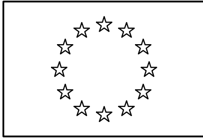

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 08 July 2004
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CONVERGENCE PROGRAMME OF CYPRUS

(2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The first Cypriot convergence programme covering the period 2004-2007 was submitted on 24 May 2004. The programme indicates the intention to adopt the euro by 2007 and for early participation in ERMII, and hence to meet the convergence criteria on deficit and debt as of 2005.

It should be noted at the outset that future economic developments in Cyprus remain subject to unusual uncertainty. In case of future reunification, the economic situation of the entire island would fundamentally shift. The convergence programme briefly discusses some of the outstanding complex issues surrounding the economic-institutional aspects of the Annan Plan for reunification and provides a brief assessment of the macroeconomic budgetary impact.

The programme largely complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[2].

The general government deficit increased to 6.3% of GDP in 2003, above the 3% of GDP Treaty reference value, while the debt ratio increased to 72.6% of GDP, above the 60% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Cyprus on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On 5 July 2004, the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in Cyprus and to make recommendations to Cyprus to bring this situation to an end.

The convergence programme provides the fiscal consolidation path and macro-economic scenario for the period 2004-2007. Projected GDP growth and inflation for 2004-2005 are close to the Commission Spring 2004 forecast. Medium term projected GDP growth is based on a rebound in exports (especially tourism, a mainstay of the economy) and a strengthening of domestic private demand. At 4.4% on average, forecast GDP growth appears plausible, also given historical growth rates and previous recoveries in tourism following international crisis.

Other than the projected scenario discussed above (the so-called "central scenario"), the programme contains three alternative scenarios for the macroeconomic and budgetary projections: an "upper" scenario, a "lower" scenario and a "higher interest rates" scenario, with different assumptions on average GDP growth (+- 0.5% points) and higher interest rates (+0.5% points). The programme projections given in the so-called "central" scenario is considered as the reference scenario for assessing budgetary projections

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[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001. The text model structure provided in Annex 2 of the Code of Conduct is not strictly adhered to in the Cyprus convergence programme text structure. The latter consists of four chapters instead of seven, combining elements of the model structure of Chapters 3, 5 and 7, and elements of Chapters 4 and 6. Also, the tables indicate only data on CPI inflation and not HICP inflation.

because, on the basis of currently available information, it seems to reflect plausible growth assumptions.

The spike in inflation from 2.8% in 2002 to 4.0% in 2003 was mainly due to one-off factors such as higher VAT rates related to harmonisation with the acquis. Despite a growth rebound from 2004 onward, inflationary pressures are expected to remain subdued with inflation projected to fall to 2% in 2004 and remain at such levels until 2007. The programme envisages keeping the current monetary policy framework of an ERMII-type peg to the euro in place until the eventual adoption of the euro.

The primary objectives of the fiscal consolidation programme are to reduce the general government deficit from a projected 5.2% of GDP in 2004 to 2.9% of GDP by 2005 and then below 2% of GDP by 2007; reach a strong improvement in the primary balance which would rise from a projected deficit of 1.6% of GDP in 2004 to a surplus of 2% of GDP by 2007; and to reverse significantly the upward trend of the debt-to-GDP ratio from 75.2% of GDP in 2004 to below 69% by the end of the programme period. Compared to the 2003 pre-accession economic programme (PEP), the fiscal consolidation path postpones the front-loaded adjustment from 2004 to 2005 and makes it larger. The deficit path for 2005-2006 would then be much in line with that set out in the PEP. To this end, the convergence programme envisages a series of mostly structural measures to contain expenditure, which is where most of the slippage occurred in past years, and to increase revenue. Revenues and expenditures contribute in broadly equal measure to the overall deficit reduction by almost 5 percentage points of GDP over the period 2004-2007.

The adjustment path presented in the programme reflects the government commitment to improve public finances with the intention to adopt the euro by 2007; this is the main factor behind the strong frontloading of the fiscal adjustment to decrease the general government budget deficit by 2.3 percentage points of GDP in 2005. Given the size of this adjustment and the mixed record on fiscal consolidation of Cyprus, reducing the deficit below 3% of GDP by 2005 is a challenging target. The number of envisaged measures is relatively large, each measure with relatively small savings or revenues. This can be regarded as a form of ‘risk spreading’, yet to introduce many measures simultaneously might complicate implementation, both practically and politically. The convergence programme also notes that the government remains committed to take ‘additional measures if deemed necessary’ to reach the deficit targets. Following this strong adjustment, the adjustments that follow for 2006-7 are much smaller at about 0.6 percentage points annually, and hence should be relatively unproblematic to attain.

The programme indicates a peak in the debt-to-GDP ratio of 75.2% in 2004 which then turns downward to reach 68.4% of GDP by 2007. This strong decrease is mainly driven by increasingly positive primary balances and an annual nominal GDP growth above the average nominal interest rate on government debt in 2005-2007. As indicated, the underlying GDP growth scenario is not implausible but the projected debt-ratio path also depends on the rather ambitious front-loaded fiscal consolidation for 2005.

The programme briefly reviews the government’s structural reform programme which focuses on labour, product and capital market policies, as well as policies aiming at diversifying the Cypriot economy towards higher value added activities and a knowledge-based economy. It additionally notes, but does not further give any details on, the intention to improve public administration efficiency. However, no budgetary assessments are given for these policies (in the 2003 PEP, the indicated budgetary costs

of structural reforms were not significant, amounting to around 0.4% of GDP over the period 2003-2006). As the programme notes, these policies are mostly a continuation of the reform strategy outlined in previous pre-accession economic programmes, and the programme justifiably considers the various structural policies as interconnected and mutually supportive. Overall, therefore, the policies outlined in the programme in this area seem reasonable although the record has sometimes shown some delays in liberalisation, notably in some product markets.

Cyprus faces risks of budgetary imbalances in meeting the costs of an ageing population. While the health care system reform is to be implemented in 2006, measures to reform the pension scheme are only in the initial stage. A timely and effective implementation of such reforms, together with the others measures necessary to secure an adequate primary surplus is essential to put public finances on a sustainable footing.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	**2004**	**2005**	**2006**	**2007**
Real GDP (% change)	**CP**	**2.0**	**3.5**	**4.3**	**4.4**	**4.5**
	COM	2.0	3.4	4.1	n.a.	n.a.
	PEP	*2.0*	*4.0*	*4.6*	*4.6*	*n.a.*
CPI inflation (%)	**CP**	**4.1**	**2.0**	**2.0**	**2.0**	**2.0**
	COM	4.0	2.2	2.1	n.a.	n.a.
	PEP	*4.6*	*1.8*	*2.0*	*2.0*	*n.a.*
General government balance (% of GDP)	**CP**	**-6.3**	**-5.2**	**-2.9**	**-2.2**	**-1.6**
	COM	-6.3	-4.6	-4.1	n.a.	n.a.
	PEP	*-5.4*	*-3.7*	*-2.8*	*-2.2*	*n.a.*
Primary balance (% of GDP)	**CP**	**-3.0**	**-1.6**	**0.7**	**1.4**	**2.0**
	COM	-3.0	n.a.	n.a.	n.a.	n.a.
	PEP	*-0.4*	*1.2*	*2.0*	*2.5*	*n.a.*
Government gross debt (% of GDP)	**CP**	**72.6**	**75.2**	**74.8**	**71.5**	**68.4**
	COM	72.2	74.6	76.9	n.a.	n.a.
	PEP	*63.6*	*62.6*	*60.7*	*56.1*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. INTRODUCTION

