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REPORT FROM THE COMMISSION

Cyprus

Report prepared in accordance with Article 126(3) of the Treaty

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1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the “excessive deficit procedure” (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an “excessive deficit” is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Cyprus and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 126(3) of the Treaty on the Functioning of the European Union (TFEU).

Article 126 TFEU lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) 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); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "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".

Immediately following its accession to the EU in May 2004, an EDP for Cyprus was initiated by the Commission[2] with the adoption of a report under Article 104(3) of Treaty Establishing the European Community (TEC) in view of a deficit of 6.3% of GDP in 2003, i.e. above the reference value of 3% of GDP. In July 2004, following recommendations from the Commission, the Council decided, in accordance with Article 104(6) TEC, that an excessive deficit existed in Cyprus and addressed a recommendation in accordance with Article 104(7) TEC to Cyprus with a view to bringing the excessive deficit situation to an end as rapidly as possible and by 2005 at the latest. In July 2006, following an overall assessment which showed that the deficit was reduced to 2.4% of GDP in 2005, the Council decided to abrogate its decision on the existence of an excessive deficit under Article 104(12) TEC.

According to data notified by the authorities in March 2010[3] and subsequently validated by Eurostat[4] the general government deficit in Cyprus reached 6.1% of GDP in 2009, thus exceeding the 3% of GDP reference value, while general government gross debt stood at 56.2% of GDP, below the 60% of GDP reference value but on a rising trend.

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1 OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 10 November 2009, available at http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm.

2 Documents related to the excessive deficit procedure for Cyprus are available at: http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm

3 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Cyprus can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables

4 Eurostat news release No 55/2010 of 22 April 2010.

Table 1: General government deficit and debt [a]

	2005	2006	2007	2008	2009	2010		2011	
						COM	CY	COM	CY
General government balance	-2.4	-1.2	3.4	0.9	-6.1	-7.1	-6.0	-7.7	-4.5
General government gross debt	69.1	64.6	58.3	48.4	56.2	62.3	61.0	67.6	63.2

Note:
[a] In percent of GDP.
Source: Eurostat, Commission services' spring 2010 forecasts and Stability Programme of Cyprus 2009-2013.

The figure for the 2009 deficit provides *prima facie* evidence on the existence of an excessive deficit in Cyprus in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Cyprus with the adoption of this report. Section 3 of the report examines the deficit criterion and section 4 the debt criterion. Section 5 deals with public investment and other relevant factors.

This report takes into account the Commission services' spring 2010 forecast, released on 5 May.

3. DEFICIT CRITERION

In 2009, the general government deficit reached 6.1% of GDP. Well in excess of 3% of GDP, the deficit is not close to the Treaty reference value.

The excess over the 3% of GDP reference value is exceptional. In particular, it does result from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to data published by the statistical service of Cyprus, real GDP contracted in the year 2009 by 1.7%. An adverse external environment, as a consequence of the financial crisis and the global downturn – in particular, the worsening growth outlook of the key trading partners (euro area, UK and Russia)- and weak domestic demand weighed strongly on growth in 2009. In particular, exports of both goods and services declined due to lower external demand and a weak performance of tourism. Shipping services also declined with the collapse of world trade. Investment recorded a strong correction, amidst a fall in foreign demand for housing, low capacity utilisation and the restructuring of corporate balance sheets. In parallel, high household indebtedness together with tight lending conditions, a worsening labour market and negative confidence effects led to a decline in private consumption. Government consumption was the only demand component supporting economic activity.

Table 2: Macroeconomic and budgetary developments [a]

	2005	2006	2007	2008	2009	2010		2011	
						COM	CY[3]	COM	CY[3]
Real GDP (% change)	3.9	4.1	5.1	3.6	-1.7	-0.4	0.5	1.3	1.5
Potential GDP (% change)	3.9	3.3	2.9	2.6	2.2	1.1	2.8	0.7	2.8
Output gap (% of potential GDP)	-0.6	0.2	2.4	3.4	-0.7	-2.1	-2.4	-1.6	-2.5
General government balance	-2.4	-1.2	3.4	0.9	-6.1	-7.1	-6.0[4]	-7.7	-4.5
Primary balance	1.1	2.1	6.4	3.7	-3.6	-4.4	-3.7	-4.8	-2.1
One-off and other temporary measures	0.9	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1
Government gross fixed capital formation	3.1	3.0	2.9	3.0	4.1	4.1	4.1	4.1	4.1
Cyclically-adjusted balance	-2.2	-1.3	2.5	-0.4	-5.8	-6.3	-5.2	-7.1	-3.6
Cyclically-adjusted primary balance	1.3	2.0	5.5	2.4	-3.3	-3.6	-2.8	-4.2	-1.1
Structural balance [b]	-3.1	-1.3	2.5	-0.4	-5.8	-6.3	-5.2	-7.1	-3.6
Structural primary balance	0.5	2.0	5.5	2.4	-3.3	-3.6	-2.9	-4.2	-1.2

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.
[3] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.
[4] For 2010, the updated Stability Programme of Cyprus reported a planned deficit of 6.0% of GDP compared to 6.2% of GDP included in the March 2010 EDP notification.

