COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Cyprus

Report prepared in accordance with Article 104(3) of the Treaty

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration data reported by Cyprus and validated by Eurostat in March 2004, the general government deficit in Cyprus reached 6.3% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value.

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	-4.3	-4.5	-2.4	-2.4	-4.6	-6.3	-4.6	-4.1
General government gross debt	61.6	62.0	61.7	64.4	67.1	72.2	74.6	76.9

Source: Eurostat and Commission Spring 2004 forecasts.

At this stage, the estimated figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Cyprus, in the sense of the Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for Cyprus.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”, which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that “if a Member State does not fulfil the requirements under one or both of these criteria[1], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …”

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Cyprus and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

[1] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

2. Recent macroeconomic developments and prospects

After generally strong growth in the early 1990s, real GDP growth declined to about 2% in 1996-1997, linked to lower tourism arrivals following disturbances along Cyprus' 'Green line' and the start of a severe drought. Growth picked up again to between 4-5% annually in 1998-2001, mainly linked to a recovery in tourism – a mainstay and driving force of the economy. This pick-up was supported by an expansionary fiscal policy in 1997 and 1998. However, in 2002 and 2003 GDP growth declined to 2%, following a renewed steep fall in tourist arrivals in both years. This was linked to modest growth of the EU (the major tourist source for Cyprus), repercussions of September 11, 2001 and other terrorist attacks, the Iraqi war and SARS, all of which contributed to diminishing external (tourism) demand feeding directly and indirectly into lower growth and a deterioration of public finances. The Commission Spring 2004 forecast expects annual growth to pick up again to 3-4% in 2004-2005. Per capita income in purchasing power standards as a percentage of the EU 15 average has steadily increased to reach 78% by 2003, the highest of the new Member States.

The composition of growth during 1998-2003 shows a mixed picture with domestic and external demand trading places as the main factor pushing growth. This was partly the result of changes in the fiscal policy stance, while at the same time investment growth showed a cyclical pattern and private consumption expanded unevenly. The external account remained in deficit of around 4% of GDP throughout most of the period 1998-2003, recording a 4.3% of GDP deficit in 2003. For 2004 and 2005 the Commission forecasts expect a pick up in GDP growth, led by external demand, with domestic private demand also contributing, though tempered by fiscal consolidation.

Table 2: Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.8	4.7	5.0	4.0	2.0	2.0	3.4	4.1
Contribution: Domestic demand	8.7	0.1	4.5	5.6	5.6	1.3	2.0	4.3
Change in inventories	0.8	0.1	0.9	-1.2	0.2	-0.2	0.1	-0.4
External trade	-4.7	4.5	-0.4	-0.4	-3.8	0.9	1.3	0.2
Unemployment rate (% of labour force)	n.a.	5.3	5.2	4.4	3.9	4.4	4.1	4.0
Unit labour costs (% change)	1.1	2.3	4.9	2.5	4.7	3.4	1.6	1.0
HICP (% change)	2.3	1.1	4.9	2.0	2.8	4.0	2.2	2.1
External account[a] (% of GDP)	-5.6	-1.7	-3.5	-4.0	-5.4	-4.3	-3.6	-3.3
GDP/capita, PPS (% of EU-15 avg.)	74	75	76	78	77	78		

[a] Net lending/ borrowing vis-à-vis the rest of the world = current account + capital account

Source: Eurostat and Commission Spring 2004 forecasts.

With unemployment rates of only 4-5%, Cyprus effectively does not have an unemployment problem. Despite the economic slowdown in 2002-2003, the relatively flexible labour market held up well; in 2003 unemployment rose only moderately to reach 4.4% while employment growth reached 0.5%. The Commission forecast projects a marginally declining unemployment rate for 2004-2005 at the same time as employment growth picks up with the rebound in the economy.

Cyprus' good inflation performance has been the result of exchange rate stability, a credible monetary policy and incomes policies that aim to keep wage rate increases below productivity rises. Inflation spikes in 2000 and 2003 to 4.9% and 4.0%, respectively, were mainly - but not exclusively - linked to staged increases in VAT rates in line with *acquis* commitments. For 2004 and 2005 inflation is expected to fall back again to slightly above 2%.

