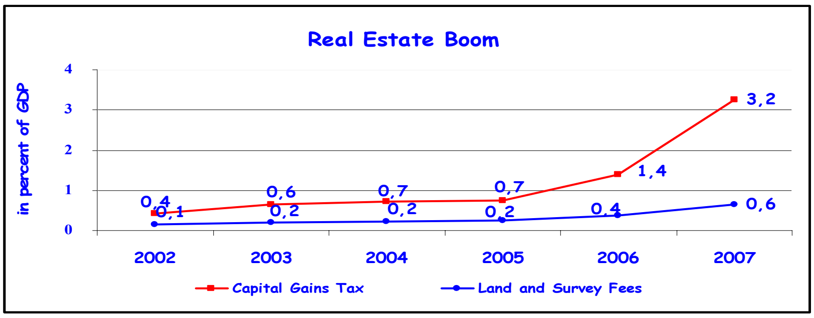
Box 5: Revenue Developments: How temporary are they?

Government revenues during 2007 exhibited an exceptional performance. Within a year total government revenues are estimated to have increased, as a percentage to GDP, by 3.3 percentage points compared to the preceding year. This development reflects the acceleration in the rates of growth of both taxes on production and imports as well as current taxes on income and wealth.



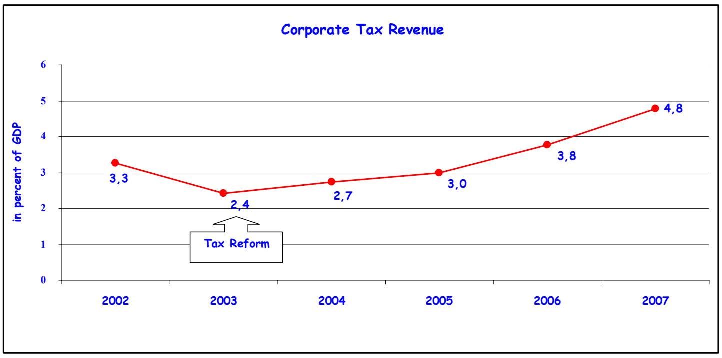
Taxes on production and imports have been exhibiting a steady increase, as a percentage to GDP, since 2002, estimated to reach 19.6% of GDP in 2007 compared with 13.3% in 2002. The considerable increase in taxes on production and imports, as a percentage to GDP, is mainly attributed to the gradual application over a two year period (2002-2004) of the minimum excise duty rates prescribed by the acquis on petroleum products, tobacco and alcohol. Similarly, the minimum VAT rate and the widening of the VAT base, as prescribed by the acquis, was gradually introduced over the said two-year period, raising the rate from 8% in 2002 to 15% in late 2003. Furthermore, the VAT rate on hotel and restaurant services was increased from 5% to 8%, as from the beginning of 2006. The effects of harmonization of the VAT base continue to affect the revenue growth of this category. The widening of the tax base brought by the application of a 15% VAT rate, as from 1.5.2004, on the sale of premises built with a permit issued post EU accession exhibit an impact in 2007. This is due to the fact that buildings generally require two years to be completed and then sold. Henceforth, the growth of taxes on production and imports can be considered as structural.

The trend exhibited by current taxes on income and wealth, as a percentage to GDP, is somewhat different from that above as, at the beginning of the period under review, they exhibited a decline, falling by approximately 3.6 percentage points of GDP to 7.5% in 2004. This development was the result of the major tax reform introduced in 2002, whereby corporate and income tax rates were slashed. The trend was reversed, as from 2005 onwards, and current taxes on income and wealth exhibit a steady increase estimated to reach 13.5% of GDP in 2007. The reversal in the trend is, firstly, attributed to the impact of the application of a deemed dividend distribution, a 15% tax on 70% of profits not distributed within two years, which was introduced in 2002, in the context of the major tax reform. Thus, the impact on revenues was witnessed for the first time in 2006. The subsequent improvement in revenues of this category is attributed to an improved profitability of the corporate sector, in conjunction with increased revenues brought by the boom in the real estate. Capital gain taxes and land and survey fees that form part of current taxes on income and wealth have grown at exponential rates and are estimated to reach 3.2% and 0.6% of GDP in 2007 compared with 1.4% and 0.4% the year before. Although, both capital gain taxes and land and survey fees are calculated by applying a percentage on the profit made from sale of and on the total value of



the asset transacted, respectively, and although it can be argued that a part of the increase of revenues was brought by the re-pricing of the assets is structural, we consider that most of the total increase of revenues amounting to 1.5% of GDP between 2007 and 2006 is of temporary nature.

Similarly to current taxes on income and wealth, corporate tax revenues as a percentage to GDP exhibited a decline in 2003 following the major tax reform that reduced corporate tax revenues considerably introducing a common rate for both domestic and international companies. Consequently, corporate tax revenues as a percentage to GDP fell to 2.4% in 2003 compared with 3.3% the year before. Subsequently, the trend exhibited was reversed and corporate tax revenues showed a steady growth estimated to reach 4.8% of GDP in 2007 up from 3.8% in 2006. The performance of corporate tax revenues is solely attributed to the improved profitability of the corporate sector, in conjunction with the substantial increase of the number of companies that are established in Cyprus taking advantage of the favourable corporate tax regime and an array of double tax treaties. Indicatively, the profits of two of the major financial corporations exhibited a substantial increase during the last two years. Namely the profits of the Bank of Cyprus are estimated to exhibit an increase of the order of 68% in 2007 compared with the year before following an increase of the order of 148% in 2006 compared with 2005. Similarly, the profits of Marfin Popular Bank are estimated to increase at a rate of 300% in 2007 following an increase of 73% the year before. These increased revenues are considered to be of structural nature.



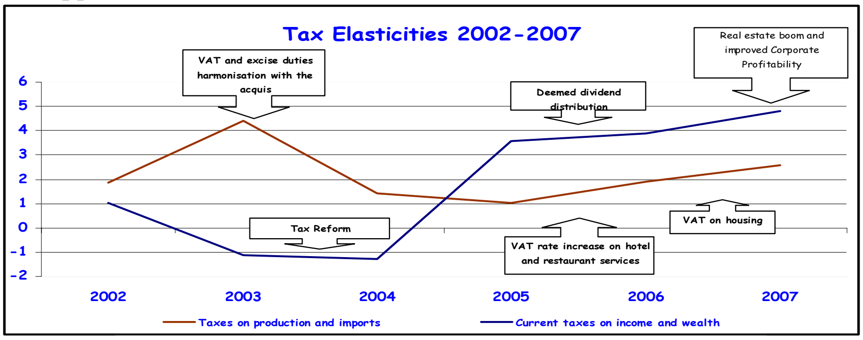
The elasticities calculated according to the growth performance of taxes on production and imports and current taxes on income and wealth over the period 2002-2007 have also been affected by the factors mentioned above, namely the tax reform introduced in 2002[4], which included, among other things, the raising of the excise duty and VAT rates, the widening of the VAT base and the decrease of corporate and individual income tax rates.

During the period under review, elasticities of taxes on income and wealth exhibited a drop from around 1.0 in 2002 to -1.1 and -1.3 in the subsequent two years. The considerable drop in elasticities, as already mentioned, is mainly attributed to the reduction of corporate and individual income tax rates, in the wake of a major tax reform. During 2005 and 2006 elasticities re-bounded to 3.6 and 3.9, respectively. The turnaround is mainly attributed to the revenues derived from the application of a deemed dividend distribution on undistributed profits in 2006. In 2007, the elasticity of taxes on income and wealth is estimated to rise to 4.8 due to the effects of a real estate boom and an improved profitability of the corporate sector.

The taxes on production and import elasticities at the beginning of the period under review exhibited a rise from an elasticity of 1.9 in 2002 to 4.4 in 2003 attributed to the gradual increase of the VAT base and rate from 8% to 15% and the increases in the excise duty rates on petroleum products, tobacco and alcohol. During 2004 and 2005 the elasticity of taxes on production and imports scaled back to historical levels falling to 1.4 and 1.0, respectively. This development is attributed to the application of the Common Customs Tariff that led to a

[4] A detailed analysis of the tax reform of 2002 can be found in Annex II of the Convergence Programme 2004-2008 submitted in May 2004.

decrease in the level of import duties collected and to the reform of the excise duty regime on motor vehicles. In 2006, the elasticity re-bounded reaching a level of 1.9, slightly above historical levels and is then estimated to reach 2.6 in 2007. The increased elasticity of taxes on production and imports in the last two years is, mainly, attributed to the increase in the VAT rate applied on hotels and restaurant services from 5% to 8% as from 1.1.2006 and the impact



from the application of a 15% VAT rate on building premises that was introduced upon accession to the E.U. The latter covered building premises erected with a building license issued post EU accession, thus having an impact in revenues as from 2007 onwards as building premises usually take two years to be completed in Cyprus. As far as, the programming period is concerned, the elasticities of taxes on production and imports and current taxes on income and wealth are forecast to fall to 0.4 and 0.6, respectively, in the first year of the programme and then return back to historical levels of 1.0 and 1.2, respectively.

In conclusion, part of the rise in government revenue associated with the real estate boom is considered exceptional and is not anticipated to continue in 2008, due to:

- Base effects.
- Tightening of financial conditions.
- Large rise in the burden of household indebtedness.
- Advanced purchases in 2007 in anticipation of the application of VAT rate of 15% on building land in 2008.

Overall, during the year total revenue is expected to increase by 15.3% reaching 45.9% percent of GDP compared with 42.6% the year before.

More analytically, total taxes are estimated to increase at a rate of 23.8%, increasing significantly their share to 33.2% of GDP as compared with 28.6% in 2006.

Taxes on production and imports are anticipated to reach 19.6% of GDP up from 17.8% in the previous year, exhibiting an increase of the order of 18%. The increased share to GDP is attributed, apart from improved effectiveness of the tax authorities, to buoyant consumption and import growth as well as to the gradual impact from the application of a 15% VAT rate on the sale of new buildings, constructed with building permits issued post EU accession.