Source: Eurostat, Commission services' spring 2010 forecasts and Stability Programme of Cyprus 2009-2013.

The excess over the 3% of GDP reference value is not temporary in the sense of the Treaty and the Stability and Growth Pact. The budgetary forecasts as provided by the Commission services indicate that the budgetary deficit would reach about 7% of GDP in 2010, on the basis of a macroeconomic scenario that is significantly less favourable than projected in the April 2010 update of the Stability Programme. This projection includes adopted or legislated measures. Potential extra-budgetary measures still under discussion with uncertain or no information on their modalities and timing of implementation, are not taken into account. For 2011, based on the customary no-policy-change scenario assumption[5], the deficit is forecast to increase further to about 7¾% of GDP.

In sum, the deficit is not close to the 3% of GDP reference value. While the planned excess over the reference value is exceptional, it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. DEBT CRITERION

During the period 2004 and 2008, the general government gross debt ratio declined by over 20 percentage points to 48.4% in 2008, well below the 60% Treaty reference value. The reduction of debt commenced in 2005 but accelerated in the subsequent years. The declining trend was mainly driven by favourable cyclical conditions on the back of high economic growth and substantial primary surpluses. Moreover, a significant debt-reducing stock-flow

[5] The no-policy change forecast takes into account the (partial) withdrawal of measures of extraordinary nature linked to the crisis.

adjustment took place in 2008, associated to the depletion of the sinking fund deposits held in the Central Bank, leading the decline of debt to 48.4% of GDP.

Table 3: Debt dynamics [a]

	2004	2005	2006	2007	2008	2009	2010		2011	
							COM	CY	COM	CY
Government gross debt ratio	70.2	69.1	64.6	58.3	48.4	56.2	62.3	61.0	67.3	63.2
Change in debt ratio [b] (1 = 2+3+4)	1.3	-1.1	-4.4	-6.3	-9.9	7.8	6.1	4.8	6.3	2.2
Contributions:										
• Primary balance (2)	0.8	-1.1	-2.1	-6.4	-3.7	7.7	8.5	3.7	9.6	2.1
• “Snowball” effect (3)	-1.5	*-0.6*	*-1.3*	*-2.7*	*-1.7*	*-0.8*	*-2.3*	*1.1*	-3.1	*0.4*
of which:										
Interest expenditure	3.3	*3.5*	*3.3*	*3.0*	*2.8*	*-1.6*	*-1.4*	*2.3*	-0.7	*2.4*
Real GDP growth	-2.7	*-2.6*	*-2.7*	*-3.0*	*-1.9*	*0.9*	*0.2*	*-0.3*	-0.8	*-0.9*
Inflation (GDP deflator)	-2.1	*-1.6*	*-1.9*	*-2.7*	*-2.6*	*0.0*	*-1.2*	*-0.9*	-1.6	*-1.2*
• Stock-flow adjustment (4)	2.0	0.7	-1.0	2.9	-4.4	0.9	-0.1	0.0	-0.2	-0.2

Notes:
[a] In percent of GDP.
[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where *t* is a time subscript; *D*, *PD*, *Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: Eurostat and Commission services’ spring 2010 forecasts.

However, in 2009, the general government gross debt increased again to 56.2% of GDP. This increase of 7¾ percentage points of GDP was mainly the result of the significant deterioration in the primary balance and debt-increasing "snowball" effects on the back of falling nominal GDP. Stock-flow adjustments also had a negative contribution to the debt level equivalent to about 1 percentage point of GDP, due to accumulation of government assets at the end of the year in order to meet debt maturity obligations arising early in January of 2010, as well as, differences between cash and accruals. For 2010, Cyprus notified a planned debt of 62% of GDP, thus exceeding 60% of GDP Treaty reference value. The April 2010 stability programme plans a slightly lower figure (61%) and foresees a further increase to 63.2% of GDP in 2011.

The Commission services spring 2010 forecasts project debt to rise further to 62.3% of GDP in 2010 and 67.6% in 2011on the back of a deteriorated primary balance.

In view of these trends, the debt ratio cannot be considered as “sufficiently diminishing and approaching the reference value at a satisfactory pace” in the sense of the Treaty and the Stability and Growth Pact.

