Convergence Programme

of the

Republic of Cyprus

2004-2008

Ministry of Finance

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CONVERGENCE PROGRAMME

OF THE

REPUBLIC OF CYPRUS

CONTENTS

INTRODUCTION

In accordance with the Council's Regulation (EC) 1466/97, the Republic of Cyprus submitted its first Convergence Programme in May 2004. This is the first update of the Convergence Programme, drawn up in accordance with the guidelines set out in the 'Opinion on the content and format of stability and convergence programmes (2001 Code of Conduct)'.

The intensification of the tight fiscal stance instituted in 2004 is central to the philosophy of this Programme, based on the achievement of a three-fold objective: the first relates to the required adherence to the Council's Recommendation under Article 104(7), to bring to an end the situation of the excessive government deficit by 2005; the second, relates to the consolidation of public finances over the medium-term so as to achieve a close to balance or in surplus budgetary position, as well as reversing the path of the government debt to GDP ratio toward and under the 60% reference value of the Maastricht performance criterion; the third relates to procuring sustainability in public finances over the long-term taking account of the impact of an ageing population on the government's expenditures and revenues.

The aforementioned fiscal stance is expected to be supported by prudent monetary policies and an overall robust macroeconomic framework. The revival of economic activity in 2004, in line with the May 2004 Convergence Programme forecast, is expected to gather pace over the period 2005-2008 and create a framework conducive to fiscal consolidation, adding at the same time, a welcome counter-cyclical attribute to restrictive fiscal policy. Moreover, given the full employment conditions prevailing in the Cypriot economy, as well as the current account position, the contractionary fiscal policy is expected to be compatible with the pursuance of the internal and external economic stability.

A credible fiscal consolidation plan aiming at ensuring fiscal discipline and sound public finances in a medium and long-term perspective is central to a policy framework targeting at the participation of Cyprus in the ERM II. The strategic goal of the earliest possible adoption of the euro, if possible in 2007, entailing an early participation in the ERM II, calls on Cyprus to design and implement credible budgetary policies. It should be noted in this respect that on 19 October 2004, the Council of Ministers decided to promote the participation of Cyprus in the ERM II the soonest possible, by endorsing all the requisite consultations and actions that need be made.

The Government of the Republic of Cyprus fully comprehends the above challenge and commits itself to the resolute continuation of fiscal consolidation, launched in 2004 and the achievement of the target of reducing the fiscal deficit below 3% in 2005. In this context, the Government stands ready to introduce additional corrective measures, should this be warranted by adverse developments, resulting from lower than expected economic growth and/or delays or failures to implement any of the envisaged fiscal measures. With regard to the latter, it should be noted that a safety margin with the view of alleviating the impact of a possible delay in the implementation of some of the measures has already been incorporated in the design of the fiscal consolidation plan incorporated in this Programme.

Furthermore, a close monitoring of the progress recorded in implementing the measures is taking place under the auspices of a technical committee chaired by the Minister of Finance. In this respect, a fiscal consolidation timetable, taking stock of the situation and laying down the budgetary impact has been included in this Programme. It should be stressed also that, the fiscal measures eligible to be included under the current legal framework have already been incorporated in the Budget Bill for 2005, adding to the factors that reinforce certainty on the implementation of the consolidation programme.

The Council of Ministers has extensively discussed the fiscal consolidation measures and at the same time endorsed all the requisite actions that need be taken for their implementation. This Convergence Programme and the incorporated fiscal measures will be submitted also to the House of Representatives for discussion. The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as both feasible and credible.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The over-riding objective of economic policy continues to be the safeguarding of macroeconomic stability and the fostering of sustainable economic growth under conditions of full employment and a healthy balance of payments position. While achieving a sound fiscal position in the short and medium-term is a prime policy priority, the overall policy framework is also directed towards promoting the working of the main long-term sustainable development drivers and enhancing the potential growth capacity of the Cypriot economy. Despite the relatively good positioning of the economy, as exemplified by the fulfilment of several long-term Lisbon targets, efforts to further reform the labour and product markets, also in line with the country-specific Broad Economic Policy Guidelines' (BEPGs') will be sustained.