Cyprus submitted its first convergence programme covering the period 2004 to 2007 on 24 May 2004. The programme was prepared by the Ministry of Finance and has been approved and adopted by the Cypriot Council of Ministers on May 21 2004. However, it was not possible to submit the programme to the House of Representatives prior to submission to the Commission. It incorporates measures taken in the 2004 budget and in the 2003 pre-accession economic programme (PEP), and adds further measures for a new fiscal consolidation programme.

The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[3]. Compared to the rather long 2003 PEP text the programme shows an improvement in concision and provides reasons for non-compliance or slippage of earlier commitments.

The aim of the convergence programme is to reduce the general government deficit to below 3% of GDP in 2005 (from 6.3% of GDP in 2003 and 5.2% of GDP in 2004) and below 2% of GDP by 2007. The nominal deficit target is thus envisaged to satisfy the reference value from 2005 onward. The programme plans to achieve this by creating a rising surplus in the primary balance attaining 2% of GDP by 2007. A further (linked) target is to reverse the upward trend of the debt to GDP ratio and put it on a 'distinct downward path', targeting a decline by almost 7 percentage points in 2004-2007 to below 69% by 2007. The envisaged fiscal adjustment is based both on containing public consumption expenditures and on improving revenue performance. With the frontloading of the fiscal adjustment in 2005, this fiscal path reflects the intention to enter the euro area by 2007. The government also commits to taking additional measures, if necessary, to achieve the fiscal targets in the programme.

It should also be noted that future economic developments in Cyprus remain subject to unusual uncertainty. In case of future reunification, the economic situation of the entire island would fundamentally shift. The convergence programme briefly discusses (in the main text and in Appendix III) some of the outstanding complex issues surrounding economic and institutional aspects of the Annan Plan, such as financial viability of, and coordination of economic policy among, the Constituent states and Federal state, and provides a brief assessment of the macroeconomic budgetary impact.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

Following real GDP growth of 4-5% in 1999-2001, growth fell to 2% in 2002-2003. For 2004 and 2005 the programme projects a pick-up to 3.5% and 4.3%, respectively, driven by domestic demand and supported by a rebound in external demand. These developments are in line with the Commission Spring 2004 Forecast. For 2006 and 2007,

[3] The text model structure provided in Annex 2 of the Code of Conduct is not strictly adhered to in the Cyprus convergence programme text structure. The latter consists of four chapters instead of seven, combining elements of the model structure of Chapters 3, 5 and 7, and elements of Chapters 4 and 6. Also, the tables indicate only data on CPI inflation and not HICP inflation.

the programme foresees a growth rate of 4.5%, which is not unreasonable given recent growth performance, an expected rebound to more 'normal' dynamism in tourism (a mainstay of the economy) also linked to higher growth in the EU, and a pick-up in private domestic demand in an environment of increased consumer and producer confidence. The external assumptions of the macroeconomic scenario are in line with the Commission Spring 2004 forecast.

Unemployment in Cyprus is very low at about 4% in 2004 and is expected to gradually inch down even further as growth strengthens again.

After peaking to 4% in 2003, inflation is foreseen to return to relatively low levels of about 2%, in line with the Commission forecast.

Other than the projected path discussed above (the 'central scenario'), the programme discusses three alternative macroeconomic scenarios, based on different assumptions on GDP growth ('lower' and 'upper' scenario) or interest rates ('higher interest rates') and carries out a sensitivity analysis of the fiscal consolidation path (central scenario). The differences between the alternative budgetary outcomes are relatively small. Given historical growth rates and earlier rebounds in tourism following international crises (such as the Gulf War in 1991), the macroeconomic forecast in the central scenario looks plausible and is therefore considered as the reference scenario for assessing budgetary projections.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	2.0	2.0	3.4	3.5	4.1	4.3	n.a.	4.4	n.a.	4.5
Contributions:										
- Final domestic demand	0.8	1.1	3.0	2.5	4.2	3.8	n.a.	4.1	n.a.	4.1
- Change in inventories	0.1	-0.2	-1.0	0.1	-0.4	-0.2	n.a.	-0.3	n.a.	-0.2
- External balance on g&s	1.1	1.1	1.3	0.9	0.2	0.5	n.a.	0.6	n.a.	0.6
Employment* (% change)	0.5	0.9	0.7	1.0	0.9	1.0	n.a.	2.0	n.a.	3.0
Unemployment rate** (%)	4.4	4.1	4.1	3.9	4.0	3.2	n.a.	3.1	n.a.	3.0
HICP inflation° (%)	4.0	4.1	2.2	2.0	2.1	2.0	n.a.	2.0	n.a.	2.0
GDP deflator (% change)	4.3	5.3	2.5	1.7	2.3	2.1	n.a.	1.9	n.a.	1.9
Current account°°(% of GDP)	-4.4	-4.4	-3.7	-4.4	-3.5	-	n.a.	-	n.a.	-

* For CP: National accounts definition ** For 2005-2007 CP: registered unemployment ° For Cyprus: CPI inflation °° CP: 'an average current account deficit of 3% is anticipated' for 2005-2007 (p.21)

<u>Sources</u>: *Convergence programme (CP); Commission services spring 2004 forecasts (COM)*

2.2. External accounts

In 2003, the current account recorded a deficit of 4.4% of GDP, down from 5.4% of GDP in the previous year, despite the continued fall in tourism arrivals. This lower deficit reflects lower import demand linked to restrained growth, a decline in military imports, the impact of one-off imports of aircraft in 2002, and an improvement in the terms of trade due to an appreciation in the nominal effective exchange rate changes. The current account deficit decreased despite the further increase in the general government deficit, suggesting an even stronger increase in the private sector savings-investment balance which will at least partly be linked to the decline in private sector investment.