Furthermore, the excise duty receipts were affected by the reform of the taxation on motor vehicles introduced in late 2006[5], which basically reduced the tax burden levied on them, and has led to a surge in demand for motor vehicles, having a positive impact on public finances. The effects of the tax reform on motor vehicles are expected to dissipate during the course of 2008.

The surge in the demand for real estate has led to a significant re-pricing of the value of the assets contributing to an accelerated rate of growth of land and survey fees for the second consecutive year. The land and survey fees, which basically include transfer and mortgage fees and are calculated as a percentage of the price of the asset transacted, are estimated to have increased to 2.4% of GDP in 2007 compared with 1.6% the year before.

Taxes on income and wealth are anticipated to increase to 13.5% of GDP compared with 10.9% in 2006, exhibiting an annual increase of 33.4%. This increased share as a percentage of GDP by 2.6 percentage points is attributed to the buoyant growth of revenues derived from the taxation of profits from the sale of immovable property, as a result of a booming real estate sector, partly brought by the anticipated application of a 15% VAT rate on building land and easing financing conditions, as well as to the increased profitability of the corporate sector. More specifically, capital gain taxes in 2007 are estimated to have risen as a percentage to GDP to 3.2% compared to 1.4% in 2006; similarly corporate income tax receipts are estimated to have risen to 4.8% of GDP in comparison with 3.8% the year before.

In October 2007, the Government introduced a minor tax reform, which mainly included the raising of the tax-free income for individuals and aligning the tax brackets, retroactively, as from 1.1.2007, the application of the reduced VAT rate on specific goods and services and the reduction of the excise duty levied on heating oil by €0.08 cent per litre to €0.21 cent per litre. The total impact on public finances on a full year basis is estimated at 0.5% of GDP.

Property income is estimated to exhibit a decline contracting to 0.7% of GDP in 2007 compared with 1.2% in 2006, exhibiting a decrease of the order of 36%. The contraction in property income is attributed to a substantial reduction of dividend income from semi-governmental organisations.

[5] The legislation was enacted into Law on the 7th of November, 2006.

The revenue performance of 2007 was hampered by the termination of the temporary annual transfers from the EU Budget provided for in the Treaty of Accession. Its net impact is estimated to have reached 1% of GDP, compared with a forecast of 0.4% the year before.

Total public expenditure is expected to increase at a rate of 8.4% in 2007 reaching 44.4% percent of GDP compared with 43.8% the year before. The increase in total expenditure in 2007 can be attributed, mainly, to higher than targeted social transfers, as well as, expenditures brought forward[6] originally planned for 2008.

The social payments are expected to increase to 13.1% of GDP compared with 12.4% the year before, due to the increased emphasis on social cohesion, in line with the objectives of the National Reform Programme. Specifically, social security payments and pensions and gratuities of the public sector are estimated to rise as a percentage to GDP to 6.4% and 2.4%, respectively, exhibiting growth rates of 11% and 16%, respectively. The former's growth is affected by population ageing, while the latter's affected by the impact of the gradual extension of the retirement age in the public sector to 63 years of age.

A survey of the Statistical Service indicated that vulnerable groups are mostly households, with at least one pensioner and single parent families. More specifically the survey indicated that 70% of households with one pensioner over 65 years of age, 47% of households with two pensioners over 65 years of age and 35% of single parent families live close to or below the poverty line. In light of this and in line with the objectives of the National Reform Programme under the Lisbon Strategy, the Government has introduced a specific set of targeted measures directed towards these groups. The measures basically included the raising of these groups monthly income and the allowances provided for people who are on welfare, and are estimated to have an annual impact of 0.2 percent points of GDP.

The higher rate of increase of social expenditures was offset, to some extent, by a decelerated growth of compensation of employees and intermediate consumption expenditure estimated to increase at a rate of 4.7%, decreasing as a percentage of GDP to 20.1% as compared to 20.5% in 2006. This decelerated growth is attributed on the one hand to the assignment of the administration of the two airports to a private corporation, a one-off factor, and on the other to lower outlays for security.

Interest expenditure is anticipated to be contained to 3.2% of GDP, lower by 0.1 percent of GDP, compared with last year.

Gross fixed capital formation is anticipated to stabilise at around 3% of GDP in 2007.

[6] The expenditures brought forward refer to land expropriations for development projects and the financing of the Agricultural Development Scheme of 2004-2006 estimated at 0.6% of GDP.

Features of the Forthcoming Budget

The forthcoming budget for 2008, which was approved by the Council of Ministers on the 6th of September 2007, is based on cautious estimates of revenue, which do not assume a continuation of the extraordinary growth rates observed in 2007. The Budget for 2008 is based on the successful strategy implemented during 2004-2006. The compilation of the forthcoming Budget was predicated on the linkage of medium-term fiscal targets. The main characteristics of the forthcoming budget are the application of expenditure ceilings on current and capital expenditures in conjunction with the reallocation of government expenditures towards growth-enhancing activities and other policy priorities, established in the National Reform Programme for Cyprus.

Total revenues are forecast to rise by 3.2%, and thus to contract as a percentage to GDP to 44.3% compared with 45.9% the year before. The decline is mainly attributed to a forecast deceleration in the rate of growth of tax revenues brought by a slackening in the rate of growth of land and survey fees and capital gain taxes, having an impact of the order of 1½% of GDP.

Additional factors that also impact negatively on the developments of revenue forecast for 2008, that have been taken into account, are the increase of tax-free income for individuals and the alignment of tax brackets projected to have a negative impact of 0.05% of GDP, the reduction in the excise duty levied on heating oil, projected to have a negative impact of 0.05% of GDP and the application of the reduced VAT rate of 5% on specific goods and services such as products of bakeries and confectioneries and entrance fees to cultural and sport events, projected to also have a negative impact of 0.05% of GDP.

Furthermore, it was forecast that dividend income from semi-governmental organisations will be zero in 2008, having a negative impact on property income of the order of 0.05 percentage points of GDP. Similarly, the decumulation of sinking fund deposits and the anticipation that Central Bank profits will be lower are estimated to negatively affect government revenues as interest and dividends earned will be reduced. These are estimated to have an impact of the order of 0.2 percentage points of GDP.

It is noted that, the increases of the excise duties on petroleum products, the application of a reduced VAT rate on foodstuffs and pharmaceuticals and the application of the minimum VAT rate on restaurant services and building land, originally envisaged to be introduced in the course of 2008 due to the expiration of the derogations granted upon EU accession, have not been taken into account in the estimation of revenue forecast for 2008.

Total government expenditure is projected to increase by 5.6%, below nominal GDP growth, and declining to 43.8% of GDP compared to 44.4% the year before. This decline is mainly attributed to a fall, as a percentage to GDP in social payments related to the gradual extension of the retirement age in the public sector to 63 years of age. These are projected to decline to 12.8% of GDP compared with 13.1% the year before.

Similarly to the above, interest expenses are projected to exhibit a further decline, falling to 2.9% of GDP compared with 3.2% in 2007. This fall results from a declining stock of debt brought by primary surpluses, the running down of sinking fund deposits and comparatively lower interest rates reflecting, inter alia, entry to the euro area.

The general government surplus is projected to decline during the course of 2008, and is forecast to fall to 0.5% of GDP compared with an estimated surplus of 1.5% in 2007. The projected budgetary position compares favourably with the revised country-specific MTO, which has been set at a balanced budget, thus providing a sufficient safety margin against the risk of breaching the 3% of GDP reference value as the minimum benchmark for Cyprus is currently estimated at a deficit of 1.8% of GDP.

The measures included in the Stability Programme reveal a high degree of continuity with the measures incorporated in the last Convergence Programme; Box 6 lists the main changes to fiscal projections compared to last year.

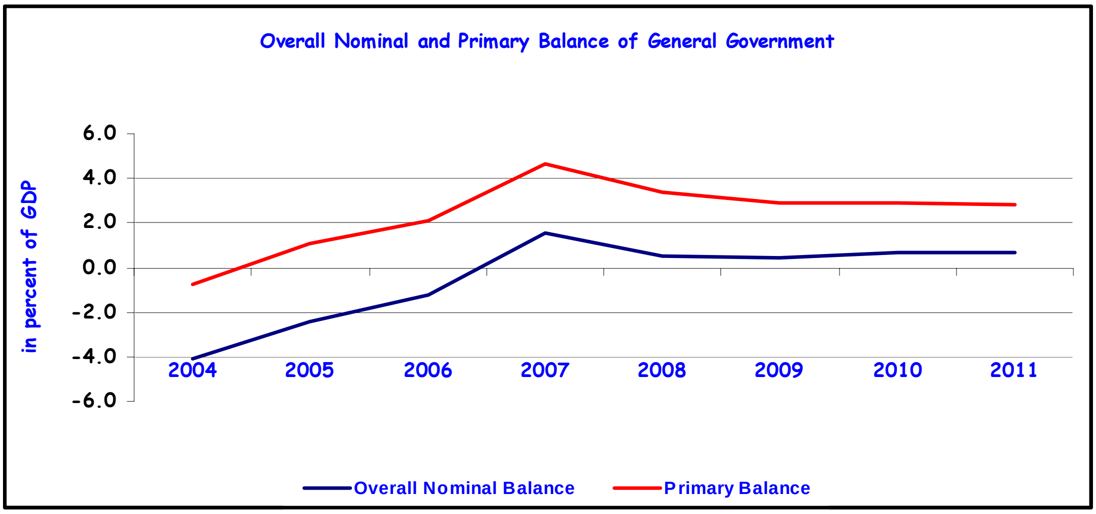
Box 6: Main Changes to Fiscal Projections

The main parameters of the Stability Programme that have a significant impact on the prospects of public finances are:

- The turnaround in public finances estimated for 2007, and their base effects.
- Deceleration in the rate of growth of revenue from capital gain taxes and land and survey fees.
- Increase of tax-free income and alignment of tax brackets for individuals, retroactively, as from 1.1.2007.
- The excise duty tax rates on motor vehicles and heating oil have been reduced in 2006 and 2007, respectively. The projected fiscal impact is expected to materialise fully in 2008.
- Application of the reduced VAT rate on specific goods and services as from 2007. The projected fiscal impact is expected to materialise fully in 2008.
- The carry over effect of 2007 also led to an accelerated decrease of public debt-to-GDP ratio having an impact on the profile of interest payments.