Fiscal Policy

The intensification of the consolidation effort initiated in 2004 will be the backbone of the fiscal policy framework, with the aim of pursuing compliance with the Council's Recommendation under Article 104(7). Therefore a tighter fiscal stance over the programme horizon 2005-2008 is envisaged, in line with the aforementioned objective partly dictating a front-loading of the budgetary adjustment in 2005. Following the achievement of the fiscal target set in the May 2004 Programme, (with the deficit estimated to be reduced to 4,8% of GDP in 2004 instead of the 5,2% of GDP specified in the first Programme), this Programme foresees, first, the compliance with the deficit criterion by the end of 2005 through a reduction in general government net borrowing to 2,9% of GDP in 2005 and thereafter, the further decline of the deficit to somewhat below 1% of GDP by 2008.

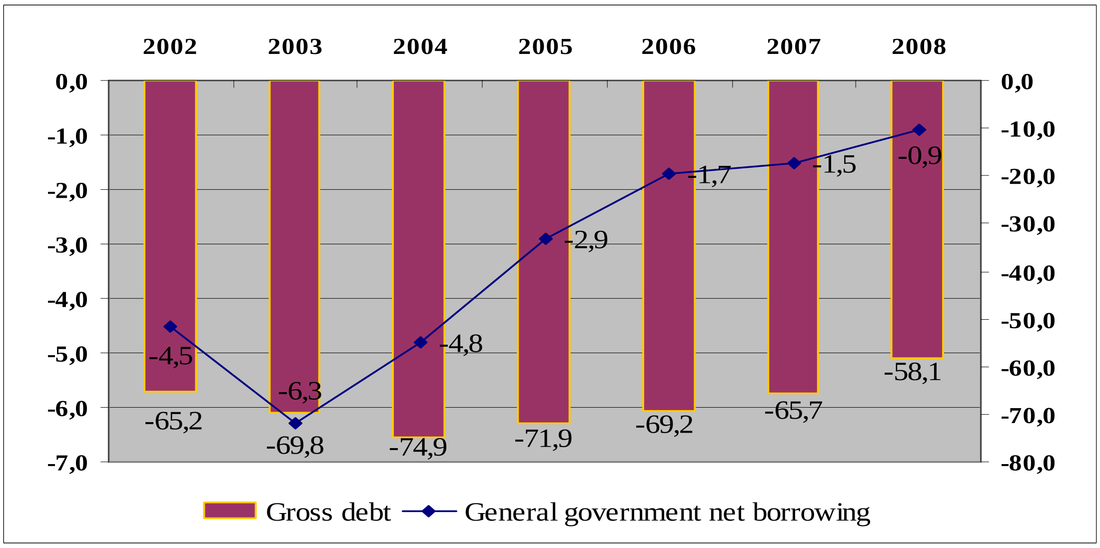
The outcome is that in cyclically adjusted terms, a total of 3,4 p.p. of GDP reduction in the general government balance is envisaged over the period 2004-2008.

In line with the above, the rise in the general government debt to GDP ratio is reversed after 2005 and placed on a distinct downward path. The Programme foresees the reduction of the general government debt from 74,9% of GDP at the end of 2004 to a level below the 60% reference value, 58,1% of GDP by 2008. A primary surplus expected to emerge in 2005 and peak by the end of the Programme horizon, the strong growth performance, as well as the gradual abolition of the policy to accumulate sinking funds deposits in the form of liquid assets to facilitate the repayment of public debt largely explains the projected path of the debt ratio.

With regard to the medium-term objective of ‘a close to balance or in surplus’ budgetary position, this Programme targets a fiscal deficit figure of 0,9% of GDP by the end of 2008. This projection reflects a cautious and conservative scenario, adopted by the Authorities of the Republic of Cyprus, which among other factors takes into account the fact that Cyprus’ net position as regards its contributions and absorptions to and from the EU Budget respectively will change after 2006, with the envisaged adoption by the EU of the Financial Perspective for 2007-2013.