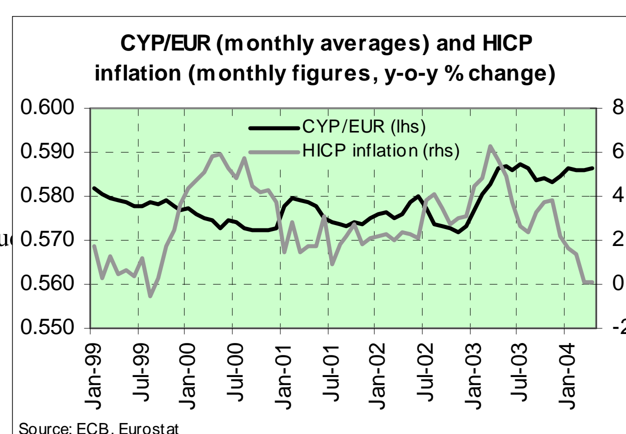
Although current account deficits are not bad *per se,* depending on the underlying cause, continuing current account deficits have been a weak spot in the economy. The current account deficit for 2004 is expected to remain at the 2003 level, reflecting a partial rebound in exports and imports with GDP growth still picking up, although demand will be moderated by fiscal consolidation. For 2005 and 2006 the current account is projected to decrease further to 3% of GDP, concurrently with the decreasing general government deficit which is only partially offset by a diminishing savings-investment balance as private sector investment picks up, increasing the investment ratio. At the same time, the expected rebound in export markets (including tourism) and the envisaged continuation of structural reforms supported by full capital account liberalisation are projected to increase competitiveness and boost export performance, especially that of services (e.g. telecommunication and business services). This scenario does not look unrealistic, albeit is perhaps somewhat optimistic. Similar projected paths have not been achieved with previous fiscal consolidation programmes as the latter started slipping. Also, historically such current account deficit levels would be relatively low[4]. Furthermore, the picture is not straightforward; not only fiscal slippage but also private sector dissaving has sometimes prevented the current account deficit from declining (e.g. in 1998 and especially 2000). On the other hand, financing the current account deficits has not been a problem so far. The liberalised capital account and structural reforms are expected to further help finance the current account deficit through non-debt flows, notably foreign direct investment (FDI) which has been increasing concomitantly with capital liberalisation, especially since 2002 when net inward FDI reached 3% of GDP. Notwithstanding the latter points, the necessity of reducing the current account deficit to more modest and manageable levels remains intact and can be taken as conditional on strict implementation of the fiscal consolidation programme.

Alternative scenarios for the current account developments and the underlying domestic savings-investment balances may be considered and more attention could perhaps be paid to the analysis of the composition of capital inflows, domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Monetary policy in Cyprus has historically been geared towards price stability, through a peg of the Cyprus pound (CYP) first to a basket of currencies, then to the ECU, and since 1999 to the euro, with a central rate of 1CYP = €1.7086. In August 2001, the euro/CYP fluctuation band of ±2.25 percent was widened to ±15 percent in the context of further liberalisation of the capital account. In practice, the CYP has remained close to its central parity and only exceptionally approached the stronger edge of the old narrow band. In nominal effective terms, the CYP has followed the movements of the euro against major currencies, which has led to a continuous effective appreciation in nominal and real terms since January 2001.

Prudent monetary policies, a stable exchange rate to the euro and moderate



[4] Current account deficits in Cyprus have tended to flu

real wage growth despite near full employment conditions resulted in relatively low HICP inflation averaging 2.7% for the period 1997-2001. The spike in inflation in 2002 and 2003 to 2.8% and 4.0% respectively (HICP annual average rate of change) was mainly due to one-off factors such as higher VAT and other indirect taxation changes related to harmonisation with the EU acquis. At the same time, subdued economic growth and the appreciation of the CYP in nominal effective terms led to an overall fall in import prices and exercised a dampening effect on inflation. Despite some rebound in economic activity in 2004, inflationary pressures are expected to remain subdued. With the impact of VAT and excise duty rate increases progressively fading out, CPI inflation is expected to fall to 2% in 2004 and remain at such levels until 2007.

The low inflation environment allowed the central bank to progressively cut policy rates and maintain an interest rate differential vis-à-vis the euro area between 100 and 200 basis points. Money market interest rates fell from some 6.5% at the beginning of 2001 to an average of 3.9% in 2003. In a move to pre-empt possible pressures on the foreign exchange market related to the completion of the capital account liberalisation process, the central bank increased policy rates by 100 points on 30 April, bringing the marginal lending facility rate to 5.5%. Long-term interest rates (yield on ten-year government bonds) have recently converged closer to euro area levels and averaged 4.7% or some 60 points above the euro area in 2003.

The convergence programme envisages keeping the current monetary policy framework in place until the eventual adoption of the euro. The authorities intend to enter the euro area as soon as possible, if possible in 2007, and accordingly foresee an early participation in ERM II.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

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 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 especially on the expenditure side and which aimed at reducing the deficit to 2.0% by 2002. This plan was relatively successful and contributed to lowering the budget deficit to 2.4% of GDP in 2000 and 2001, although some slippage started to occur already in 2001. The plan was revised and extended in 2001 and again in 2002, while fiscal consolidation once more went increasingly off-target, with the deficit reaching 4.6% of GDP in 2002 instead of a previously planned 2.6%. This slippage was linked to low growth especially due to adverse external conditions (notably in tourism) but also, much like on previous occasions, to government expenditure overruns such as unexpectedly high defence outlays and discretionary spending aimed to offset the economic downturn. At the same time, a staged tax reform started in mid-2002 to lower direct taxation and increase indirect taxation[5] which was estimated to have a neutral impact on public finances. This

[5] 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

package was not implemented as originally planned as a number of one-off measures were introduced, particularly in the form of compensatory current transfers, to compensate for increases in indirect taxes in order to secure broad political support. The programme estimates that the net impact of the tax reform increased the general government deficit in 2003 alone by about 1.5% of GDP.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**
General government balance	**-4.3**	**-4.5**	**-2.4**	**-2.4**	**-4.6**	**-6.3**
General government gross debt	61.6	62.0	61.7	64.4	67.1	72.2
Source: *Commission services*						

For 2003 the originally planned target for general government net borrowing provided in the 2002 PEP was 1.9% of GDP, with an expected GDP growth rate of 4.6%. However, the same factors that had led to an increase in the general government deficit in 2002 (an adverse external environment with lower GDP growth, increased government spending plus revenue shortfalls) entailed a widening of the deficit to 6.3% of GDP.

To counter this increasing slippage, and with the fiscal consolidation plan effectively abandoned, the government presented in August 2003 a new fiscal consolidation plan in the 2003 pre-accession economic programme. Most of the projected fiscal adjustment in the PEP came from the expenditure side; however, this implied strict control of spending, which was not fully implemented.

On the revenue side, the general government revenue-to-GDP ratio reached 38.5%, or 2.9 percentage points above targeted levels. Nevertheless, lower growth and tax evasion limited total revenue expansion. Total revenue increased mainly through expansion in 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, mainly due to the reduction in the highest personal tax rate as well as the introduction of a (lower) uniform corporate tax rate of 10%.