The Government is committed to further adhere to the provisions of the revised Stability and Growth Pact and implement the policies necessary for the successful participation in the Economic and Monetary Union. The objective is to maintain sound public finances and address the issue of long-term fiscal sustainability. The achievement of the country-specific medium-term objective in 2006 and the estimated surplus for 2007 enables the maintenance of a small surpluses through-out the programming period and the sustaining of high primary surpluses. Achieving these will ensure that the debt-to-GDP ratio continues its distinct downward path, leading to a rapid decline of the debt to 40.5% of GDP by the end of 2011.

It is acknowledged, that strict implementation is required, in particular on the expenditure side, with a view to achieving the fiscal targets and enable a re-allocation of expenditures, in favour of Lisbon-related priorities and targeted social spending. Indeed, the substantial improvement of the fiscal balance creates the necessary room to support the Lisbon objectives, including the upgrading of targeted social measures, while safeguarding in parallel, the respect of the country specific MTO, in a comfortable manner.



Structural Balance and Fiscal Stance

Despite the faster rates of growth recorded, following the economic slowdown in 2002-03, the economy continues to operate below full capacity, especially in the manufacturing and tourism sectors. To provide a clear picture of the underlying fiscal position, the following analysis takes into account the cyclical position of the economy relative to its full capacity, or potential level, and distinguishes between permanent and one-off measures, which have been introduced, or are planned.

One-off measures

The improvement in the fiscal position of Cyprus economy in nominal terms during 2006 occurred despite the absence of any one-off measures, in contrast to the situation in 2002-2005[7], where one-off operations played a role. During 2007, the bulk of the extraordinary revenue brought by the extraordinary boom in the real estate sector is considered as temporary and is treated as a one-off revenue measure. This one-off measure is estimated to amount to 1.5 percent of GDP in 2007.

The Stability Programme for the remainder of the programming period does not include any temporary or one-off measures. Budgetary projections are based on the current macroeconomic scenario, with tax elasticities assumed to scale back to historical levels.

[7] One-off revenue measures as a percentage to GDP amounted to 0.3%, 1.7%, 1.1% and 0.9% for 2002, 2003, 2004 and 2005, respectively.

Table V: Cyclical Developments and one-off measures

as a percent of GDP	2006	2007 est.	2008 proj.	2009 proj.	2010 proj.	2011 proj.
GDP growth at constant prices	3.8	4.2	4.1	4.0	4.0	4.0
Net Borrowing of General Government	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**
Net Interest payments	3.3	3.2	2.9	2.4	2.2	2.2
Potential GDP growth, % change	3.7	3.7	3.7	3.7	3.7	3.7
GDP output gap[8]	-2.0	-1.5	-1.0	-0.7	-0.3	0.0
Cyclical budgetary component	-0.8	-0.6	-0.4	-0.3	-0.1	0.0
Cyclically-adjusted balance	**-0.3**	**2.2**	**0.9**	**0.8**	**0.8**	**0.7**
Cyclically-adjusted primary balance	3.0	5.4	3.8	3.2	3.0	2.9
One-off revenue measures	-	1.5	-	-	-	-
Cyclically-adjusted balance net of one-off and other temporary measures	**-0.3**	**0.7**	**0.9**	**0.8**	**0.8**	**0.7**
Structural Improvement	2.1	1.0	0.2	-0.1	0.0	-0.1
Cyclically-adjusted primary balance net of one-off and other temporary measures	3.0	3.9	3.8	3.2	3.0	2.9

The cyclically-adjusted balance and structural balance

Taking into account that, the estimates of actual budget balances are imperfect indicators for assessing public finances, indicators of cyclically adjusted budget balances have been incorporated in the compilation of the Stability Programme 2007-2011, in order to take into account cyclical variations. The cyclically adjusted budget balance is projected to be turned around from a deficit of 0.3% of GDP in 2006 to a surplus of 2.2% in 2007, and is expected to decline to 0.9% of GDP in 2008 and remain approximately at that level during 2009-2011 (Table V), implying that the fiscal stance is broadly neutral over the programming period 2008-2011.

A similar picture is also presented for the cyclically-adjusted balance net of one-off measures (Table V). The cyclically-adjusted balance net of one-off measures, as a percent of GDP, was reduced markedly by 2 percentage points in 2006, compared to the previous year, and by 1 percentage points in 2007 resulting in an estimated structural surplus, net of one-off measures of, around 0.7% of GDP in 2007. The structural adjustment effort is neutral over the period 2008-2011 as the cyclically adjusted balance, net of one-off measures, is forecast to stabilise at a surplus of around 0.8% of GDP.

[8] In percent of potential GDP.

Debt Management

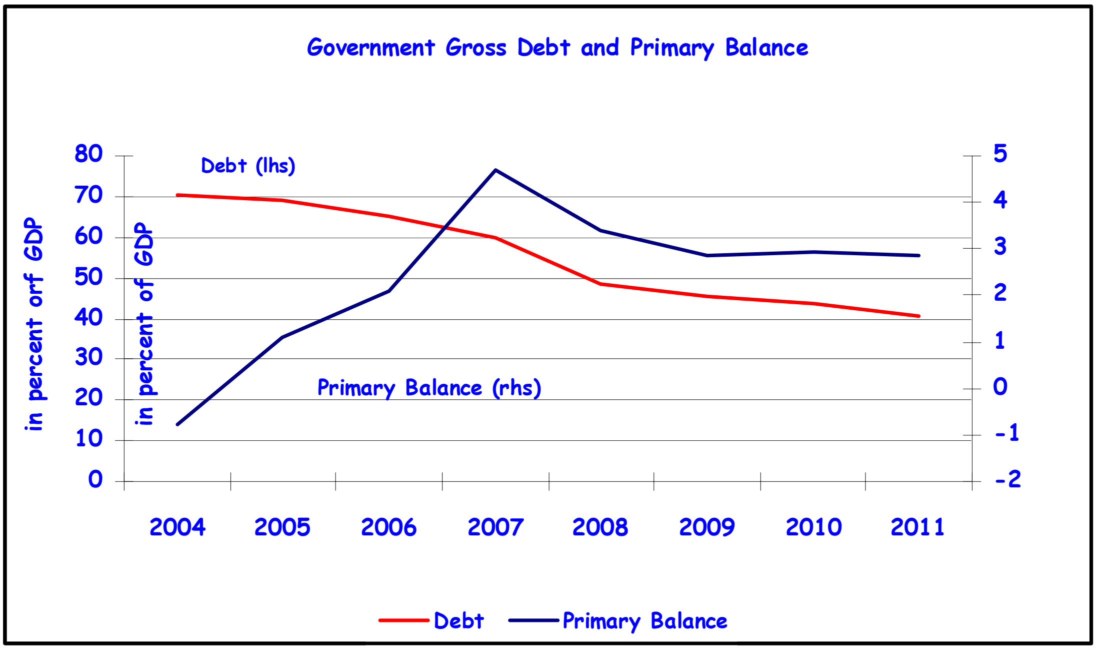
Debt Levels and Developments

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 set relatively less ambitious MTOs.

In the case of Cyprus, the level of government debt is expected to fall to 60% of GDP in 2007 compared to 65.2% in 2006 exhibiting a decrease of about 5 percentage points of GDP. The debt-to-GDP ratio in 2008 is projected to continue its downward path and fall to 48.5% of GDP exhibiting a further decrease of 11.5 percentage points of GDP. The considerable decrease of debt-to-GDP ratio is attributed to the achievement of high primary surpluses and the running down of financial assets, including sinking fund deposits.



A large share of public debt, estimated at 5.6% of GDP at the end of 2007, corresponds to debt issued for the accumulation of assets of the sinking fund, which as already mentioned, is steadily being run-down and anticipated to be largely eliminated in 2008 (with the exception of some small amounts of 10 and 15-year bonds which will expire by 2018).

The distinct downward path of debt-to-GDP ratio is projected to continue through-out the programming period and decline to 40.5% by 2011, due to the achievement of high primary surpluses.

The primary balance is estimated to continue to be in surplus and reach 4.7% of GDP in 2007, but decline over the programming period falling to around 2.8% of GDP by 2011.

Stock-Flow Adjustment

The factor contributing to changes in government debt, other than government deficits/surpluses, is the Stock-Flow Adjustment (SFA). The main operations refer to the accumulation of financial assets. The accumulation of government deposits, equivalent to 0.5 and 4.4[9] percent of GDP in 2006 and 2007, respectively, reflect a tendency to over-finance the government borrowing requirements, as well as better-than expected budgetary outcomes.

The magnitude of the SFA exhibits a rapid decrease and is anticipated to turn positive in 2007 reaching 0.8% of GDP following a negative SFA of the order of 2% of GDP in 2006. The positive SFA of 2007 is a result of the exceptional budgetary outcome of the year that led to an accumulation of financial assets held at the Central Bank of Cyprus, since government debt can not be redeemed prematurely. The SFA is projected to turn again negative in 2008 reaching 6.6% of GDP contributing to the substantial reduction of government debt in the said year; this includes privatisation proceeds from the sale of the Cyprus Development Bank amounting to 0.3% of GDP. The contributions of SFA are projected to turn positive during 2009-2011 reaching 0.6% of GDP in 2009 and 2% in 2010 and subsequently falling back to 0.2% by 2011. The debt-to-GDP ratio is projected to stay on a distinct downward path throughout the programming period at a satisfactory pace.