The achievement of the medium-term objectives of Cyprus will be based on the continuation of the fiscal consolidation programme introduced in 2004 and more specifically on containing the increase in public expenditures well below the nominal GDP growth, as well as further enhancing tax effectiveness. This policy approach, in conjunction with some ‘reserve’ measures e.g. the introduction of income criteria establishing eligibility for specific social benefit schemes and the improved utilisation of government property which are likely to be implemented in 2006, imply that the medium-term objective is within the reach of fiscal policy by the end of 2008.

Graph 1: General Government Balance and Gross Debt (% of GDP)



Lax and delayed implementation of policy measures outlined in the PEPs of 2002 and 2003, highlighted certain deficiencies in fiscal governance, which need be tackled in a medium-term perspective. To tackle this problem, the Authorities reached a preliminary agreement with the IMF for a technical assistance programme targeting the strengthening of best practices of fiscal management. Problems were related to reactions linked to the implementation of the measures by political and/or special interest groups. Taking this experience into account, the Government of the Republic of Cyprus exerted a great effort toward gaining the support and commitment of the political parties and social partners for the content and implementation of the current Convergence Programme. It should be noted in this respect, that consultations with all the political parties and social partners preceded the preparation of this Programme with a view of creating the support that would facilitate consensus in its implementation.

Monetary and Exchange Rate Policy

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, in part, through the linkage of the Cyprus pound with a currency anchor, be it a single currency or a basket of currencies.

As suggested by the overall positive economic performance of the country, particularly in the last two decades, where high growth, low unemployment and stable inflation rates were recorded, the policy of using the exchange rate as a means to contain inflation and inflationary expectations has served the economy well, not only in terms of safeguarding price stability, but also in terms of contributing to the country's development process, through the provision of a stable and supportive macroeconomic environment.

Given the exchange rate policy framework in the small and open economy of Cyprus, domestic demand pressures are reflected in higher imports and rising external current account deficits. Generally, macroeconomic policies have been used to influence domestic demand, with a view to also keeping the current account deficit at manageable levels. However, in preparing for the ERM II and eventual participation in the Economic and Monetary Union, the Authorities of Cyprus are aware that greater reliance has to be placed on structural reforms, labour market and fiscal policies, to maintain competitiveness and to adjust domestic demand to appropriate levels.

Moreover, in view of the prospect of giving up the exchange rate instrument in the foreseeable future and locking the Cyprus pound into the euro, the issue of exchange rate competitiveness is being more closely monitored. Against the background of results from existing studies (including one from the IMF), which suggest that the exchange rate of the Cyprus pound was broadly in line with economic fundamentals, the recent appreciation of the euro and the Cyprus pound and its impact on the competitiveness of the Cypriot goods and services is being monitored and analysed, also taking into account various factors, including relative movements in key prices and costs affecting export profitability.

It is envisaged that the current ERM II-type exchange rate framework shall continue to be in place until the eventual adoption of the euro. Notwithstanding the increased difficulties that have risen because of the fiscal slippages in 2002 and 2003, the Authorities aim to join the euro area as early as possible and, towards this end, are determined to firmly maintain policies that safeguard the fulfillment of the Maastricht criteria.

The fact that the Cyprus pound has been pegged to the ECU since June 1992 up to the end of 1998 and subsequently to the euro since the beginning of 1999, without this leading to balance of payments tensions and pressures on external reserves, provides evidence that the economy of Cyprus can sustain an early participation in the ERM II and successfully confront the challenge of adopting the euro by 2007.

Concerning the main monetary and credit aggregates, these are expected to continue to evolve over time in accordance with the identity that links money, velocity of circulation of money, prices and real GDP, with the evolution of domestic and private credit in line with nominal GDP.

Structural Reforms

Structural reforms procure the necessary grounds that, in a long-term perspective, will enable Cyprus to develop a robust and flexible economy, exhibiting the desired resilience to external shocks, while enhancing the efficiency of the market mechanism and raising potential productive capacity. It is noteworthy that Cyprus is relatively advanced towards fulfilling the long-term Lisbon targets, especially those relating to the labour market performance.