At the same time, the general government expenditure-to-GDP ratio jumped by 4.7 percentage points to 44.8%, or 3.7 percentage points above planned levels. A main item accounting for the rapid rise in expenditure was the growth in government wages, a result of the 7.5% increase in basic salaries granted in 2003 and also covering increases back paid for 2001 and 2002. Expenditure growth also resulted from the introduction of compensating social expenditure measures, in order to alleviate the negative effects of the tax reform. At the same time, capital expenditure expanded rapidly to 3.8% of GDP as part of an expansionary fiscal policy aiming to counteract the economic slowdown.

4.2. Programme overview

The general government deficit for 2004 is projected to decrease to 5.2% of GDP, still well above of the original target set the 2003 PEP of 3.7% of GDP (see table 4). The objectives of the new fiscal consolidation programme include a reduction of the general government deficit to below 3% of GDP by 2005, with a further and more gradual

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wealth taxes, and abolition of the defence fund levies. For a detailed overview, see Appendix II of the convergence programme.

reduction to below 2% of GDP by 2007, and to achieve an improvement in the primary balance from -1.6% of GDP in 2004 to +2% of GDP by 2007. Concomitantly with the budget deficit reduction, the programme aims to set the gross debt ratio on a distinctly downward path. Compared to the 2003 PEP, the convergence programme postpones the front-loaded adjustment from 2004 to 2005 and makes it larger, while deficit targets for 2005-2006 are much in line with those set out in the PEP.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
			General government balance		
CP	**-6.3**	**-5.2**	**-2.9**	**-2.2**	**-1.6**
COM	-6.3	-4.6	-4.1	n.a.	n.a.
PEP	*-5.4*	*-3.7*	*-2.8*	*-2.2*	*n.a.*
			General government expenditure		
CP	**44.8**	**44.6**	**43.3**	**42.9**	**42.5**
COM	43.8	42.5	42.1	n.a.	n.a.
PEP	*42.7*	*41.5*	*41.1*	*40.7*	*n.a.*
			General government revenues		
CP	**38.5**	**39.4**	**40.4**	**40.7**	**40.9**
COM	37.6	37.9	37.9	n.a.	n.a.
PEP	*37.3*	*37.8*	*38.3*	*38.5*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

The overall objective of the fiscal consolidation programme is to reduce the general government deficit by 4.7 percentage points over the period 2004-2007. The programme allocates this deficit reduction almost equally to expenditure control, which is where historically most of the slippage occurred, and revenue enhancement. The proposed path reflects the clear and explicitly stated government commitment to improve public finances with the intention to adopt the euro by 2007. This is the main factor behind the strong frontloading of the fiscal adjustment already in 2005, when the general government deficit, as noted, is to be reduced by 2.3 percentage points to 2.9% of GDP or just under the 3% Treaty reference value for the deficit. The deficits for 2006 and 2007 are then targeted for a much slower pace of reduction, at 0.7 and 0.6 percentage points, respectively.

The programme also compares the targeted general government deficit path including the quantitative impact of expenditure and revenue measures with a ‘trend’ (or unchanged) policy deficit path. This comparison gives an aggregate revenue and expenditure ‘adjustment’ of 6.9 percentage points of GDP over the period 2004-2007, spread over the various expenditure and revenue measures described below[6].

Regarding expenditures, the major objective is to keep public expenditure growth below that of nominal GDP; the measures aim to reduce expenditure as a percentage of GDP by 2.3 percentage points to 42.5% of GDP, mainly through the reduction of public consumption. Most of the measures are structural and implemented from 2005 onward.

[6] See Appendix I table 8 for an overview.

They include the introduction of overall annual ceilings for expenditure increases over the medium term; a freeze in government employment and wages, containment of current transfers and subsidies, and, by way of structural measures that also address pension and social security system reform, phased increases in the retirement age of public sector employees. It should also be noted that general government gross fixed capital formation investment is not affected by these measures but targeted to remain at 3.8% of GDP throughout the period.

On the revenue side, the programme aims at an increase of revenues by 2.4 percentage points to 40.9% of GDP by 2007, mainly through higher tax revenues. Again, most of the measures again are structural and implemented from 2005 onward. These refer to modification of legislation on title deeds on buildings erected with minor irregularities, approval of pending legislation on bank secrecy and tax amnesty and measures to increase tax collection efficiency.

The programme objective to reduce the general government deficit by 4.7 percentage points over the period 2004-2007 is ambitious but does not appear unachievable within this time frame, also given as the reasonable growth assumptions, which imply returning close to potential GDP growth rates by 2005, and the strong political commitment to reach the deficit reduction targets as noted in the programme. However, the test lies especially in the projected adjustment for 2005. Given the size of this adjustment in 2005 and the mixed record on fiscal consolidation of Cyprus, achieving the projected deficit reduction that year is a challenging target. It therefore remains to be shown by the Cypriot authorities whether these envisaged measures would be sufficient although the convergence programme also states that the government will take 'additional measures if deemed necessary' to reach the general government deficit targets. This commitment, and the frontloading itself, clearly show the determination of the authorities to stick to these targets. Nevertheless, it remains to be seen whether such (additional) measures will indeed be taken under perhaps more challenging economic circumstances.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	**2004**	**2005**	**2006**	**2007**	**Change: 2007-2003**
Revenues	38.5.	39.4	40.4	40.7	40.9	**2.4**
of which:						
- Taxes & social security contributions	34.5	35.3	35.9	36.2	36.3	**1.8**
- Other (residual)	3.7	3.8	4.2	4.2	4.2	**0.6**
Expenditure	44.8	44.6	43.3	42.9	42.5	**-2.3**
of which:						
- Primary expenditure	41.5	41.0	39.7	39.3	38.9	**-2.6**
of which:						
Gross fixed capital formation	3.8	3.8	3.8	3.8	3.8	**0.0**
Collective consumption	11.1	9.3	9.1	9.0	8.9	**-2.2**
Transfers & subsidies(incl. in kind)	20.7	22.3	21.3	21.2	21.0	**0.3**
Other (residual)	5.9	5.6	5.5	5.3	5.2	**-0.7**
- Interest payments	3.3	3.6	3.6	3.6	3.6	**0.3**
Budget balance	**-6.3**	**-5.2**	**-2.9**	**-2.2**	**-1.6**	**4.7**
Primary balance	**-3.0**	**-1.6**	**0.7**	**1.4**	**2.0**	**5.0**

Sources:
Convergence programme; ECFIN calculations

4.3. Targets and adjustment in 2004

For 2004, the government budget as approved by parliament in January 2004 foresaw a central deficit of 3.7% of GDP, equal to the target in the 2003 PEP set for the general government deficit. In March 2004 the Ministry of Finance revised its forecast of the central deficit upward to 4.1% of GDP, while for general government the deficit was now set at 4.3% of GDP. The Commission 2004 Spring forecast projected a slightly higher deficit of 4.6% of GDP. The convergence programme however now targets the deficit at 5.2% of GDP. The major factors behind this divergence are the slightly lower GDP growth (3.5% in the convergence programme against 4.0% in the PEP), ongoing adverse effects of the compensating expenditure measures introduced in the context of the tax reform as well as continuing discretionary public expenditures increases. Given that growth assumptions, in line with the Commission forecast, appear realistic and that the programme introduces additional corrective budgetary measures compared to the 2003 PEP, this target should be attained. The deficit reduction by 1.1 percentage points goes in the right direction even though it is not very ambitious, with most of the adjustment postponed to 2005.