Table VI below presents the gross debt level and the contribution to change in gross debt for the period of 2006-2007, and projections covering the period 2008-2011.

[9] The figure corresponds to the government deposits at the end of September 2007.

Table VI: General Government – Debt Developments

as a percent of GDP	2006	2007 est.	2008 proj.	2009 proj.	2010 proj.	2011 proj.
Gross Debt Level	65.2	60.0	48.5	45.3	43.8	40.5
Change in Gross Debt	-3.9	-5.2	-11.5	-3.1	-1.6	-3.2
Contributions to Change in Gross Debt						
Primary Balance	2.1	4.7	3.4	2.9	2.9	2.8
Interest Payments	3.3	3.2	2.9	2.4	2.3	2.2
Nominal GDP Growth	6.4	7.0	7.0	6.4	6.3	6.3
Stock-flow adjustment	-2.0	0.8	-6.6	0.6	2.0	0.2
Net Financial debt	58.5	52.3	47.4	43.7	40.1	36.6
Implicit interest rate	4.8	4.9	4.8	4.9	5.0	5.0

Debt Management

During 2007 the interest rate spread between euro area and Cyprus narrowed further as the ECB continued to raise interest rates during the first half of the year. Yields on government bonds declined due to diminished issuance of government paper during the year, reflecting the government's solid financial position, and waning appetite for Cyprus government bonds from foreign investors.

The structure of debt has continued to improve, following a similar trend observed in recent years. The share of short-term debt has been further reduced during 2007, falling to approximately 2% compared with 5.7% the year before, which will ameliorate substantially the servicing costs in 2008. During the programming period the Government will continue adhering to its goal of keeping short term debt at very low levels. In addition, the share of external debt was kept broadly stable at around 23%.

With the introduction of the euro on January 1, 2008 debt management practises will need to be reviewed. The possibility of issuing debt in euros across the vast euro-based money market will undoubtedly bring about important cost savings, provided that debt management strategies are carefully formulated, taking into account of all risk parameters and expected returns across different markets. A more sophisticated debt management model must be introduced which will address all relevant issues.

Work is still underway for implementing the necessary changes in the domestic bond market, in order to improve the market structure and improve the efficiency of the government bond market. The decision has been taken for the introduction of a primary dealers system and work is underway for the implementation of such a system.

The short-term objectives of the current debt management strategy are the following:

- Set up a Primary Dealers System (PDS) for the Government bond market, with the use of an electronic trading platform.

- Continue improving the flow of information between the responsible government departments and the Central Bank, in order to achieve the smooth financing of the Governments' borrowing requirements. The government is in the process of setting up formal arrangements aimed to achieve this goal.
- Put in place procedures and tools that will help in tackling unforeseen contingencies. The options available to the Government are now under consideration.
- Continue monitoring the maturity of outstanding government debt, so as to maintain a well structured maturity schedule and improve the terms of borrowing.

The medium to long-term objective is to reform the present debt management system so as to be able to adapt to changing market conditions, including the introduction of the euro. In order to proceed with these reforms a number of priorities have been identified, and include:

- Creating and maintaining channels of communication with other market participants and interested parties, especially foreign investors and institutions.
- Increasing the technical competence of staff in the area of debt management.
- Improving the debt management and risk management arrangements.
- Improving decision-making mechanisms in order to better respond to the changing market conditions.

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 marginal deficit of 0.1% of GDP as a substantial part of their operations and investment programmes are financed by transfers from the central government (Table VII).

The Central Government balance continued to be in deficit in 2006, amounting to 3.7% of GDP in 2006. In contrast to the above, the Social Security Funds, which is based on a pay-as-you-go principle, has recorded surpluses[10] reaching 2.6% of GDP in 2006, thus reducing the overall general government deficit[11] to 1.2% in 2006.

During 2007, it is estimated that the Central Government balance will improve considerably as the deficit will contract to 0.7% of GDP. The smaller deficit of the Central Government and the estimated surplus of the Social Security Funds of 2.3% of GDP will bring the surplus of the General Government to 1.5% of GDP.

The sizeable surplus of the Social Security Funds is attributed to the fact that the system has not fully matured yet, as well as to the still favourable demographics. With the system maturing over the next decade and the expected demographic changes, due

[10] The Government as an employer and as a contributory party to the whole scheme contributes annually approximately 3 percent of GDP.
[11] Interest earned by the Social Security Funds on debt issued by the Central Government is consolidated.

to population ageing, the Social Security Funds financial position is projected to deteriorate and exhibit a downward trend over the programming period 2008-2011.

Specifically, the surplus of the social security funds is projected to decline from a forecast of 2.1% of GDP in 2008 gradually to 1.2% by 2011. The decline in the surpluses of the Social Security Funds is partly offset by a forecast improvement of the Central Government balance, which is projected to improve from a deficit of 1.6% of GDP in 2008 to 0.5% in 2011.

Table VII: General Government Budgetary Developments by Sub-Sector

in percent of GDP	2006	2007 est.	2008 proj.	2009 proj.	2010 proj.	2011 proj.
Net lending by sub-sectors						
General Government	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**
Central Government	-3.7	-0.7	-1.6	-1.3	-0.8	-0.5
Local Government	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Social Security Funds	2.6	2.3	2.1	1.8	1.5	1.2

Budgetary implications of “major structural reforms”

The projects and measures promoted within the framework of the implementation of the Lisbon Programme are financed through:

- National resources;
- EU funds; and
- Public Private Partnerships.

The necessary budgetary appropriations for the actions included in the microeconomic and employment section have been provided in the Budgets of 2007 and 2008. The net budgetary expenditure of the microeconomic and employment actions is estimated at 2% of GDP in 2007; this estimation rises to 2.7% in 2008 and 2009.

Furthermore, a number of infrastructure projects in the area of transport and the environment will be co-financed by the Cohesion Fund, whereas a number of measures and actions aiming at enhancing the production base of disadvantaged areas and increasing the employability possibilities for targeted groups will be co-financed from the EU Structural Funds under the current EU programming period. In the next programming period of the EU (2007-2013), it will be the objective to co-finance a number of infrastructural projects mainly in the areas of marine transport and the environment as well as measures and actions in other areas via the various instruments of the EU Cohesion Policy. Moreover, it is noted that important infrastructural projects, such as airports, marinas, storage depots for petroleum products and a terminal for importation, storage and vaporisation of liquefied natural gas will be undertaken through public private partnerships.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

The baseline, medium-term projections presented in this Programme are based on a balanced assessment of the external environment, current trends and policies. However, there are both upside and downside risks to these central projections, which are broadly balanced.

The downside risks emanate from the following factors:

- Stronger effect of recent turmoil in financial markets on growth in partner economies, in particular the EU.
- Higher oil and other commodity prices would impact the economy through negative terms of trade effects, increased inflationary pressures and lower growth in partner countries, especially the EU.
- Strong appreciation of the euro in real effective terms.
- Possible geopolitical tensions, in particular the Middle East, which may affect tourism.

The risks on the upside emanate from the following factors:

- Possible underestimation of potential GDP growth and subsequently growth prospects in the coming years.
- Possible underestimation of growth momentum and trade prospects with emerging markets economies and oil producing partners, including Russia and Middle Eastern countries.
- Stronger confidence effects of the forthcoming accession to the eurozone, in particular for the attractiveness of Cyprus as an international business centre.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

To assess the sensitivity of the projected general government deficit and debt figures, alternative assumptions for real GDP growth rates and interest rates have been incorporated in three distinct scenarios. All simulations assume that, while automatic stabilisers would be allowed to operate fully, expenditure targets could not be altered.

Empirical evidence shows that GDP growth is especially affected by geopolitical tensions in the region impacting directly on tourism and other services. The geopolitical tensions of 2001-2003 led to an average deceleration in the rate of growth by approximately two percentage points. Contrary to the above, during “good” times GDP growth has accelerated by some one percentage point above potential. These, will form the basis of the sensitivity analysis to be carried out in this chapter.

Assumption 1: *Real GDP growth is one percentage point higher annually compared with the baseline scenario.* Other things being equal, the budget surplus would be some 0.4 percentage points of GDP higher at the beginning of the programming period reaching a surplus of 0.9 percent of GDP; the resulting surplus follows an upward trend reaching 2.3% of GDP by the end of the programming period. The public debt-to-GDP ratio is projected to decline by an additional 1.6 percent of GDP by the end of the programming period compared with the baseline scenario.

Assumption 2: *Real GDP growth is two percentage points lower annually compared with the baseline scenario.* Other things being equal, the budget balance is projected to deteriorate by some 0.8 percent of GDP at the beginning of the programming period reaching a deficit of the order of 0.3 percent of GDP; the resulting deficit follows an upward trend reaching 2.5% of GDP by the end of the programming period. The public debt-to-GDP ratio is projected to remain on a downward path albeit less pronounced falling to 43.7% by the end of the programming period, 3.2 percentage points of GDP higher compared with the baseline scenario.

Table VIII: Three Scenarios for Public Finances

in percent of GDP	2008	2009	2010	2011	2008-2011 4– year Average
Central Scenario					
GDP	4.1	4.0	4.0	4.0	4.0
General Government Balance	0.5	0.5	0.7	0.7	
General Government Debt	48.5	45.3	43.8	40.5	
Upper Scenario (GDP growth; one percentage point higher)					
GDP	5.1	5.0	5.0	5.0	5.0
General Government Balance	0.9	1.3	1.9	2.3	
General Government Debt	48.1	44.5	42.6	38.9	
Lower Scenario (GDP growth; two percentage points lower)					
GDP	2.1	2.0	2.0	2.0	2.0
General Government Balance	-0.3	-1.1	-1.7	-2.5	
General Government Debt	49.3	46.9	46.2	43.7	

Assumption 3*: Interest rates remain some 100 basis points above baseline each year during 2008-2011*. In this case, the government deficit would be some 0.3 to 0.4 percent of GDP higher during the programming period, and the government debt-to-GDP ratio would be higher by 1.39 percentage points of GDP by the end of the programming period.[12]

[12] In this scenario real GDP growth is assumed to remain unchanged even though lower interest rates could be expected to have a positive effect on real economic growth.