Despite the pursuit of fiscal consolidation as the indisputable prime policy priority, efforts to further promote the requisite structural reforms are not being relaxed. Diversifying the Cyprus economy towards higher value added activities, is among the policy priorities, addressing at the same time the dictates of the country-specific guidelines in the context of the BEPGs. In these settings, the Government has adopted and is implementing a three-pillar strategy:

(i) The promotion of structural changes in the product, capital and labour markets constitutes a very important pillar. In particular, the complete liberalisation of the economy by the elimination of the remaining market rigidities and the fostering of competition in goods and services markets, through inter alia the further strengthening of the competition and regulatory authorities, will result in a reallocation of the factors of production in favour of the activities in which Cyprus possesses comparative advantages.

(ii) The fostering of the knowledge-based economy. To foster the knowledge-based economy, a range of policy objectives have been clearly set encompassing corresponding measures in the context of the Framework Programme for Research and Technological Development and the National Development Plan 2004-2006, with the overall target being to achieve the 2006 target of a total R&D intensity of 0,5% of GDP. In broad categories these objectives pertain in advancing R&D and innovation, promoting the introduction of the information society, increasing the supply of trained researchers and qualified ICT personnel, upgrading of research infrastructures and improving the capability of the education and training systems to adapt to skill requirements.

(iii) A supportive development strategy ameliorating the constraints to sustainable development. In this respect, the Strategic Development Plan, has as two of its main priorities: (1) The Expansion and Upgrading of Basic Infrastructures and (2) The Development of Human Capital. With respect to the former priority, particular emphasis is attached to expanding and upgrading the infrastructure in the sectors of transport, linking Cyprus with the Trans-European Networks, energy and telecommunications, in line also with the Growth Initiative of the EU. Concerning the latter priority, Cyprus has prepared the Single Programming Document (SPD) under Objective 3 of the Structural Funds (human capital development). The SPD has been agreed with the EU Commission. In December 2004 the measures described in the SPD and the programme complement under Objective 3 will start to be implemented.

In accordance with the country specific policy guidelines contained in the 2004 update of the BEPG, Cyprus attaches particular attention towards tackling the issue of its dependence, to a certain extent, on the tourism sector.

In any case, efforts should take into account the comparative advantages of the island and the fact that Cyprus' natural endowments favour tourism activities. This essentially means that, in parallel to the promotion of other activities a policy of diversifying the tourist product should be pursued. It should be pointed out, that the recently revised Strategic Development Plan for Tourism acknowledges the need to differentiate Cyprus' tourist product and focus on quality through, inter alia, the advancement of infrastructure projects, the promotion of tourism incentives, special measures towards addressing the seasonality problem and the restructuring and reinforcement of the competent Cyprus Tourism Organisation (CTO).

2. ECONOMIC OUTLOOK

Cyclical Developments and Current Prospects

In 2004, Cyprus began the recovery phase of the economic cycle with real GDP estimated to rise by 3,6%, thereby showing clear signs of recovery after the low real growth of roughly 2% recorded in 2003 and 2002. However, growth continues to be below the potential rate of growth estimated at around 4,5%.

The recovery is primarily attributed to the acceleration of the rate of growth of domestic demand and more particularly private consumption and investment in construction and machinery and equipment, as well as the continuing strong performance of exports of services, other than tourism.

On the negative side, factors restraining growth below potential, were the hesitant recovery of the world economy, the rise in the price of oil in the international markets and to a limited extent, the small real effective appreciation of the exchange rate due to the continuing weakening of the dollar and the increase in key Central Bank interest rates on the 30th of April, 2004.

Private consumption is expected to record a relatively high increase of around 4,5% in real terms in 2004 compared to 2,6% in 2003, reflecting the increase in disposable income due to the increase of employment and real earnings as well as the effects of the last phase of the broader tax reform which came into effect on the 1st of January, 2004, in conjunction with subdued private consumption over the three preceding years.

Public consumption on the other hand, is expected to decrease by 2,7% compared to a 4,7% increase in 2003, reflecting the implementation of the fiscal consolidation programme and especially the large cuts in defence spending.