The revised fiscal consolidation programme presented in the 2003 PEP formed the basis for the 2004 budget. Targets specified for general government net borrowing in 2004 were accompanied by measures to improve revenue and limit expenditure growth. These included, on revenue, increases in fees for public services and royalties, and measures to improve tax administration and tax compliance. On expenditure, a multi-year fiscal framework will gradually be implemented with pre-specified spending limits for each ministry; measures to contain wages and increase civil service efficiency; and a ceiling on, or reduction of, defence outlays, (agricultural) subsidies and other current transfers.

The growth of total public expenditure in 2004 is set to slow down to 4.5% as compared to over 18% in 2003, thereby moderately reducing the ratio of expenditure to GDP from 44.8% to 44.6% (see table 5). This is the net result of, on the one hand, a decrease in public consumption by 1.8 percentage points of GDP for 2004 resulting from the deceleration in the growth of wages and salaries after the freeze on government wages and employment for the entire programme period, and moderation in the growth of capital expenditures to 6% from the unusually high growth rate in 2003 (when investment increased by 30%). On the other hand, social transfers (including those in kind) and subsidies are set to increase by 1.6 percentage points of GDP, partly the result of compensating transfers introduced to alleviate negative effects of the tax reform, while interest payments increase by 0.3 percentage points of GDP (mostly linked to higher debt), thereby mostly offsetting the expenditure reduction measures.

On revenues, the aim is to increase overall government revenues from 38.5% of GDP to 39.4% of GDP in 2004. The process of tax harmonization with the acquis started in July 2002 with a comprehensive tax reform and was fully implemented by May 2004. The tax reform shifted the tax burden from direct to indirect taxation and was estimated to have a neutral impact on public finances. Apart from measures to reinforce tax administration and compliance as envisaged in the 2003 PEP, the programme outlines the following structural taxation measures to be introduced in 2004 and projected for the entire period: regularisation of dividend income policy for semi governmental organizations, the approval of bills governing bank secrecy and taxation of undeclared income,

modification of legislation on title deeds on buildings erected with minor irregularities, and measures to increase tax collection efficiency.

4.4. Targets and adjustment in 2005 and beyond

As noted above, the fiscal consolidation path presented in the programme reflects the political objective to adopt the euro by 2007. This is the main reason the strong frontloading of the fiscal adjustment in 2005 when, according to the program the deficit should be reduced by 2.3 percentage points of GDP to 2.9%, just below the 3% Treaty reference value for the deficit criterion. The reduction in the budget deficit is set to continue in subsequent years although at a much slower pace, to attain 1.6% of GDP by 2007. With interest payments projected at 3.6% of GDP throughout the period, the primary balance is then set to turn from a deficit of 1.6% of GDP in 2004 to a surplus of 0.7% of GDP in 2005 and 2% of GDP by 2007 (see table 5).

In quantitative terms, the total fiscal adjustment for 2005 is divided between an increase in the revenue ratio of 1 percentage point and a decrease in the expenditure ratio of 1.3 percentage points.

In addition to the budgetary measures of a structural nature introduced in 2004, which have an effect on the rest of the programme period, supplementary measures from 2005 onward on the revenue side include raising airport taxes and landing fees; introduction of a mobile telecommunications tax; and charges on land appreciation due to zoning changes.

At the same time, measures to contain expenditure from 2005 onward focus on overall ceilings for increases of current and capital expenditures (for 2005 at 3% and 4%, respectively). Other measures for 2005 mainly regard collective consumption and social transfers and include a marginal reduction in defence outlays, the abolition of unemployment benefits granted to retired public sector employees and of the subsidised earnings-related pension scheme of public sector employees[7].

The adjustment should bring the deficit for 2005 in line with the earlier 2003 PEP target (and well below the Commission forecast, on a no- policy change base). This target is demanding and ambitious. Although a fiscal adjustment of similar magnitude and speed was achieved in 2000 (see table 3), it occurred under conditions of higher GDP growth in 2000 (5.1% compared to 4.3% projected for 2005 in the programme). Also, the relatively large number of measures, each with relatively small savings adding up to the total adjustment, might complicate implementation. Therefore, the objective for 2005 is subject to considerable uncertainty. Furthermore, the deficit target of 2.9% of GDP in 2005 leaves little margin concerning the Treaty reference value for the deficit in that year, thus rendering the planned fulfilment of the deficit Maastricht criterion vulnerable to lower than assumed growth, as also indicated in the sensitivity analysis presented in the convergence programme[8]. From the reference scenario it also appears that the frontloading of the fiscal adjustment in 2005 is not expected to have a significantly

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[7] Given the long list of measures, Annex I includes the convergence programme table outlining the measures and expected budgetary impact over the period.

[8] The analysis shows that a 0.5 percentage point lower GDP growth rate on unchanged policy pushes the deficit just above the 3% criterion to 3.1% of GDP in 2005.

negative impact on growth. For a small and very open economy this is not unreasonable, although, given the size of the adjustment, negative demand effects cannot be excluded. As deficits are further targeted to decrease to 2.2 and 1.6% of GDP respectively, the safety margins below the 3% deficit threshold for 2006 and 2007 would appear to be more comfortable.

4.5. Debt ratio

The programme projects an increase of the government debt-to-GDP ratio in 2004 by 2.6 percentage points (see table 6) to a peak of 75.2%, slightly above the Commission forecast of 74.6%. Thereafter, the programme sets an increasingly rapid decline in the debt ratio to 68.4% of GDP by 2007, led by the increasingly positive primary balances and nominal GDP growth exceeding the average interest rate on government debt ('snow-ball' effect). The convergence programme does not detail stock-flow adjustments for the period, although according to Commission calculations on the basis of the programme data the stock-flow adjustment for 2005 remains (relatively) sizeable at 1.3 percentage point. This is probably linked to a reclassification of sinking funds[9], leading in previous years to stock-flow adjustments of about 1-4 percentage points. The differences with the Commission forecast are mainly related to the higher general government deficit in 2004 and (much) lower deficit in 2005 provided in the convergence programme.