3. THE SITUATION OF GOVERNMENT FINANCES

The general government deficit declined from nearly 4.3% of GDP in 1998 to 2.4% in 2000 and 2001 but then climbed again from 2002, reaching 6.3% of GDP in 2003, above the 3% of GDP reference value. In addition, both in the Commission's and the authorities' view, it is expected to stay well above this threshold in 2004-2005. The debt-to-GDP ratio rose from 1999 onward by 10 percentage points to reach 72.2% of GDP in 2003 and hence also was above the 60% of GDP reference value.

The analysis of budgetary developments is still hampered by some transitional data problems, although a consistent series of fully consolidated ESA95 data on general government revenues and expenditures over recent years has lately become available.

3.1. Recent budgetary developments until 2002

Cyprus has so far shown a mixed record on fiscal consolidation. After several years of high GDP expansion and relatively contained fiscal deficits, fiscal policy turned aggressively expansionary in reaction to the slowdown in 1996-97. Spending rose across the board, swelling the general government budget deficit from 3.4% of GDP in 1996 to around 5% of GDP in 1997 and 1998. To counter this deterioration, a fiscal consolidation plan was introduced in 1999 that included a series of mostly one-off measures and aimed at reducing the deficit to 2.0% by 2002. The fiscal consolidation programme was relatively successful in that it contributed to lowering the general government budget deficit to 2.4% of GDP in 2000 and 2001, although slippage started to occur in 2001. The programme was revised and extended in 2001 and 2002. At the same time, fiscal consolidation again went increasingly off-target, with the deficit reaching 4.6% of GDP in 2002 instead of a previously planned 2.6%. This slippage can partly be ascribed to lower GDP growth. Furthermore, also adversely affecting public finances for 2002 were unexpectedly high defence outlays and, similarly to 1997-1998, expenditure aimed to offset the economic downturn. These expenditure increases more than offset declining outlays from a phasing out of subsidies and lower interest payments. At the same time, a staged tax reform starting in mid-2002 to lower direct taxation and increase indirect taxation[2] aimed to have a zero impact on public finances. However, this

[2] The reform was approved by parliament in July 2002 and included as main elements an increase of VAT rates from 10% to 13% in July 2002 and to 15% in January 2003, phased increases of excise duties on energy, tobacco and alcohol, with simultaneous reductions in direct income, corporate and wealth taxes, and abolition of the defence fund levies.

was not implemented as originally planned, as one-off compensatory measures were introduced in order to secure broad political support.

For the period 1998-1999 Cyprus ran primary deficits, followed by a surplus in 2000 and 2001, in line with the fiscal consolidation efforts. With the fiscal slippage in 2002 the primary balance returned to (increasing) deficits. Despite concomitantly rising debt stocks, lower interest rates kept total interest payments at around 3-3½% of GDP.

The general government deficit was predominantly driven by central government net borrowing.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.8	4.7	5.0	4.0	2.0	2.0	3.4	4.1
General government balance	-4.3	-4.5	-2.4	-2.4	-4.6	-6.3	-4.6	-4.1
Primary balance [a]	-1.1	-1.4	1.1	1.2	-1.3	-3.0	-	-
Total expenditures	38.6	38.7	38.7	40.4	41.7	46.4	42.1	41.7
of which: gross public investment [a]	3.0	2.6	3.1	3.1	3.1	3.8	-	-
Total revenues	34.3	34.2	36.3	38.0	37.2	40.2	37.5	37.6
General government gross debt	61.6	62.0	61.7	64.4	67.1	72.2	74.6	76.9

[a] Data problems preclude calculation for 2004 and 2005

Source: Eurostat and Commission Spring 2004 forecasts.

