



REPUBLIC OF CYPRUS

MINISTRY OF FINANCE

Minister's Office

27 October, 2016

Valdis Dombrovskis
Vice-President
European Commission

Pierre Moscovici
Member
European Commission

Dear Valdis, Dear Pierre,

I would like to thank you for your letter dated 25.10.2016, regarding the European Commission's preliminary assessment of Cyprus' Draft Budgetary Plan (DBP) for 2017. This is the first DBP to be submitted by our government, following the completion of Cyprus' macroeconomic adjustment programme earlier this year.

Allow me to point out that during the programme period Cyprus achieved a sizeable fiscal consolidation, which has been sustained for a number of consecutive years. More specifically, a nominal budget deficit of -4.9% of GDP in 2013, was brought down to -0.2%¹ in 2014 and 2015. For 2016, the estimate is for a similar nominal budget deficit of -0.3% of GDP.

Consequently, the primary balance has been in surplus since 2014. In fact, Cyprus, has been the top-performer amongst EU member-states for 2014 and 2015, with a primary surplus of 2.6% of GDP. Cyprus is expected to continue being the EU top-performer in 2016, with an estimated primary surplus of 2.3% of GDP.

These fiscal outcomes represent a continuous over-performance on the programme targets, which cannot be attributed to a better than anticipated macroeconomic environment, since economic growth in nominal terms broadly matched the

¹ Excluding the one-off recapitalization of the Co-operative Credit Institutions.

anticipated forecast. In fact, it shows the significant effort and determination exerted by the Cyprus authorities resulting in the formulation and execution of a prudent fiscal policy which, among others, included a frontloaded reduction of public expenditure by 14½% cumulatively in 2012-2014.

This accentuated a deviation between the Commission's original fiscal forecasts and the actual outcomes. Characteristically, the Commission Services' forecast for 2015 was for a general government deficit of the order of 5.7%² of GDP, deviating from the actual result by 5.5 percentage points.

The prudent fiscal stance is clearly maintained also for 2017, with the nominal budget balance projected at -0.6% of the GDP and maintaining a satisfactory primary surplus at 2.0% of the GDP, which will allow Cyprus to remain among the fiscal top-performers for yet another year. It is clear from the above that there is no deviation from a prudent fiscal stance, despite the abolition of the immovable property tax (IPT) and the termination of the tax on public and private sector wages, which together amount to 0.7% of the GDP. In any case, the latter is taking place within the timeframe originally agreed with programme partners, whilst it should be noted that overall tax revenues associated with the property market are enhanced by the apparent improvement in the market. It should also be pointed out that, the 2017 Budget Bill extends the freeze on public sector hiring for yet another year, going beyond programme obligations, on the basis of legislation which has already been ratified by the House of Representatives.

As far as the structural balance is concerned, the Cyprus authorities estimate a structural balance of 0.4% of potential output in 2016 and -1.0% in 2017, based on the latest available output gap estimations of Spring 2016. These estimates come in stark contrast to the Commission's estimates of -0.1% and -2.0% of potential output respectively. The 2017 difference in the Commission's estimation vis-à-vis the authorities' projections cannot be explained by differences in real growth projections.

In accordance with the Commission's estimations, therefore, the structural balance is forecasted to deteriorate by 1.9 percent of potential GDP in 2017 relative to 2016. Having regard the change in the output gap of 2.3 percentage points of potential output between 2016 to 2017, as per Spring 2016 forecast, and the aforementioned deterioration in the structural balance, one can conclude that the nominal budget balance is assumed by the Commission Services to deteriorate by 3 percentage points of GDP in 2017, which does not seem to be plausible.

² European Commission Paper, "Assessment of the Public Debt Sustainability of Cyprus", 12 April 2013.

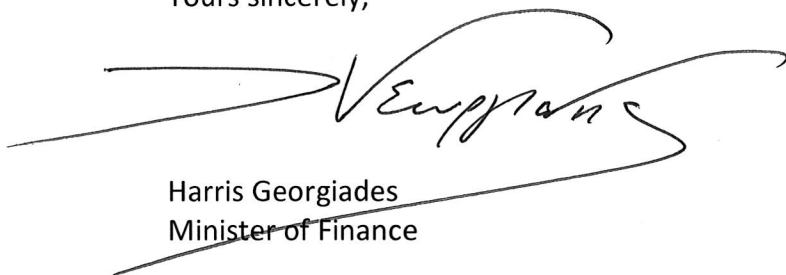
However, the above discussion is theoretical because the Commission's Spring 2016 output gap estimates cannot be considered, at this point, as acceptable for the assessment of Cyprus' DBP for 2017. As the Cyprus authorities have repeatedly pointed out, the structural balance analysis is based on the counterintuitive results of the common methodology which, indicate a positive output gap in 2017 of the order of 0.9% of potential output. This result is mainly driven by estimations of the NAWRU, projected at 12.8% in 2017, whereas the actual unemployment rate has declined to 12.5% already in 2016 and will decline further to 11.0% in 2017. Therefore, the Commission's estimates on the potential output and output gap for Cyprus essentially imply that the economy is overheating, something which cannot be economically justified by the fundamentals exhibited in the labour market and the capacity of the economy at large and may call into question the applicability of the common methodology for economies with V-shaped output paths.

The latest estimates of the Commission from the recent work undertaken in the Output Gap Working Group, indicate to some concrete weaknesses surrounding the current common output gap methodology. For Cyprus, especially, the new estimates using the NAWRU-anchored methodology lead to a significant alteration in the NAWRU, the potential output growth and the output gap itself, vis-à-vis the Spring 2016 results. The authorities' results based on the new methodology are more justified economically and point to a structural surplus of 1.0% of potential output in 2016 and a deficit of -0.2% in 2017, which is within the acceptable deviation range of 0.25 percentage points from the MTO according to the SGP rules.

In addition to the above, I would also like to bring to your attention the complete lack of transparency on the Commission's side with respect to the processes and calculations performed in order to arrive to the forecasts presented in your letter, which hampers the whole process of national ownership.

Concluding, I would like to reiterate our commitment to fiscal prudence and to achieving ambitious fiscal targets, as this was demonstrated in practice since 2014. On the other hand, it would indeed be very odd if Cyprus, a fiscal top-performer during the last few years, were to be penalized for its apparent fiscal over-performance, based on a skewed calculation of the output gap. Such a step would only serve to undermine the hard-won recovery of the Cyprus economy.

Yours sincerely,



Harris Georgiades
Minister of Finance