At 84% of total government debt in 2003, long-term maturity debt makes up the largest share of debt. The programme aims to increase this share to nearly 86% by 2007. At the same time, foreign debt (mostly in euro) is expected to increase from 22% to 30% of total debt in 2004 and to stabilise thereafter. With a small and inactive secondary bond market[10] and ongoing capital liberalisation opening up additional investment alternatives, it has proven difficult to stimulate private non-bank investor interest in medium-to long term government debt, which until now has been mainly taken up by banks. The problem has been noted before[11] but, while becoming increasingly pressing, it has so far not been effectively addressed. The programme now proposes to restructure the secondary market by introducing domestic and foreign primary dealers for public debt, in order to provide much-needed liquidity and increase competition.

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[9] Sinking funds are a means of repaying funds advanced through a bond issue. The issuer makes periodic payments to a trustee, who retires part of the issue by purchasing the bonds in the open market. The Cyprus government deposited contributions to sinking funds for government bonds in the Central Bank of Cyprus. The statistical treatment of this asset in the proper recording of gross debt was brought in line with Eurostat conventions.

[10] With a market capitalisation of about 5% of GDP, the market is quite small. This is to a large extent the legacy of Central Bank of Cyprus' (CBC) financing of general government deficits until the independence of the CBC was formally established in line with EU requirements in mid-2002. Concurrently, reliance on the CBC for financing the government deficit - unusual among developed countries - ended. Although in the past such financing was considered a last resort, the facility was used rather often, particularly in 2000, when the whole of the government deficit was financed in this way, and up to its abolition on 1 July 2002.

[11] For instance, in the Note for the attention of the Economic and Financial Committee ECFIN/405-1/03/EN *Assessment of the 2003 Pre-Accession Economic Programme of Cyprus*, Brussels, 9 October 2003; Commission of the European Communities, SEC(2002) 1401, *2002 Regular Report on Cyprus's progress toward accession*, COM(2002) 700 final, Brussels, 9.10.2002.

Although not mentioned in the programme (but noted in the 2003 PEP), the government's main contingent liability is guarantees on borrowing provided to semi-government organisations and domestic institutions. These guaranteed borrowings totalled just over £600 million or 10% of GDP at end-2002, which is relatively high[12].

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	72.2	72.6	74.6	75.2	76.9	74.8	71.5	68.4
Change in debt ratio (1 = 2+3+6)	5.1	5.2	2.4	2.6	2.3	-0.4	-3.3	-3.1
Contributions:								
- primary deficit (2)	3.0	3.0	n.a.	1.6	n.a.	-0.7	-1.4	-2.0
- snow-ball effect (3 = 4+5)	-1.4	-1.3	n.a.	0.0	n.a.	-1.0	-0.9	-0.8
- interest expenditure (4)	3.3	3.3	n.a.	3.6	n.a.	3.6	3.6	3.6
- nominal GDP growth (5)	-4.7	-4.6	-4.0	-3.6	-4.6	-4.6	-4.5	-4.4
- stock-flow adjustment (6)	3.6	3.5	1.8	1.0	2.8	1.3	-1.0	-0.3

Note:
The change in the gross debt ratio can be decomposed as follows:

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

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

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations

5. THE QUALITY OF THE PUBLIC FINANCES

The composition of the projected budgetary adjustment over the period 2004-2007 to reduce the general government deficit is almost equally divided in downward expenditure adjustments and an upward revenue adjustment. This is to be realized through a series of mostly structural measures, as described earlier in section 4.

The programme briefly reviews the government's structural reform and liberalisation programme which focuses on labour, product and capital markets, as well as measures aiming at diversifying the Cypriot economy towards higher value added activities. In the programme these strategies are also explicitly linked to the Broad Economic Policy Guidelines, the Lisbon Strategy, and, for the labour market, to the Single Programming Document for Objective 3 of EU Structural Funds. On the knowledge-based economy, policy objectives in the context of the Framework Programme for Research and Technological Development and the National Development Plan 2004-2006 aim at a 2006 target of total R&D spending of 0.5% of GDP. It additionally notes, but does not further specify, 'efforts to improve public administration efficiency as contributing towards the creation of a business climate conducive to entrepreneurship'. However, no budgetary implications are given for these policies, other than the observation that funds

[12] Such contingent liabilities are not part of government debt. However, in case such liabilities are invoked, both government debt and deficit are affected. To date there has been only one significant case of calling a guarantee, amounting to £19 million in 1984.

earmarked for research projects and supporting activities of the Research Promotion Foundation will be substantially increased for the 2003-2005 period[13].

As the programme notes, these policies are mostly a continuation of reform strategies outlined in previous pre-accession economic programmes and the programme justifiably considers these policies as interconnected and mutually supportive. Overall, therefore, the policies outlined in the programme in this area seem reasonable although here as well the record has sometimes shown some delays in liberalisation, notably in some product markets (such as telecoms and air transport).

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The section on the long-term sustainability of public finances includes demographic and macroeconomic assumptions as well as projections for public expenditures on old-age pensions and health-care.

According to the demographic projections in the programme, a gradual increase in life expectancy together with a decreasing population of working age will result in a significant worsening of the old-age dependency ratio, nearly tripling over the projection period (from 17.4% in 2002 to 46.6% in 2052). While the programme expects this to be partially offset by the inflow of immigrants, it is clear that on the whole, such unfavourable demographic dynamics will have sizeable budgetary implications in the future.

In order to counter the adverse impact of the demographic developments on the long-term sustainability of public finances, the Cypriot authorities have designed several measures to be undertaken during the programme period, while others are still being discussed. On the one hand, the National Health Scheme, planned for 2006 after having been delayed for several years, is expected to generate savings via efficiency gains due to competition pressure between the public hospitals to become more efficient, improvement of primary health care and the introduction of the concept of the family doctor and of global budgeting for the entire scheme. On the other hand, options for parametric changes to the pay-as-you-go pillar (e.g. increase in the retirement age, pension indexation, increase in the rate of return of investment by investing a part of reserves in non-government assets) and to the 2nd pillar (gradual increase of the contribution rates) are currently being discussed by the government and social partners.

If the above mentioned measures regarding the reform of pension and health care system are implemented, overall age-related expenditures are foreseen to increase by 6.9% of GDP between 2005 and 2050 according to the long-term projections presented in the programme. While health care expenditures are expected to increase by 0.9% of GDP, reflecting the savings to be brought about by the above-mentioned National Health Scheme, pension expenditures are projected to increase by 6% of GDP even if the currently discussed measures are fully implemented. As far as the medium-term is concerned, the programme's budgetary strategy based on a gradual budgetary consolidation over the programme period would allow the government debt ratio to start decreasing before the full impact of ageing takes place.

[13] In the 2003 PEP, the indicated budgetary costs of structural reforms were not significant, amounting to around 0.4% of GDP over the period 2003-2006.

The risk to long-term sustainability of public finances further increases if the objectives set in the convergence programme fail to be achieved. Firstly, it is essential to implement the National Health Scheme as planned and to reform the pension system without delay in order to contain the budgetary risks related to population ageing. As stated in the programme, not reforming the latter would imply an additional increase in pension expenditure of 3 percentage points over the period 2008-2050 (an overall increase of 9 percentage points) and a deficit in the pension scheme reserves already in 2030 instead of 2050.