This analysis suggests that the debt criterion in the Treaty is not fulfilled.

5. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report “shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State”. These factors are further clarified in Article 2(3) of Council Regulation

(EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; [and] (4) other factors considered relevant by the Commission.

5.1. Medium-term economic position

Cyclical conditions and potential growth. According to provisional estimates released by the Cypriot Statistical Service, the Gross Domestic Product (GDP) of Cyprus appears to have contracted by 1.7% in real terms in 2009. This is the first time economic activity in Cyprus recorded a negative growth rate in the last 35 years. The Commission services' spring 2010 forecast projects a further shrinking, although to a lesser extent, of the economy in 2010 with activity projected to decline by almost ½%. Subdued private consumption and investment in tandem with sluggish demand from Cyprus' main trading partners weigh on growth. This is followed by a moderate recovery of real GDP by 1¼% in 2011 on the back of an improving outlook of domestic demand concurrently with a rebound in world trade and the positive effects of the fiscal stimulus measures. Cyclical conditions showed a rapid widening of the positive output gap since 2006 and a sharp reversal in 2009, with the output gap turning strongly negative in 2009 and 2010. In 2009, the Cypriot economy was clearly below its potential, with an estimated output gap of -0.7 percentage points. The Commission services' spring 2010 forecast project a further widening of the output gap to –2.1%, reflecting a decrease in labour contribution and lower capital accumulation as a result of a drop in investment.

Recent structural reforms. At microeconomic policy level, the revised National Reform Programme 2008-2010 (NRP) aims at unlocking the business potential through enhancement of competition and entrepreneurship as well as investing in knowledge and innovation in order to boost Cyprus' attractiveness as business location for both investors and the labour force. Given the low levels of private investment on R&D, due to the small size and services-orientation of the economy, the government introduced a series of measures to encourage stronger industry participation. Given the de facto limitations though, the government has reinforced the role of the Research Promotion Foundation and invests more on the promotion of innovation. Cyprus being heavily dependant on imported oil for its energy supply and having a small and isolated island system has set energy efficiency as a top priority alongside addressing climate change. For this purpose, an energy centre that would enable the importation of natural gas to the island is under construction and expected to commence its operation by 2013. Regarding measures to further improve labour market performance, the educational reform is progressing with initiatives in primary, secondary, and tertiary education as well as the preparation of the new apprenticeship scheme. However, the gender pay gap remains high. So do also gender gaps in employment and unemployment. Furthermore, the action plan for the integration of migrants in the Cypriot society is still in the preparatory phase.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. During the period 2005-2009, the Cypriot economy made significant progress in consolidating public finances in conditions of good economic times, supported by an asset boom and buoyant tax receipts partly owing to tax-rich composition of growth. From a deficit of 2.4% of GDP in 2005 the government balance turned into a surplus of almost 1% of GDP in 2008, after reaching a surplus of 3.4% in 2007. In parallel, the debt ratio declined from 69.1% of GDP down to 48.4%. This was contemporaneous to a continued improvement in the structural balance (i.e., the cyclically-adjusted balance net of one-off and other temporary measures)[6] from a deficit of around 3% of GDP in the year 2005 to a surplus of 2½% of GDP in 2007, well above the MTO (of a balanced budget in structural terms). However, already in 2008 (which was still characterised by economic good times), the structural balance decreased to a deficit of ½% of GDP, implying a procyclical fiscal policy. In 2009 the structural balance further deteriorated markedly to a deficit of almost 6% of GDP. This was the result of not only a number of discretionary measures in response to the economic downturn (in line with the EERP) but also of rather large composition effects on account of a much less tax-rich GDP growth pattern. According to the Commission services' spring 2010 forecast, the fiscal stance is expected to deteriorate further in 2010 and 2011 with the structural deficit projected to rise to 6¼ % of GDP in 2010 and, based on the assumption of unchanged policies, to increase even further to about 7% of GDP in 2011.

Public investment. Government investment has been relatively constant in terms of GDP at about 3½% between 2005 and 2008. In 2009, the government investment-to-GDP ratio increased by 1¼ percentage points, reaching almost 5% of GDP, reflecting the discretionary fiscal stimulus package in response to the EERP. According to the Commission services' spring 2010 forecast, in 2010 and 2011, the public investment ratio is expected to remain at similar levels because of the continuation of infrastructure projects. In both years, the general government deficit ratio in both headline and structural terms would exceed the government investment-to- GDP ratio.