Table IX: Scenario with Higher Interest Rates Cumulative Differential

in percentage points of GDP with respect to the reference scenario	2008	2009	2010	2011
General Government Net Borrowing	0.30	0.42	0.39	0.28
General Government Gross Debt	0.30	0.72	1.11	1.39

The sensitivity analysis presented here confirms the importance of growth assumptions in affecting the outcome of the general government deficit and debt figures. Accordingly, the envisaged consolidation path is highly dependent on the realisation of the projected growth rates of real GDP.

Comparison with Previous Update

Compared with the forecast presented in the Convergence Programme 2006-2010, and mainly as a consequence of improved macroeconomic conditions, a continued favourable external environment and confidence effects from euro adoption, GDP growth has been revised slightly upwards in 2006 and 2007, while towards the end of the programming period it is revised marginally downwards. Even though GDP growth has been revised only slightly upwards, the general government budget balance as a percent of GDP and the government debt-to-GDP ratio forecasts, indicate a noteworthy improved fiscal position relative to the previous projections. This is mostly due to the buoyancy of public revenues, stemming from a strong expansion of the services and real estate sectors and an increase in domestic consumption relative to foreign demand for domestic goods.

The general government balance as a percentage of GDP is estimated to reach a surplus of 1.5% in 2007, exhibiting a divergence from last year's estimate of around 3.1 percentage points of GDP, attributed mainly to a surge in revenues, mainly emanating from the buoyant activity of the real estate and financial sector. The general government surplus is projected to exhibit a decline in 2008, falling to around 0.5% of GDP, but still showing an improvement compared to last year's forecast deficit of 0.7% of GDP; the improvement is projected to be sustained relative to last year's forecast albeit at lower levels, with the budget balance projected to improve and end up with a surplus of 0.7% of GDP in 2011. The general government debt-to-GDP ratio is predicted to fall in 2007 to around 60% of GDP and to 48.5% of GDP in 2008, as a result of a rising primary surpluses, and the running down of sinking fund deposits and other financial assets. These forecast compare favourably to the predictions of 60.5% and 52.5% of GDP for 2007 and 2008, which were reported in the Convergence Programme of 2006-2010. Public debt-to-GDP ratio forecast remains lower than last year's forecast throughout the period, resulting in a gross debt level of 40.5% of GDP in the year 2011.

Table X: Divergence from Previous Update

as a percentage of GDP	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
GDP Growth						
Previous Update	3.7	3.9	4.1	4.1	4.1	n.a.
Latest Update	3.8	4.2	4.1	4.0	4.0	4.0
Difference	0.1	0.3	0.0	-0.1	-0.1	-
Budget Balance						
Previous Update	-1.9	-1.6	-0.7	-0.4	-0.1	n.a.
Latest Update	-1.2	1.5	0.5	0.5	0.7	0.7
Difference	-0.7	-3.1	-1.2	-0.9	-0.8	-
Gross Debt Levels						
Previous Update	64.7	60.5	52.5	49.0	46.6	n.a.
Latest Update	65.2	60.0	48.5	45.3	43.8	40.5
Difference	0.6	-0.5	-4.0	-3.7	-2.8	-

5. 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 been 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. The gradual implementation of a Medium Term Budgetary Framework (MTBF), which commenced in 2006, has helped in containing expenditures by line ministries and, at the same time, promoted 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 redesign and prepare their annual budgets, using new Medium-Term Budgeting Framework (MTBF) and Programme and Performance Budgeting (PPB) methods.

These new methods have been introduced progressively from 2007, with all spending agencies this year being required to prepare three-year budgets for the period 2008-2010. The first steps for introducing the new PPB framework have been taken during 2007, with the implementation of pilot projects, covering three ministries. The number of ministries and spending agencies, who will be required to adopt this approach, is anticipated to increase steadily, and it is expected that all agencies by 2008 will prepare their FY 2009 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 (FY 2009 and FY 2010), in which the new methods can be developed, tested and refined.

During this trial period, the Treasury Department of the Ministry of Finance will be 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 2011 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.

It is noted that, the budgetary process for 2008, required line ministries to provide forecasts of their expenditure needs for 2009 and 2010. 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.

High priority areas

Total expenditure for *infrastructure,* in the Budget for 2008 and in projects financed through Private Public Partnership agreements, exceed 3% 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 transport. Also a number of actions included in the Strategic Action Plan for Road Safety have been implemented, resulting in a considerable reduction in the number of road deaths. Newer priorities in the area of transportation and infrastructure are reflected in the Council of Ministers approving a programme of action for the enhancement of public transport on the Island, and in the signing of the final Concession Agreement between the Government and Hermes Airports Ltd, launching the redevelopment of the two airports in Cyprus, using the BOT method.

Total expenditure on *research and technology* is budgeted to increase by approximately 5% compared to 2007, due mainly, to the creation of a technological park which aims at attracting high – tech businesses and the creation of a research centre on energy environment and water, in cooperation with the Massachusetts Institute of Technology. The implementation of the actions concerning the promotion of R&D, which were included in the National Reform Programme, over the period October 2006 – September 2007, progressed satisfactorily in all priorities. The Government has approved a substantial increase in the funds allocated via the Framework Programme of the Research Promotion Foundation (RPF) 2007-2010, reaching 0.6 percent of GDP compared with 0.1 percent in 2006.

Total expenditure on ***education*** is budgeted to increase by approximately 30% in 2008 compared to 2007, reaching 5.8% of GDP. Expenditure on education is focused mainly on the continuation of computerisation of all primary and secondary schools, the construction and extension of school buildings, the creation of new research and academic institutions (Cyprus University of Technology, Open University, Cyprus Institute). Progress in improving the quality and extension of education in these areas in 2007 is considered satisfactory. It is noted that during 2007 official permission was granted to three private colleges providing tertiary education to operate as universities.

Total expenditure on ***health*** is budgeted to increase by 13.5% in 2008 compared to 2007, reaching 3.2% of GDP. The Budget for 2008, allocates considerable funds for the operation of two new general hospitals, for financing arrangements between Harvard University and the Republic of Cyprus on Public Health and the Environment, and for the promotion of the National Health Scheme. 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. This will be accomplished through the restructuring of public hospitals into autonomous establishments under the wider public sector and the implementation of the National Health Insurance System (NHIS). The main goal of the reform of the health care system is to improve effectiveness via regulated competition and to contain costs. The implementation strategy of the NHIS in Cyprus was submitted to the Health Insurance Organisation (HIO) in November, 2006 and measures have been taken that will enable the National Health Insurance System to begin operations towards the end of 2008.

As in the annual Budget for 2007, in the Budget for 2008, the areas of agriculture, security and defence and public administration show negligible increases or even decreases in certain cases.

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. This is particularly the case in the context of the entry of Cyprus to EMU because the loss of the monetary policy instrument will require better functioning product, labour and capital markets, as well as the enhanced automatic stabilization potential of fiscal policy. With tax policy impacting on both, the authorities will be carefully monitoring the macroeconomic effects of the tax system over the coming years.

Secondly, taxes are the main source of financing desirable policies and expenditure priorities. Over the medium-term the Government will require a level of revenue to adequately fund its spending priorities. The tax structure must not only produce such a level of revenue, but in the Cyprus context the introduction of the MTBF places a greater premium on improving the accuracy and sensitivity of revenue forecasts over the medium-term so as to provide a more realistic resource envelope for formulating medium-term expenditure plans. Against the background of much higher than anticipated revenue growth during 2007 and in recent years, the Ministry of Finance is currently carrying out an exercise aimed at improving estimates of tax bases and tax elasticities, taking account of the impact of asset price changes, the composition of GDP growth and cyclical affects on their government revenue projections.

Thirdly, 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. Also, in view of the challenge of globalization consideration is also being given to the equitable taxation of immobile tax bases, such as property, while limiting taxation of mobile tax bases within the confines of the EU aquis and tax directives.

6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

Cyprus, together with other five member states of the EU, face a "high risk" with regard to the long-term sustainability of their public finances in view of the budgetary impact of an ageing population. The projected demographic changes, with the old-age dependency ratio doubling over the coming decades in the EU and Cyprus, have led to growing concerns on the long-term sustainability of the public finances.

Addressing this challenge is a key priority of the Government, especially in view of the fact that the demographics have already turned unfavourable and are affecting negatively the financial position of the Social Security Funds (SSF).

With a significant improvement in public finances achieved in recent years, especially in 2007, the current SP focuses on the consolidation of the current strong fiscal position and the reform strategy for the Social Security and Healthcare systems.

The remainder of this chapter discusses recent developments in demographic trends, which will affect long-term fiscal sustainability. Based on these new developments, it tentatively assesses whether the baseline projection for the long-term fiscal position requires updating, which is important for assessing the impact of the proposed reforms. Such updated projections will be further refined during the next few months and will form the basis of the revised long-term forecasts for Sustainability and Ageing Working Group report to be published in 2009.

Recent Demographic Developments

A recent assessment of the key underlying demographic assumptions used in the previous forecast exercise has revealed that, although the majority of the assumptions still remain valid, two important parameters need to be reassessed more thoroughly, namely, life expectancy and net migration (Table XI).