Summing up, the unfavourable demographic situation requires a comprehensive strategy for containing the costs of population ageing. While the health-care system reform is to be implemented in 2006, measures to reform the pension scheme are only in the initial stage. Delays or incomplete implementation of the reform measures would result in significant budgetary burden, jeopardising the long-term sustainability of public finances. Moreover, if not corrected, the recent high deficits and debt ratio are a source of great concern for the long-term sustainability of public finances. The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. However, on the basis of the policies as currently embodied in the programme, there are still risks of long-term budgetary imbalances emerging in Cyprus[14].

[14] The programme itself indicates a number of possible future measures that would be required to improve sustainability, but gives no further commitment on these measures.

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and Associated Factors

Percentages unless otherwise indicated	ESA Code	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
GDP growth at constant market prices (7+8+9)	B1g	2,0	3,5	4,3	4,4	4,5
GDP level at current market prices (£ mln)	B1g	6614,3	6959,7	7408,9	7880,9	8391,8
GDP deflator		5,3	1,7	2,1	1,9	1,9
CPI change (annual average)		4,1	2,0	2,0	2,0	2,0
Employment growth *		0,9	1,0	1,0	2,0	3,0
Labour productivity growth **		1,1	2,4	3,0	3,1	3,2
		Sources of growth: percentage changes at constant prices				
1. Private consumption expenditure	P3	2,0	3,3	3,7	3,7	3,7
2. Government consumption expenditure	P3	2,7	-3,2	2,3	2,7	2,8
3. Gross fixed capital formation	P51	-4,3	4,6	5,9	6,0	6,0
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	1,7	1,8	1,5	1,1	0,8
5. Exports of goods and services	P6	0,6	5,4	6,4	6,8	6,9
6. Imports of goods and services (excl. aircrafts and defence)	P7	-1,3	3,3	4,9	5,1	5,4
		Contribution to GDP growth				
7. Final domestic demand excl. Δ in Inventories		1,1	2,5	3,8	4,1	4,1
8. Change in inventories and net acquisition of valuables	P52+ P53	-0,2	0,1	-0,2	-0,3	-0,2
9. External balance of goods and services	B11	1,1	0,9	0,5	0,6	0,6

* Occupied population, domestic concept, persons, National Accounts definition

** Growth of GDP per person employed at constant prices

Table 2 General Government Budgetary Developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General Government	S13	-6,3	-5,2	-2,9	-2,2	-1,6
2. Central Government	S1311	-8,7	-7,6	-5,8	-5,2	-4,6
3. State Government	S1312	-	-	-	-	-
4. Local Government	S1313	-0,2	-0,2	-0,2	-0,2	-0,2
5. Social Security Funds	S1314	2,6	2,6	3,1	3,2	3,2
General Government (S13)						
6. Total Receipts	ESA	38,5	39,4	40,4	40,7	40,9
7. Total Expenditure	ESA	44,8	44,6	43,3	42,9	42,5
8.Budget Balance	B9	-6,3	-5,2	-2,9	-2,2	-1,6
9. Net Interest Payments		3,3	3,6	3,6	3,6	3,6
10. Primary Balance		-3,0	-1,6	0,7	1,4	2,0
Components of Revenues						
11. Taxes	D2+D5	27,5	28,3	28,6	28,8	29,0
12. Social Contributions	D61	7,0	7,0	7,3	7,4	7,3
13. Interest Income	D41	0,3	0,3	0,3	0,3	0,3
14. Other		3,7	3,8	4,2	4,2	4,3
15. Total receipts	ESA	38,5	39,4	40,4	40,7	40,9
Components of Expenditure						
16. Collective Consumption	P32	11,1	9,3	9,1	9,0	8,9
17. Social Transfers in Kind	D63	9,0	10,1	10,0	9,9	9,8
18. Social Transfers Other Than in kind	D62	10,5	11,2	10,4	10,4	10,4
19. Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
20. Subsidies	D3	1,2	1,0	0,9	0,9	0,8
21. Gross Fixed Capital Formation	P51	3,8	3,8	3,8	3,8	3,8
22. Other		5,9	5,6	5,5	5,3	5,2
23. Total Expenditures	ESA	44,8	44,6	43,3	42,9	42,5

Table 3 General Government – Debt Developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross Debt Level		72,6	75,2	74,8	71,5	68,4
Change in Gross Debt		5,2	2,6	-0,4	-3,3	-3,1
Contributions to Change in Gross Debt						
Primary Balance		-3,0	-1,6	0,7	1,4	2,0
Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
Nominal GDP Growth	B1g	7,4	5,2	6,5	6,4	6,5
Other Factors Influencing Debt Ratio						
Of which: Privatization receipts		-	-	-	-	-
p.m. implicit interest rate on debt		4,5	4,4	4,4	4,4	4,4

Table 4 Cyclical Developments

% of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP Growth at Constant Prices	B1g	2,0	3,5	4,3	4,4	4,5
2. Actual Balance	**B9**	**-6,3**	**-5,2**	**-2,9**	**-2,2**	**-1,6**
3. Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
4. Potential GDP Growth		4,5	4,5	4,5	4,5	4,5
5. Output Gap		-2,5	-1,0	-0,2	-0,1	0,0
6. Cyclical Budgetary Component		+1,3	+0,5	+0,1	0,0	0,0
7. Cyclically – Adjusted Balance (2-6)		**-4,0**	**-4,7**	**-2,8**	**-2,2**	**-1,6**
8. Cyclically – Adjusted Primary Balance (7-3)		-0,7	-1,1	0,8	1,4	2,0

Table 5 Divergence from most recent PEP

% of GDP	ESA code	2003	2004	2005	2006	2007
GDP Growth						
Previous Update	B1g	2.0	4.0	4.6	4.6	
Latest Update	B1g	2.0	3.5	4.3	4.4	4.5
Difference		0.0	-0.5	-0.3	-0.2	
Actual Budget Balance						
Previous Update	B9	-5,4	-3,7	-2,8	-2,2	n.a.
Latest Update	B9	-6,3	-5,2	-2,9	-2,2	-1,6
Difference		0,9	1,5	0,1	0,0	
Gross Debt Levels						
Previous Update		63,6	62,6	60,7	56,1	n.a.
Latest Update		72,6	75,2	74,8	71,5	68,4
Difference		9,0	12,6	14,1	15,4	

Table 6 Long-term Sustainability of Public Finances (Unreformed policy scenario)