Quality of public finances. Between 2003, when the deficit reached the peak of the decade at 6.5% of GDP, and 2008, Cyprus implemented a fiscal adjustment of about 7½ pp of GDP. Consolidation has been mainly revenue-driven, 5% of GDP, on the back of sizeable deficit-reducing one-offs, especially between 2003 and 2005. However, the tax amnesty launched during those years, together with improvements in tax administration, might have led to a broadening of the tax bases and, thus, to a permanent increase of tax revenues. On the expenditure side, general government expenditure has fallen from 45% of GDP in 2003 to 42½% in 2008. In particular, current primary expenditure declined by 1¼ percentage points. Nevertheless, in 2009 expenditure increased by about 3¾ percentage points of GDP, partly due to measures in response to the economic and financial crisis and additional expenditure due to automatic stabilisers. As a result, public investment increase by about 1 percentage point of GDP while social payments also increased by 1¾ percentage points due to social cohesion measures in line with objectives of the National Reform Programme. In the recent past, Cyprus' budgetary framework has been improved with the adoption of the Financial Management Accounting System (FIMAS). As from 2006, Cyprus also enacted the gradual adoption of a 3-year medium term budgetary framework (MTBF) and as from 2007 it introduced a Programme and Performance Budgeting (PPB). Nevertheless, the new framework is still phasing in and it is only foreseen to be fully in place in 2012. The hitherto practice of adopting supplementary budgets during the course of the year, has implied an increase in current expenditure beyond the intended reallocation of funds. Once the new budgeting framework is fully implemented, it is expected to cease this practise and lead to a more effective and efficient budgeting process, contributing to contain expenditure by

[6] Estimated by the Commission services on the basis of the commonly agreed methodology on estimating output gaps.

ministry according to the ceilings set. At the same time, the new budgeting process would set a sound basis for reallocating expenditure in favour of growth enhancing activities consistent with the priorities set by the National Reform Programme.

Long-term sustainability of public finances. The long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades partly due to the fact that the pension scheme is still in a maturing phase. The programme introduces a recently adopted pension reform that is projected to reduce the increase in pension expenditure. In view of the projected impact of ageing on government expenditure, the Council invited Cyprus to "strengthen the long-term sustainability of public finances by pursuing the reform of the pension and healthcare systems". The assessment of long-term sustainability has not changed since the adoption of the Council opinion.

5.3. Other factors put forward by the Member State

In a letter of 27 April 2010, the authorities of Cyprus listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities.

5.4. Other factors considered relevant by the Commission

Recent public finance developments in Cyprus were also influenced by the following factors in the area of budgetary institutions and procedures. As a response to the economic crisis, Cyprus has adopted some fiscal stimulus and structural measures in line with the European Economic Recovery Plan (EERP). The overall impact of the total of recovery measures is estimated to have been about 2¼% of GDP in 2009 and almost 2% in 2010, excluding the impact of the pension reform. Of these, about three fourths are temporary measures, which at their expiry will automatically reduce government expenditure.

As regards financial markets, the Cypriot government has not adopted any specific package to stabilise the financial sector. However, the Government issued treasury bills in early January 2009, with maturity December 2009, for refinancing its short-term (cash flow) needs and for increasing the liquidity conditions in the banking system. The total value is of the order of almost 8% of GDP, of which about one half has been deposited in banks and credit institutions.

In its opinion of 27 April 2009 on the previous update of the Stability Programme, the Council considered that the expansionary fiscal measures were in line with the EERP. However, against the background of a sharp deterioration in the global economic environment, the budgetary strategy was subject to significant downside risks, with the growth assumptions underlying the macroeconomic scenario of the programme being favourable. In the light of the high external imbalances, maintaining prudent policies and strengthening fiscal sustainability should be a major priority. In particular, controlling current expenditure represented a major challenge for the fiscal policy in Cyprus while fostering the quality of public finances was also important with a view to underpinning a smooth adjustment of the economy in the light of the imbalances it is faced with.

Therefore, the Council invited Cyprus to (i) implement the measures in line with the EERP as planned, while avoiding further deterioration of public finances in 2009 compared to the target; (ii) reverse the projected fiscal loosening in 2010 and beyond, by restraining expenditures in order to ensure a sound fiscal position in the medium term; (iii) in view of the ongoing fiscal deterioration and of the projected impact of ageing on government expenditure, improve the long-term sustainability of public finances by pursuing the reform of the pension and health care systems.

6. CONCLUSIONS

According to the April 2010 EDP notification the general government deficit in Cyprus reached 6.1% of GDP in 2009, above and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. However, it cannot be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains below the 60% of GDP reference value in 2009. However it is on a rising trend and it is planned to exceed the reference value in 2010. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. This suggests that the debt criterion in the Treaty is not fulfilled.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.