Table XI: Cyprus - Assumptions for Population Projections: Comparisons with Actual Data

	Net Migration		Total Fertility		Life expectancy Males		Life expectancy Females	
	Proj.	**Actual**	**Proj.**	**Actual**	**Proj.**	**Actual**	**Proj.**	**Actual**
2004	6000	15724	1.45	1.49	76.3	77.0	80.8	81.7
2005	6000	14416	1.45	1.42	76.3	77.0	80.8	81.7

Source: Cyprus Statistical Service

The comparisons make it clear that net migration is an issue, which ought to be re-examined thoroughly, as it can potentially affect the conclusions concerning long-term fiscal sustainability. Developments in Cyprus in recent years have been quite striking regarding net migration both from EU countries since accession to the EU, but also from third countries. The buoyant economy is facing labour shortages which only can be met, at least in the short term, by inward migration. It is likely that these migration trends are to persist over the medium, and probably the long-term, albeit at lower intensity.

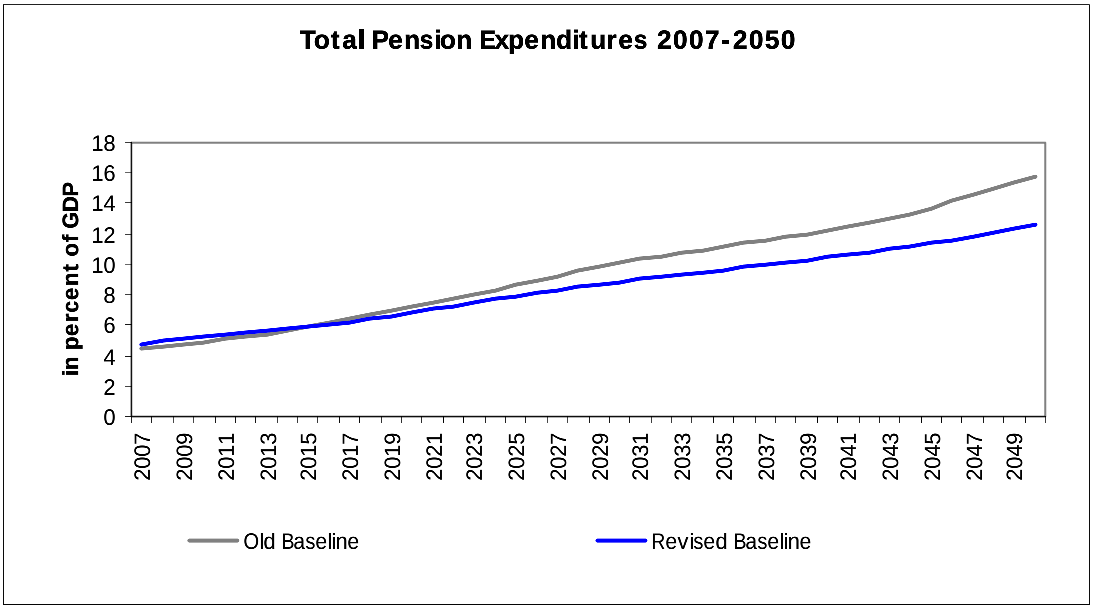
Analysis conducted at a macroeconomic level further revealed that, due to a shrinking labour force, significant migration flows will also be required in the long-term to sustain a growth of GDP, of the order of 2% per annum. Such a growth potential still implies a considerable deceleration of GDP growth in the long term from today's level of 3½-4% per annum. With these revised assumptions on migration, potential GDP growth would average some 2% over the period 2030 to 2050: indeed, by 2050 potential GDP is over 9% higher than in the last baseline scenario.

In relation to the life expectancy at birth, it follows from the above table that over the period 2004-05 life expectancy for both males and females increased at a higher rate than anticipated. In particular, the actual life expectancy for males and females was higher than that anticipated by 8.4 months and 10.8 months, respectively. Thus the profile for life expectancy has been adjusted upwards to reflect the recent data, although its trend over the long term is still considerably below to what a full convergence scenario with other EU countries would imply.

Also, labour force figures for recent years reveal a significant rise in participation rates, especially for females, than earlier foreseen.

The reassessment of potential GDP in the long term, the revised path for net migration and life expectancy, as well as, higher labour force participation rates have been taken into consideration to conduct the actuarial assessment of the SSF. These results are compared with the previous official AWG projections.

- These comparisons show little difference between the two base line scenarios up to 2025 with the ratio of social security fund reserves to GDP falling under both scenarios from over 30% of GDP in 2020 to around 21% by 2025.
- Thereafter, the faster growth rate of potential real GDP stemming from higher net immigration under the revised base scenario, results in lower ratios of pension expenditure to GDP as compared with the earlier baseline scenario.
- This difference together with resulting greater investment earnings on a higher social security reserve and reduced interest payments result in much lower general government deficits; albeit still very high under the revised base scenario which results in the government debt to GDP ratio rising to very high levels by 2050, but at a lower level than the earlier baseline scenario.
- Under both baseline scenarios the long-term sustainability of the government finances is not safeguarded as the debt to GDP ratio rises exponentially to excessively high levels as social security fund reserves begin falling at an increasing rate from around 2020 under both scenarios.
- Total pension expenditure as a percent of GDP is lower based on revised baseline (figure).
- In the revised baseline scenario the higher immigration from 2020 onward just serves to slow the pace of deterioration of the government finances, but does not halt the emergence of mounting deficits in the social security accounts.



Discussion of parametric reforms of the social security system has intensified throughout 2007, but no concrete measures have been adopted. However, in recent weeks there appears to be a consensus on the set of initial reforms which will most likely be agreed in the first half of 2008. These "first-wave" reforms would most probably include:

1. Phased increases in social security contribution rates – possibly seven increases of 1.3 percentage points every five years – first increase in 2008 and last increase in 2037;
2. stricter eligibility conditions to obtain old-age pension - increase of the minimum contribution requirement to 15 years, with at least 10 years of paid contributions;
3. maximum limit of 4 years on credits granted to an insured person in the lower band for any period of full time education or approved training after the age of 16 (under the existing legislation there is not any maximum limit imposed); and
4. stricter eligibility conditions for the payment of a lump sum at age 68, for those who are eligible for old-age pension at 65 - six years of paid contributions (currently the minimum requirement is 3 years).

In addition, social partners have discussed extensively the measure of the gradual increase of pensionable age from 63 to 65, but no consensus has yet been reached.

A reform scenario, which incorporates these reforms involving higher contribution rates and adjusted pension payments from the measures enumerated above, was run. It generates results which bolster the viability of the social security fund. The phased increase in social security contribution rates raises the government revenue to GDP ratio by 3½ percentage points by 2050, while pension payments as a ratio to GDP, fall by one percentage point compared with the revised base scenario. In addition, with these reforms contributing to a steady increase in the SSF reserve, investment earnings on the reserve continue to rise and contribute to the strengthening of the government finances. Moreover, higher government surpluses arising from these reforms lead to much lower interest payments and eventual net interest receipts, simultaneously with a sharply falling debt.

In the reform scenario SSF reserves are built up approximately in line with the phased increases in contribution rates peaking at around 53% of GDP by 2037. With the ending of increases in contribution rates in 2037 and pension payments to immigrants rising as they reach retirement age toward the last years of the projection period, the reserve ratio begins falling, indicating that reforms need to be sustained and even intensified over the long-term.

As higher contribution rates will harm cost competitiveness, consideration will have to be given, if life expectancy trends develop as anticipated, to a phased increase of the retirement age in exchange for a more gradual increase in social security contributions.

In addition to these parametric reforms the Ministry of Finance has commissioned a report on the investment framework of the Social Security Fund by the World Bank. The World Bank staff visited Nicosia twice and have drafted a report, which outlines a proposal for reforming the investment framework for the SSF, and the conditions which must be met for a successful implementation of their strategy, most important of, which is parametric reforms which address the problems at its source, i.e., reforms to retirement rules and benefits, which address the changing demographic trends.

Reforms of the Healthcare System

Improvement of the quality of the health care system and the effective tackling of the anticipated increases in public health expenditure constitute important challenges to the Cyprus economy.

In order to tackle these challenges, the Government of Cyprus is proceeding with the introduction of a National Health Insurance Scheme (NHIS) and the restructuring of the public hospitals into autonomous establishments, under the wider public sector.

As regards the implementation of the NHIS, a Strategic Plan has been prepared by external consultants, namely McKinsey & Company, which has been delivered to the Cyprus authorities on the 8th of November 2006.

The Strategic Plan proposes, mainly, the following:

- A phased introduction of the NHIS. It will begin with primary care which is envisaged to be introduced by late 2008 whereas the inclusion of secondary care into the NHIS will follow at a later stage. The phased approach is anticipated to facilitate a smooth changeover from the current system
- Development of remuneration schemes for general practitioners and specialists, providing incentives for high quality health care and contained costs.
- With relation to the funding of the Scheme, and in order to close the potential gap between the costs and the revenues of the NHIS, a number of levers are

being suggested, including higher contribution rates, introduction of so called "sin–taxes", application of co-payment, and reduced coverage of certain services.

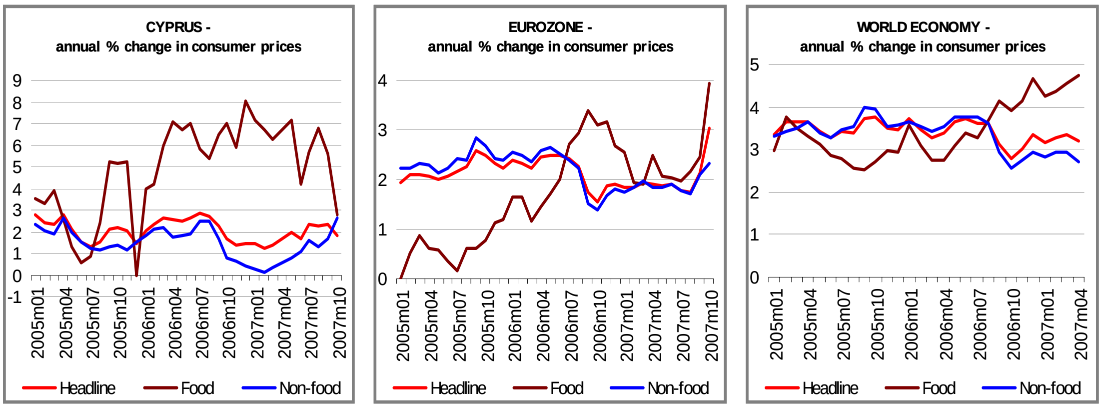
These reforms, as outlined in more detail in the National Reform Programme, will be proceeded by the granting of autonomy to public hospitals as envisaged in the relevant law. The Government considers this it as a necessary first step, directly linked with the successful implementation of the NHIS. Through it, hospitals will be granted operational independence granting them the necessary flexibility on issues relating to recruitment of personnel, budget etc. In parallel public financial support will be phased out.