3.2. Budgetary developments in 2003

For 2003 the originally planned target for general government net borrowing provided in August 2002 was 1.9% of GDP, with an expected GDP growth rate of 4.6%. However, given the adverse external environment, increased government spending plus revenue shortfalls linked to lower growth led to a general government deficit of 6.3% of GDP. This is similar to fiscal developments in 2002 when the same factors (low growth, revenue shortfalls and increased expenditure) led to an increase in the general government deficit to 4.6% of GDP.

To counter this increasing slippage, and with the then current fiscal consolidation plan effectively abandoned, the government presented in August 2003 a new fiscal consolidation programme in the 2003 pre-accession economic programme (PEP). Most of the projected fiscal adjustment in the PEP comes from the expenditure side; however, this implies strict control of spending, on which the record has not been reassuring.

On the revenue side, the general government revenue-to-GDP ratio reached 40.2%, or 2.9 percentage points above planned levels. Nevertheless, lower growth and tax evasion limited total revenue expansion, both from direct and indirect taxation. Total revenue increased mainly through the expansion of indirect taxation revenues, reflecting the impact of the further VAT rate-increase from 13% to 15% in January 2003. In contrast, revenue from direct taxation registered an absolute decline, due mainly to the reduction in the highest marginal tax rate on natural persons as well as the introduction of a (lower) uniform corporate tax rate of 10%.

The general government expenditure-to-GDP ratio jumped by 4.7 percentage points to 46.4%, or 3.7 percentage points above planned levels. The acceleration of public expenditure growth applies to both current and capital expenditure. A main item accounting for the rapid rise was the growth in government wage costs, due to the 7.5% increase in basic salaries granted in 2003 and also covering increases back paid for 2001 and 2002. At the same time, capital expenditure expanded very rapidly as well, at a rate of 30%, as part of an expansionary fiscal policy aiming to counteract the economic slowdown. On the other hand, lower interest rates kept interest payments growth in check, while subsidies also showed low growth, at least partly reflecting efforts to phase them out.

Table 4: Successive targets for the 2003 general government balance and estimated outcome

	Real GDP growth assumption (%)	General government balance (% of GDP)
August 2002: Pre-Accession Economic Programme	4.6	-1.9
August 2003: Pre-Accession Economic Programme	2.0	-5.4
April 2004: Commission Spring 2004 forecasts	2.0	-6.3

Source: Commission services

3.3. Prospects for 2004

For 2004, the government budget as approved by parliament in January 2004 foresaw a central government budget deficit of 3.7% of GDP. In March 2004 the Ministry of Finance revised its forecast of the deficit upward to 4.1% of GDP, while for general government the deficit was now foreseen at 4.3% of GDP (as against 3.7% in the 2003 PEP). The Commission 2004 Spring forecast is largely in line with this target but, given the mixed historical record of fiscal consolidation and upward deficit revisions by the government, and if the announced measures are not rigorously implemented, it assumes that objectives will not be completely met and the deficit is projected to be at 4.6% of GDP.

The revised fiscal consolidation programme presented in the 2003 PEP formed the basis for the 2004 budget. Ceilings specified for general government net borrowing in 2004 are supported by measures to improve revenue and limit expenditure growth and include, on the revenue side, increases in fees for public services and royalties, measures to improve tax administration and tax compliance. On the expenditure side, measures focus on containing wages and on civil service efficiency, a ceiling on and reduction of defence outlays, (agricultural) subsidies and other current transfers, and the introduction of a multi-year fiscal framework with pre-specified spending restraints for each ministry.

3.4. Recent debt developments and prospects

The debt-to-GDP ratio remains above the 60% of GDP Treaty reference value. The debt dynamics in the period 1998-2003 were mostly driven by an inadequate level of primary surpluses, given the interest burden and adverse stock-flow adjustments. At the same time the increases in nominal GDP provided a counterweight that mitigated pressure toward increasing debt ratios. As regards stock-flow adjustments, no major privatisations have taken place but the relatively sizeable adjustments for 2000, 2001 and 2003 are largely linked to a reclassification of sinking funds previously excluded from the calculation of gross general government debt. For 2004 the debt ratio is projected to increase somewhat further to just below 75% of GDP.