The rate of expansion of gross fixed capital formation, excluding the extraordinary expenditure on aircrafts and ships, is expected to grow by almost 6,6% compared to 5,2%

in 2003 owing to the continued strong rate of expansion of investment in construction as well as to the appreciable increase of investment demand in machinery and equipment.

Total exports are expected to grow by 4,7% in real terms after the negative growth of 1,4% recorded in 2003, mainly due to the rapid expansion of non-tourist services' exports. The dynamic growth of services other than tourism is particularly satisfying and reflects the gradual process of diversification of the economy leading to a lower dependency on tourism.

As far as tourism is concerned, receipts from tourism are expected to fall slightly in nominal terms, mainly due to the lower prices offered by hoteliers to tour operators in an effort to boost tourist demand.

In the labour market, registered unemployment is expected to remain at the same level as in 2003, at 3,5%. The recovery of economic activity is expected to result in labour productivity rising by approximately 2,2% compared to a mere 0,8% increase in 2003, which was due to the cyclical slowdown of economic growth. Unit labour costs are expected to increase by around 1,5% in nominal terms in 2004, compared to about 4,5% in 2003, reflecting moderate wage growth and a noteworthy improvement in labour productivity gains.

Inflation, as measured by the CPI, is expected to decelerate to 2,1% in 2004 compared to a 4,1% increase in 2003. This development was expected, due to the elimination of the effects of one-off factors such as the increase of the VAT rates, and other indirect taxes, which led to a rise in inflation in 2003. In addition, the nominal effective appreciation of the Cyprus pound resulted in an overall fall in import prices, which exercise a further dampening effect on inflation. Other factors explaining the containment of inflation in 2004 include wage moderation, fiscal consolidation and the increase of interest rates on the 30th of April, 2004. The upward effect of oil prices on inflation was offset due to the decrease of excise duties on vehicles and a resulting decrease in the retail price of motor vehicles.

The current account balance for 2004 is expected to record a deficit of 4,1% of GDP compared with 3,4 % of GDP in 2003. The deterioration in the 2004 current account balance is mainly the result of a large rise in imports attributable to higher oil prices and buoyant private consumption and strong fixed investment demand.

Concerning the financial account, FDI flows constitute the main source of financing of the current account deficit in the recent years. “Portfolio Investment” and “Other Investments” contribute to the financing of the current account to a lesser extent, despite their variability, which largely reflects transfers of funds from one investment type to the other, for instance, transfer from currency deposits, which are the main component of “Other Investments” to bonds, which are classified as “Portfolio Investment” and vice versa.

The significant role of FDI in financing the current account deficit in recent years, also in view of the fact that a significant part of it consists of “reinvested earnings”, constitutes an additional strong indication of the sustainability of the current account deficit and the appropriateness of the exchange rate policy pursued by the authorities in recent years. This argument is consistent with other relevant characteristics of the economy, such as, the successful ecu-peg and euro-peg policies pursued since 1992 and 1999, respectively, the full employment conditions of the economy and the overall broad macroeconomic stability of the country.

It should be noted that in 2002, Cyprus introduced a methodological revision to the Balance of Payments reporting in line with IMF’s BPM5 standards. The most important feature of the revision was the change in the residency definition, whereby the large international business sector having physical presence in Cyprus has been included in the residents’ category. This has significantly boosted exports of services and at the same time led to significantly higher reinvested earnings, which are recorded as higher inflows of foreign direct investment and as outflows on the income balance. The higher, than previously reported, export of services is also attributed to the improvement in the quality of data due to the newly introduced method of collecting detailed information through the banking sector.

The revision of the Balance of Payments data series has not only resulted in an improved current account deficit-to-GDP ratio, but has also led to a strong upward revision of FDI inflows and reinvested earnings which now represent almost half of the total net FDI inflows. As a result, the coverage of the current account by net FDI inflows has increased to more than 200 percent in 2001 and despite a subsequent decline it remained above 100 percent in 2002 and 2003. For 2004, a small decline in coverage is expected.