APPENDICES

APPENDIX I: HICP Inflation Prospects for 2007-2011

Inflation in Cyprus has remained low in recent years, driven in large part by exogenous factors, namely oil prices and indirect tax changes (related to the harmonization of minimum tax rates as part of the accession process of Cyprus to the EU).

In recent months, the price of oil has fluctuated considerably and has increased markedly since the summer approaching now $100 per barrel. In terms of Cyprus pounds and euros, however, the prices have not increased so sharply. At the same time food prices have soared in world markets and have affected significantly price developments in Cyprus.



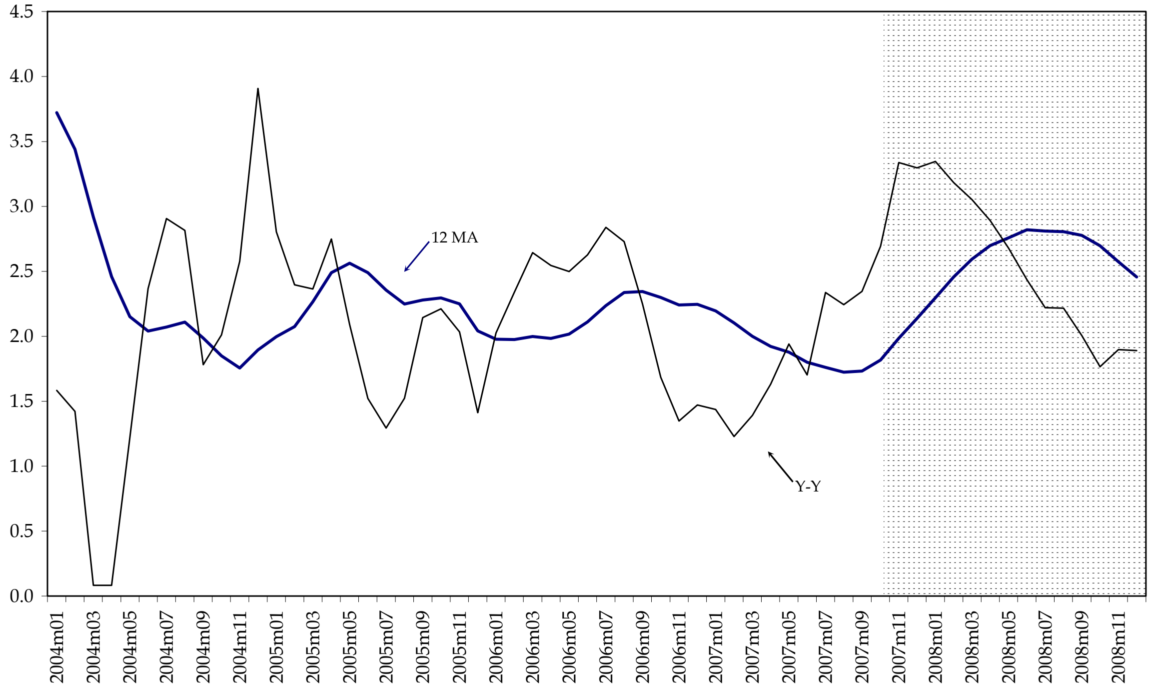
Against this background, inflation is projected to average some 2.2% in 2007, and to accelerate somewhat in 2008 to 2.5% (Figure A1). Due to base effects, inflation will accelerate further in December and January to over 3.3% before it ebbs to 2.2% by July 2008. It is forecast to rise on average by around 2.0% in 2009-2011. The forecast is based on the following:

- the oil price is expected to increase by 10% in 2008 compared to 2007; from $71 per barrel in 2007 to $79 in 2008. Thereafter, a 3% decrease is assumed for 2009 with the oil price declining to $76 per barrel. Still, due to euro appreciation over the US dollar, the oil price in Cyprus pounds is likely not to show any increase. USD/CYP exchange rate is expected to be around 2.38 for 2007 and a further depreciation of the dollar is assumed for 2008, with the average rate for 2008 being around 2.41;
- prices of clothing and footwear, and communications are assumed to remain unchanged over the forecast horizon, in contrast to the recent past which experienced significant price declines (-1.9% and -4.3% respectively, for the period January 2005 – October 2007);
- food prices are forecast to rise at a higher rate than the overall HICP in 2008, but decline from high rates of over 5 percent at the turn of the year, to reach around 4-4½% in the second part of 2008; and
- the rest of the HICP categories are assumed to increase in line with recent (2005-onwards) trends.

The forecast presented here, which is purely based on trend extrapolation, is consistent with an assessment of inflation based on a more structural view of the economy:

- first, it has to be noted that the projections assume that consumer demand will be unaffected by the tax changes;
- real wage increases will be contained, broadly in line with productivity growth, and consistent with historical price-wage behavioural relationships. Recent collective bargaining agreements seem to point to lower nominal wage increases, especially in a number of ailing sectors;
- inflows of foreign workers are putting downward pressure on wages in several key sectors. As capital adjusts, productivity will increase thus putting further restraint on prices;
- the entry of Cyprus to the Euro-area will effectively ease monetary conditions in the short-term, with interest rates lowered and minimum reserve requirements of banks substantially reduced. But thereafter, monetary conditions will firm in line with those generally prevailing in the Euro-area; and
- finally, the pursuing of the medium-term fiscal objective will continue to exert a negative impact on aggregate demand in the medium term.

Figure A1: HICP Inflation, Jan2004-Oct2007 and prospects until 2008



APPENDIX II: Tables

Table 1a. Macroeconomic prospects

	ESA Code	Year 2006	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
		€ million	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	12027.9	3.8	4.2	4.1	4.0	4.0	4.0
2. Nominal GDP	B1*g	14317.6	6.4	7.0	7.0	6.4	6.3	6.3
Components of real GDP								
3. Private consumption expenditure	P.3	7958.0	4.2	4.9	4.2	4.0	4.0	4.0
4. Government consumption expenditure	P.3	2085.7	7.4	2.2	4.2	4.2	3.7	3.7
5. Gross fixed capital formation	P.51	2332.6	5.8	8.0	4.5	4.2	3.6	3.3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	41.9	0.3	0.3	0.3	0.3	0.3	0.3
7. Exports of goods and services	P.6	6323.9	4.8	1.6	2.7	3.3	3.7	3.9
8. Imports of goods and services	P.7	6714.1	6.8	3.3	3.1	3.5	3.5	3.6
Contributions to real GDP growth								
9. Final domestic demand		12376.4	5.1	5.2	4.4	4.2	4.0	4.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	41.9	0.0	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-390.4	-1.2	-1.0	-0.3	-0.2	-0.1	0.0

Table 1b. Price developments

	ESA Code	**Year 2006**	**Year 2006**	**Year 2007**	**Year 2008**	**Year 2009**	**Year 2010**	**Year 2011**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		119.0	2.4	2.7	2.9	2.3	2.3	2.2
2. Private consumption deflator		116.6	2.4	2.5	2.8	2.3	2.3	2.3
3. HICP[1]		102.2	2.2	2.2	2.5	2.0	2.0	2.0
4. Public consumption deflator		128.6	2.9	2.5	2.8	2.3	2.3	2.3
5. Investment deflator		122.4	2.6	3.0	2.5	1.7	1.7	1.6
6. Export price deflator (goods and services)		109.4	1.6	2.5	2.8	2.3	2.3	2.3
7. Import price deflator (goods and services)		111.3	2.1	2.5	2.6	2.1	2.1	2.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	Year 2006 Level	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change
1. Employment, persons[1] (000´s)		356.7	2.1	1.9	1.8	1.8	1.8	1.7
2. Employment, hours worked[2] (million)		704.8	3.4	1.9	1.8	1.8	1.8	1.7
3. Unemployment rate (%)[3]		4.5	4,5	4,2	4,0	3,9	3,7	3,6
4. Labour productivity, persons[4] (€, 2000 prices)		33710.7	1.7	2.3	2.2	2.2	2.2	2.2
5. Labour productivity, hours worked[5] **(€, 2000 prices)**		10.0	0.4	2.3	2.2	2.2	2.2	2.2
6. Compensation of employees (€ million)	D.1	8132.6	7.7	6.7	6.9	6.4	6.3	6.3
7. Compensation per employee (€)		22799.6	5.5	4.8	5.0	4.5	4.5	4.5

[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 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.9	-6.6	-6.5	-6.3	-5.9	-5.6
of which: - Balance on goods and services		-4.1	-4.6	-4.6	-4.6	-4.4	-4.2
- Balance of primary incomes and transfers		-1.8	-2.0	-1.8	-1.7	-1.5	-1.4
- Capital account		16.4	-	-	-	-	-
2. Net lending/borrowing of the private sector	B.9	-4.7	-8.1	-7.0	-6.8	-6.6	-6.3
3. Net lending/borrowing of general government	EDP B.9	-1.2	1.5	0.5	0.5	0.7	0.7
4. Statistical discrepancy			-	-	-	-	-

