COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Cyprus, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Cyprus's convergence programme covering the period 2004-2007 was submitted on 24 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the "code of conduct on the content and format of stability and convergence programmes"[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> 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.

1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM (2002) 668 final, 27.11.2002.

The programme largely complies with the data requirements of the Code of Conduct"[4].

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 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

[4] 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.

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: 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)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Cyprus and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Cyprus, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July 2004] the Council examined the convergence programme of Cyprus, which covers the period 2004 to 2007. The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"

The budgetary strategy underlying the programme aims at reducing the general government deficit from 6.3% of GDP in 2003 to 2.9% of GDP by 2005 to comply with the Maastricht deficit criterion by 2005 and further reduce the deficit to 2.2% of GDP in 2006 and 1.6% of GDP by 2007. To this end, the convergence programme envisages creating a rising primary balance surplus from a projected -1.6% of GDP in 2004 to 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 projection period. This is underpinned by a package of mostly structural measures to contain expenditure and to increase revenue, to about an equal degree. The measures are mostly implemented from 2005 onward.

The programme focuses on revenue enhancement and on expenditure control, which is where historically most of the slippage occurred. The particular 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

5 OJ L209, 2.8.1997, p.1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

points of GDP in 2005. Given the mixed record on fiscal consolidation, this looks rather ambitious.

The macro-economic scenario underlying the programme, which projects real GDP growth to accelerate from 3.5% in 2004 to 4.5% in 2007, seems to reflect plausible growth assumptions. The projection for inflation also appears realistic. The programme contains four different scenarios for the macroeconomic and budgetary projections: a “central” scenario, an “upper” scenario, a “lower” scenario and a “higher interest rate” scenario. The so-called “central” scenario is considered as the reference scenario for assessing budgetary projections because, on the basis of currently available information, it seems to reflect plausible growth assumptions.

The programme foresees the deficit to be reduced to (below) the 3% of GDP reference value in 2005 and to fall further thereafter, although these targets are not consistent with a position of close-to-balance during the programme period.

The budgetary outcome could be worse than projected. In particular, the size of the targeted decrease in 2005 of the general government deficit and the fiscal consolidation history of Cyprus makes the task particularly ambitious. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to (below) the 3% of GDP deficit threshold by 2005. It also may not provide a sufficient safety margin against breaching this threshold with normal macroeconomic fluctuations,

In the programme, the debt ratio peaks at 75.2% in 2004 and then declines by almost 7 percentage points to reach 68.4% of GDP by 2007. This strong decrease is mainly driven by increasingly positive primary balances and nominal GDP growth exceeding interest payments on government debt in 2005-2007. The evolution of the debt ratio may be less favourable than projected given the risks to the deficit outcomes mentioned above.

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

On [5 July 2004], on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in Cyprus in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Cyprus with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of Cyprus

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	2.0	3.5	4.3	4.4	4.5
Employment growth (%)	0.9	1.0	1.0	2.0	3.0
CPI inflation (%)	4.1	2.0	2.0	2.0	2.0
General government balance (% of GDP)	-6.3	-5.2	-2.9	-2.2	-1.6
Government gross debt (% of GDP)	72.6	75.2	74.8	71.5	68.4