In 2004 there was acceleration in both the growth of total money supply (M2) and credit to the private sector. The annual growth rate of these aggregates in October reached 7,8% and 6,2% respectively, compared with 5,4% and 5,7% in October 2003. The acceleration in M2 was mainly driven by the increase in credit growth as well as the rise in net foreign assets. The acceleration in credit to the private sector was mainly due to the rebound of economic activity and particularly the continued growth in the construction sector. The short term NIBOR (3-month Nicosia Interbank Offered Rate) averaged 4,66% in the January-October period while the long-term interest rate (yield on 10-year government bonds) averaged 6,01% in the eleven months to November 2004.

During 2004 there was one hike in the official interest rates by 100 basis points. The negative political climate in April 2004 mainly due to the political instability and uncertainty sustained by the referendum on the Annan Plan, combined with the abolition of capital controls on 1st of May and the concurrent rumours of an imminent devaluation resulted in an increase in the outflow of capital during the last two weeks of April. Even though these outflows were not particularly large, the Monetary Policy Committee, in a pre-emptive move, raised interest rates on 30th of April by 100 basis points, thus sending a strong signal in support of the Cyprus pound to the markets. Following the interest rate rise in April, capital outflows have reversed and confidence in the domestic currency has been reinforced.

Following the interest rate hike in April, official interest rates have remained unchanged. Subsequently, this wait-and-see stance is based on the fact that domestic economic activity rebounded and inflationary pressures have been in check, mainly due to the phasing out of VAT and excise duty effects. The Monetary Policy Committee (MPC) has repeatedly emphasised the need for fiscal discipline, implying that any reduction in interest rates will only follow sustained and concrete progress in implementing fiscal consolidation. As far as the operational framework is concerned, on 1st of May 2004 the Central Bank of Cyprus (CBC) introduced a minimum reserve requirement ratio of 2,0% on foreign currency deposits. The CBC continued to intervene in the market to absorb surplus liquidity via auctions for the acceptance of deposits for most of the year. Towards the end of 2004 balanced liquidity conditions were observed.

During the first ten months of 2004 the Cyprus pound displayed very small fluctuations against the euro, reaching EUR 1,7346 on 29 October 2004 (mid- fixing price) compared with EUR 1,7054 on 31 December 2003. According to the present exchange rate policy framework, the fluctuation margins of the Cypriot currency are set at ±15% of the central parity, which is in line with Exchange Rate Mechanism II. During 2004, as in previous years, the Cyprus pound fluctuated against the euro within the ±2,25% margins of its central parity.

Table I: Selected Economic Indicators

Annual % change	**2003**	**2004**	**2005**	**2006**
Real GDP growth rate	1,8	3,6	4,0	4,4
Inflation rate (CPI)	4,1	2,1	2,6	2,2
Inflation rate (GDP deflator)	4,8	1,9	2,4	2,1
Core inflation[1]	2,5	2,4	2,3	2,2
Unemployment rate (registered)	3,5	3,5	3,4	3,2
Unemployment rate (Labour Force Survey)[2]	4,4	4,5	4,4	4,2
Current account balance (% of GDP)	-3,4	-4,1	-3,7	-3,4

[1] As a proxy for core inflation, the consumer price index excluding fresh fruit and vegetable items, petroleum products and indirect taxes (including VAT) is used.
[2] The LFS unemployment rate refers to the second quarter of each year

Current Prospects

The cyclical upswing in real economic activity is expected to gather further momentum in 2005 and GDP is forecast to record an increase of 4,0% in real terms compared to 3,6% in 2004. It is noted that GDP growth will be some 0,5p.p. lower than potential GDP growth, which is provisionally estimated at 4,5%, revealing that the Authorities adopt a conservative macroeconomic scenario which takes into account the likely impact of the persisting relatively high oil prices as well as the nominal and real effective appreciation of the Cyprus pound on growth.

Projections for 2005 are based on the assumption that the external environment will continue to be positive, with growth remaining at satisfactory levels in our main economic partners in 2005, notwithstanding the dampening impact of high oil prices. Furthermore, confidence among households and entrepreneurs is expected to improve further and thus contribute positively towards strong economic activity.