Table 5: Debt dynamics

	1998	1999	2000	2001	2002	2003	2004	2005
Government gross debt	61.6	62.0	61.7	64.4	67.1	72.2	74.6	76.9
Change in debt ratio (1= -2+3+6)	-	0.4	-0.4	2.7	2.7	5.1	2.3	2.3
Primary balance (2) [a]	-1.1	-1.4	1.1	1.2	-1.3	-3.0	-	-
Snow-ball effect (3=4+5) [a]	-	-0.9	-2.0	-0.1	0.0	-1.4	-	-
Interest expenditure (4) [a]	3.2	3.2	3.5	3.6	3.2	3.3	-	-
Contribution of nominal GDP growth (5)	-	-4.1	-5.5	-3.7	-3.2	-4.7	-4.0	-4.6
Stock-flow adjustment (6)	-	-0.1	2.7	4.1	1.4	3.6	1.8	2.8

[a] Data problems preclude calculation for 2004 and 2005

Source: Eurostat and Commission Spring 2004 forecasts.

4. OTHER RELEVANT FACTORS

4.1. Medium term prospects

According to the 2003 PEP, the government planned to reduce the general government deficit to below the Treaty reference value of 3% of GDP by 2006, with deficits in 2005 and 2006 at 2.8% and 2.2% of GDP, respectively. However, following the budgetary slippage in 2003, a March 2004 update of the Ministry of Finance reset the target deficit for 2005 at 3.8% of GDP (no new target for 2006 was given).

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". From 2002, the general government deficit of Cyprus consistently exceeded general government gross fixed capital formation which hovered around 3.1% of GDP in 2000-02 before rising to 3.8% in 2003 (see table 3). This compares to an EU-15 average of 2.3% of GDP for the same period, and 2.4% of GDP for 2003. This positive - albeit still relatively small - difference in investment rates is consistent with the public investment needs linked to the catching-up process of the Cyprus economy.

4.3. External account

In the period 1998-2003 Cyprus registered external account[3] deficits averaging just under 5% of GDP, reaching 5.4% and 4.3% of GDP in 2002 and 2003, respectively. The surpluses of the service balance of between 20-25% of GDP provided by tourism, offshore business and other services, were more than offset by trade balance deficits of around 25-30% of GDP. Notwithstanding fiscal consolidation efforts and vigorous growth in tourism until 2002-2003, there has been no clear narrowing of the external account deficit over time. Both fiscal slippage and private sector dis-saving have prevented the external account deficit from declining, the latter notably in 1998 and 2000. In 2003, despite an increased general government deficit, the external account deficit fell slightly to 4.3% of GDP, although this was also linked to lower imports of defence equipment. Inward foreign direct investment (FDI) has increased to 4.5% of GDP in 2002 as capital liberalisation progressed, but has been largely balanced by outward investment. The widening of the external account deficit in 2002-2003 is also linked to a slight loss in price competitiveness. The Commission Spring forecast projects a slightly declining external account deficit to 3.3% of GDP by 2005. This reflects a recovery in tourism and reduced import demand stemming partly from fiscal consolidation and a number of *ad hoc* factors such as further reduction in defence equipment imports and positive spill-over from the 2004 Olympic Games in Athens.

5. CONCLUSIONS

Cyprus's general government deficit increased to 6.3% of GDP in 2003. Although budgetary developments have been adversely affected by recent weakness in economic activity, the excess of the general government deficit over the 3% of GDP reference value does not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Cyprus authorities, nor is it the result of a severe economic downturn.

According to the Commission Spring 2004 forecasts as well as the Cyprus authorities, in 2004 the general government deficit will, at around 4.5% of GDP, be well above 3% of GDP. The debt-to-GDP ratio is forecast to increase by 2.3 percentage points to 74.6% of GDP in 2004, further above the 60% of GDP Treaty reference value.

[3] Net lending/ borrowing vis-à-vis the rest of the world = current account + capital account. In the current system of national accounts, this is what corresponds to the concept of the "balances of payments on current account" mentioned in Article 121(1) of the Treaty.