Table 2. General government budgetary prospects

	ESA Code	Year 2006 Level	Year 2006 % of GDP	Year 2007 % of GDP	Year 2008 % of GDP	Year 2009 % of GDP	Year 2010 % of GDP	Year 2011 % of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-172.6	-1.2	1.5	0.5	0.5	0.7	0.7
2. Central government	S.1311	-536.2	-3.7	-0.7	-1.6	-1.3	-0.8	-0.5
3. State government	S.1312	M	M	M	M	M	M	M
4. Local government	S.1313	-10.8	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	374.4	2.6	2.3	2.1	1.8	1.5	1.2
General government (S13)								
6. Total revenue	TR	6098.5	42.6	45.9	44.3	44.5	44.6	44.7
7. Total expenditure	TE[1]	6271.1	43.8	44.4	43.8	44.0	44.0	44.1
8. Net lending/borrowing	EDP B.9	-172.6	-1.2	1.5	0.5	0.5	0.7	0.7
9. Interest expenditure	EDP D.41	470.4	3.3	3.2	2.9	2.4	2.3	2.2
10. Primary balance[2]		297.8	2.1	4.7	3.4	2.9	2.9	2.8
11. One-off and other temporary measures[3]		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		4101.8	28.6	33.2	32.1	32.3	32.4	32.6
12a. Taxes on production and imports	D.2	2545.8	*17.8*	*19.6*	*18.9*	*18.9*	18.9	18.9
12b. Current taxes on income, wealth, etc	D.5	1555.2	*10.9*	*13.5*	*13.2*	*13.4*	13.5	13.7
12c. Capital taxes	D.91	0.9	*0.0*	*0.0*	*0.0*	*0.0*	0.0	0.0
13. Social contributions	D.61	1128.4	7.9	7.9	7.9	8.0	8.0	8.0
14. Property income	D.4	165.7	1.2	0.7	0.4	0.4	0.4	0.4
15. Other[4]		702.6	4.9	4.1	3.8	3.8	3.8	3.8
16=6. Total revenue	TR	6098.5	42.6	45.9	44.3	44.5	44.6	44.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		5229.3	36.5	41.1	40.0	40.3	40.4	40.6
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	2933.3	20.5	20.1	19.9	20.0	20.0	19.9
17a. Compensation of employees	D.1	2128.6	*14.9*	*14.6*	*14.5*	*14.5*	*14.4*	*14.4*
17b. Intermediate consumption	P.2	804.8	*5.6*	*5.5*	*5.5*	*5.5*	*5.5*	*5.5*
18. Social payments (18=18a+18b)		1777.8	12.4	13.1	12.8	13.4	13.4	13.6
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	19.3	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	*0.1*
18b. Social transfers other than in kind	D.62	1758.5	*12.3*	*12.9*	*12.6*	*13.2*	*13.3*	*13.5*

19=9. Interest expenditure	EDP D.41	470.4	3.3	3.2	2.9	2.4	2.3	2.2
20. Subsidies	D.3	76.7	0.5	0.6	0.6	0.5	0.5	0.5
21. Gross fixed capital formation	P.51	431.1	3.0	3.0	3.0	2.9	2.9	2.9
22. Other[6]		581.8	4.1	4.5	4.6	4.8	4.9	5.0
23=7. Total expenditure	TE[1]	6271.1	43.8	44.4	43.8	44.0	44.0	44.1
p.m.: Government consumption (nominal)	P.3	2682.5	18.7	18.4	18.4	18.4	18.4	18.3

[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 2005**	**Year 2010**
1. General public services	1	9.0	8.5
2. Defence	2	2.1	1.6
3. Public order and safety	3	2.0	1.8
4. Economic affairs	4	6.1	5.5
5. Environmental protection	5	0.0	0.0
6. Housing and community amenities	6	4.0	4.1
7. Health	7	3.0	3.3
8. Recreation, culture and religion	8	0.6	0.7
9. Education	9	6.8	6.6
10. Social protection	10	10.0	12.5
11. Total expenditure (=item 7=23 in Table 2)	**TE**	**43.6**	**44.6**

Table 4. General government debt developments

% of GDP	ESA Code	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
1. Gross debt[1]		65.2	60.0	48.5	45.3	43.8	40.5
2. Change in gross debt ratio		-3.9	-5.2	-11.5	-3.1	-1.6	-3.2
Contributions to changes in gross debt							
3. Primary balance[2]		2.1	4.7	3.4	2.9	2.9	2.8
4. Interest expenditure[3]	EDP D.41	3.3	3.2	2.9	2.4	2.3	2.2
5. Stock-flow adjustment		-1.8	0.8	-6.6	0.6	2.0	0.2
of which: - Differences between cash and accruals[4]		-0.2	-0.3	0	0	0	0
- Net accumulation of financial assets[5]		-1.5	1.0	-6.6	0.6	2.0	0.2
of which: - *privatisation proceeds*		-	-	0.3	-	-	-
- Valuation effects and other[6]		-0.1	0.1	0	0	0	0
p.m.: Implicit interest rate on debt[7]		4.7	4.9	4.9	5.0	5.0	5.0
Other relevant variables							
6. Liquid financial assets[8]		6.7	7.7	1.1	1.7	3.7	3.9
7. Net financial debt (7=1-6)		58.5	52.3	47.4	43.7	40.1	36.6

[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 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
1. Real GDP growth (%)		3.8	4.2	4.1	4.0	4.0	4.0
2. Net lending of general government	EDP B.9	-1.2	1.5	0.5	0.5	0.7	0.7
3. Interest expenditure	EDP D.41	3.3	3.2	2.9	2.4	2.3	2.2
4. One-off and other temporary measures[1]		0.0	1.5	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.7	3.7	3.7	3.7	3.7	3.7
contributions:							
- labour		0.7	0.7	0.7	0.7	0.7	0.7
- capital		1.6	1.6	1.6	1.6	1.6	1.6
- total factor productivity		1.4	1.4	1.4	1.4	1.4	1.4
6. Output gap		-2.0	-1.5	-1.0	-0.7	-0.3	0.0
7. Cyclical budgetary component		-0.8	-0.6	-0.4	-0.3	-0.1	0.0
8. Cyclically-adjusted balance (2 - 7)		-0.3	2.2	0.9	0.8	0.8	0.7
9. Cyclically-adjusted primary balance (8 + 3)		3.0	5.4	3.8	3.2	3.0	2.8
10. Structural balance (8 - 4)		-0.3	0.7	0.9	0.8	0.8	0.7

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

Table 6. Divergence from previous update

	ESA Code	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Real GDP growth (%)							
Previous update		3.7	3.9	4.1	4.1	4.1	n/a
Current update		3.8	4.2	4.1	4.0	4.0	4.0
Difference		0.1	0.3	0	-0.1	-0.1	
General government net lending (% of GDP)	EDP B.9						
Previous update		-1.9	-1.6	-0.7	-0.4	-0.1	n/a
Current update		-1.2	1.5	0.5	0.5	0.7	0.7
Difference		-0.7	-3.1	-1.2	-0.9	-0.8	
General government gross debt (% of GDP)							
Previous update		64.7	60.5	52.5	49.0	46.6	n/a
Current update		65.2	60.0	48.5	45.3	43.8	40.5
Difference		0.5	-0.5	-4.0	-3.7	-2.8	

Table 7. Long-term sustainability of public finances (baseline scenario)

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	**37.0**	**43.6**	**44.0**	**44.5**	**46.7**	**56.0**
Of which: age-related expenditures	**14.3**	**16.7**	**17.8**	**19.4**	**22.0**	**26.8**
Pension expenditure	6.2	6.9	7.5	9.2	11.5	16.1
Social security pension	4.3	4.8	5.2	6.8	8.8	12.6
Old-age and early pensions	3.8	4.4	4.6	6.0	7.9	11.1
Other pensions (disability, survivors)	0.5	0.4	0.6	0.8	0.9	1.5
Occupational pensions (if in general government)	1.9	2.1	2.3	2.4	2.7	3.5
Health care	2.4	3.0	3.3	3.5	3.9	4.0
Long-term care *(this was earlier included in the health care)*						
Education expenditure	5.2	6.8	6.6	6.3	6.1	5.7
Other age-related expenditures	0.5	1.0	0.8	0.8	0.8	1.0
Interest expenditure	3.3	3.5	2.3	1.1	1.3	6.9
Total revenue	**34.7**	**41.2**	**44.7**	**44.5**	**43.4**	**38.6**
Of which: property income	0.9	0.7	0.4	0.5	0.5	0.5
Of which: from pensions contributions (or social contributions if appropriate)	6.5	6.3	5.7	5.6	5.4	5.3
Pension reserve fund assets	**35.5**	**37.6**	**38.8**	**32.2**	**7.5**	**-105.5**
Of which: consolidated public pension fund assets (assets other than government liabilities)	**0.9**	**0.8**	**0.9**	**0.9**	**1.0**	**1.0**
Assumptions						
Labour productivity growth	2.9	1.7	1.7	2.5	2.5	2.2
Real GDP growth	5.0	3.9	4.3	3.2	2.6	1.9
Participation rate males (aged 15-64)	81.3	82.2	83.2	85.9	85.5	86.0
Participation rates females (aged 15-64)	57.3	62.3	66.9	74.7	74.9	77.2
Total participation rates (aged 15-64)	68.9	72.4	75.0	80.3	80.2	81.6
Unemployment rate	3.3	5.3	3.7	3.5	3.5	3.5
Population aged 65+ over total population	11.3	12.1	13.1	16.5	20.3	26.8

Table 8. Basic assumptions

	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Short-term interest rate (annual average)	3.5	4.2	4.4	4.3	4.2	4.1
Long-term interest rate (annual average)	4.1	4.4	4.6	4.7	4.8	4.8
USD/€ exchange rate (annual average)	1.27	1.36	1.42	1.42	1.42	1.42
Nominal effective exchange rate	0.60	1.30	0.50	0.00	0.00	0.00
World excluding EU, GDP growth	6.0	5.6	5.3	5.5	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4	2.5
Growth of relevant foreign markets	8.0	7.5	7.0	7.0	6.9	7.0
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.6	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	75.0	75.0