	% of GDP	2000	2005	2010	2020	2030	2040	2050
1.	Total expenditure	36,1	42,4	43,5	46,8	49,8	51,7	53,3
2.	Old age pensions	4,1	4,7	5,5	8,5	11,1	12,7	14,1
3.	Health care (including care for the elderly)	2,6	3,1	3,6	3,8	3,9	4,0	4,0
4.	Interest payments	5,7	5,1	4,9	5,0	5,3	5,5	5,7
5.	Other savings		0	0	0	0	0	0
6.	Total revenues	33,8	39,5	39,5	39,7	38,3	36,0	33,0
7.	Of which: from pensions revenues	6,9	7,6	7,6	7,8	6,4	4,1	1,1
8.	National pension fund assets	37,0	40,3	41,1	31,6	-6,5	-61,2	-127,3
Assumptions								
9.	Employment growth	2,4	1,2	0,7	0,2	0	0	0
10.	Labour productivity	2,6	3	3,3	3	3	3	3
11.	Real GDP growth	5,1	4,3	4	3	3	3	3
12.	Participation rate males (aged 15-64)	78,9	80	81	81,5	82	82,5	83
13.	Participation rates females (aged 15.64)	52,5	55	57,5	60	61	62	63
14.	Total participation rates (15-64)	65,5	67,5	69	70,5	71,5	72	73
15.	Unemployment rate (ILO definition)	3,4	3,2	3	3	3	3	3

Table 6a Long-term Sustainability of Public Finances (Reformed policy scenario)

	% of GDP	**2000**	**2005**	**2010**	**2020**	**2030**	**2040**	**2050**
1.	Total expenditure	36,1	42,4	41,9	43,3	44,6	44,7	44,9
2.	Old age pensions	4,1	4,3	4,5	6,6	8,5	9,3	10,3
3.	Health care (including care for the elderly)	2,6	3,1	3,6	3,8	3,9	4,0	4,0
4.	Interest payments	5,7	5,1	4,9	5,0	5,3	5,5	5,7
5.	Other savings		0	1	2	3	4	5
6.	Total revenues	33,8	39,5	39,7	40,9	40,3	39,0	36,9
7.	Of which: from pensions revenues	6,9	7,9	8,1	9,3	8,7	7,4	5,3
8.	National pension fund assets	37,0	41,7	47,5	57,2	45,0	19,3	-17,3
Assumptions								
9.	Employment growth	2,4	1,2	0,7	0,2	0	0	0
10.	Labour productivity	2,6	3	3,3	3	3	3	3
11.	Real GDP growth	5	4,3	4	3	3	3	3
12.	Participation rate males (aged 15-64)	78,9	80	81	81,5	82	82,5	83
13.	Participation rates females (aged 15.64)	52,5	55	57,5	60	61	62	63
14.	Total participation rates (15-64)	65,5	67,5	69	70,5	71,5	72	73
15.	Unemployment rate (ILO definition)	3,4	3,2	3	3	3	3	3

Table 7 Basic assumptions on the external economic environment for Cyprus

VARIABLE	ASSUMPTIONS FOR				
	2003	2004	2005	2006	2007
(annual averages)					
Interest rates (in % p.a)					
-euro area: short-term (3 months money markets)	2,3	2,2	2,8	3,3	3,5
-euro area: long-term (10- year government bonds, lowest one prevailing in euro area)	4,1	4,3	4,8	5,3	5,5
-U.S.A.: short term (3 months money markets)	1,2	1,3	1,8	2,8	3,0
- U.S.A.: long-term (10 year government bonds)	4,0	4,2	4,6	5,1	5,3
Exchange rates (“-“ depreciation)					
USD/∈ (level)	1,13	1,20	1,20	1,20	1,20
Nominal effective exchange rate of the Cyprus pound (% change)					
Exchange rate per Cyprus pound: (levels)					
US Dollar	1,93	2,04	2,04	2,04	2,04
Pound Sterling	1,18	1,13	1,13	1,13	1,13
Euro	1,71	1,70	1,70	1,70	1,70
GDP (in real terms, % change)					
-World, excluding EU (in PPP terms)	4,4	5,1	4,7	4,6	4,5
-USA	3,1	4,2	3,2	3,2	3,2
-United Kingdom	2,1	3,1	2,6	2,5	2,5
-EU-15	0,8	2,0	2,4	2,5	2,5
World trade (% change)					
EU export markets, Extra-EU (volumes)	6,7	9,2	8,3	7,8	7,5
World import volumes, excluding EU	7,3	9,7	8,5	8,0	7,7
World import prices (goods, in USD)	8,8	6,4	0,7	1,0	1,0
Commodity prices					
Oil prices (Brent, level in USD/barrel)	28,5	31,1	28,9	27,0	27,5
Non-oil commodity prices (in USD, % change)	6,6	15,6	-2,6	0,0	0,0

Table 8: Fiscal Consolidation Measures

budgetary impact as a % to GDP	2004	2005	2006	2007
Expenditure				
No general government sector employment increases including the semi governmental organizations	0,1	0,1	0,1	0,1
No contractual salary increases	0,2	0,2	0,2	0,2
Containment of the annual rate of increase of current expenses to under 3% in 2005 o Agricultural subsidies – maintaining them at 2004 levels o Grants to semi governmental organizations – 0% increase	-	-	-	-
Containment of the annual rate of increase of investments to under 4% in 2005	-	-	-	-
Marginal reduction of defence outlays	-	0,1	-	-
Containment of current transfers (pensions, monetary allowances etc.), below the rate of nominal GDP increase	-	0,2	0,2	0,2
Abolition of the unemployment benefit granted to general public sector retired employees	-	0,2	-	-
Increase of the retirement age of public sector employees from 60 to 63 years of age, with the prospect of increasing it further to 65 years of age	-	0,2	0,1	0,1
Increase of the retirement age limit of the Social Insurance Fund from 63 to 65 years of age with the prospect of increasing it further to 67 years of age	-	0,2	-	-
Abolition of the earnings-related pension scheme of public sector employees (increase of the public sector employees contributions to the same level as the private sector contributions)	-	0,2	-	-
budgetary impact as a % to GDP	**2004**	**2005**	**2006**	**2007**
Revenues				
Introduction of betterment charges on land appreciation due to zoning changes or modifications	-	0,1	-	-
Raising of airport and port taxes	-	0,2	-	-
Introduction of a mobile telecommunication tax	-	0,1	-	-
Improving the efficiency of tax collection	-	0,1	0,1	0,1
Approval of the pending legislation concerning bank secrecy and tax amnesty	0,7	0,1	0,1	0,1
Modification of the legislation concerning the issuance of title deeds for buildings erected with minor irregularities	0,6	0,6	0,6	-
Regularisation of dividend income policy for semi governmental organizations	0,5	-	-	-
Total annual impact	**2,1**	**2,6**	**1,4**	**0,8**

This table provides the projected budgetary annual impact of the various measures in comparison with the situation of no policy change. Most measures are implemented in 2005 and have a structural nature; hence the impact indicated in the table is only in the year of implementation unless in the 'unadjusted' situation further increases in expenditure/lower revenues were foreseen.