Employment is expected to rise by 1,2% in 2005 and the registered unemployment rate is predicted to decline marginally to 3,4% in 2005 compared with 3,5% in 2004.

Inflation, as measured by the consumer price index, is expected to remain low at around 2,5% in 2005 compared with 2,1% in 2004. The assumption for higher average prices for oil in 2005 will place upward pressures on domestic prices.

The current account deficit in 2005 is forecast to decline moderately to 3,7% of GDP, reflecting the positive effect of fiscal consolidation as well as a partial rebound in exports of tourism services. Non-tourism services are expected to continue their good performance and be the main contributor to export growth.

Medium-term Scenario 2006-2008

The following macroeconomic scenario has been formulated, taking into account the effects from the implementation of the fiscal consolidation programme as well as the effects of the promoted structural reforms and the broader development policy.

The key assumptions concerning the external environment of Cyprus are based, largely, on the Autumn 2004 forecasts of the European Commission and the September 2004 World Economic Outlook of the International Monetary Fund.

The projections of the Cyprus economy over the medium-term are based on the assumption of maintenance of the exchange rates of the currencies of the economic partners and competitors of Cyprus at the average level of October 2004. With respect to the oil price, it is assumed that world market prices of crude oil will average at $39,3 per barrel (Brent crude) in 2004 as reported in the 2004 Autumn Forecasts of the European Commission, as compared to $28,5p/b in 2003. For 2005, the crude oil price is assumed to rise further to $43,25 p/b, based on the assumption that the price of oil will remain at the same average price as in the last month for which there was available data, at the time the forecast was made. The price of $43,25 p/b was the average price of Brent oil for September 2004, as given by the International Energy Agency. The assumption is made that the price of oil will remain at this level thereafter until 2008.

Given the forecast growth of the markets, which are the major sources of tourism for Cyprus, and assumptions about pricing and exchange rates, it is forecast that tourist arrivals will increase by 5% annually over the 2006-2008 period, whereas per capita tourist spending in nominal terms will rise by 3% each year. This would mean that the total number of tourist arrivals will by 2008 be only 5,9% higher as compared to their 2001 level, whereas the total receipts from tourism, in nominal terms, will be only 4,3% higher vis-a-vis 2001.

With respect to domestic policies and forecasts the following assumptions are made:

- Curtailment in the annual rate of increase in employment in the public sector to 1% in the 2006 –2008 period.
- Containment of the rate of inflation in Cyprus to around 2%, in line with the forecast average rate of inflation in the EU.
- Implementation of the revised fiscal consolidation programme aiming at reducing the fiscal deficit and the public debt as a percentage of GDP.

Based on the above assumptions and considering the positive effect of the implementation of the structural reforms currently underway, and the development policy as depicted in the new Strategic Development Plan, the Cyprus economy is anticipated to exhibit an annual rate of growth of 4,5% in the period 2006–2008, in line with its production potential. The envisaged growth rate will safeguard conditions of full employment, the rate of registered unemployment eventually falling to around 3% in 2008, under conditions of internal and external macroeconomic stability.

Box I

Risks of medium-term forecasts

Being a small and open economy, the main downside risks for the forecast course of the Cyprus economy, lie primarily in the assumptions on the external environment and more particularly:

- The rate of growth of the economies of the main partners of Cyprus and the rate of increase of their import volume.
- Possible changes in the effective exchange rate of the Cyprus pound, resulting from a nominal appreciation of the euro and as a possible consequence the appreciation of the Cyprus pound vis-a-vis the pound sterling, in particular.
- Further increases in the price of oil in the international markets and the maintenance of the price at higher levels over the medium-term.

From the demand side, the main sources of faster growth over the period 2006 to 2008 are the projected more rapid growth of exports, and the continued strong expansion of domestic demand, reflecting a higher increase of gross fixed capital formation and private consumption. Real exports of goods and services are forecast to rise by around 7% per annum over the period 2006 to 2008. The faster growth of external demand is expected to result from the gradual recovery of tourist demand as well as an improvement of the quality of the tourist product within the framework of the implementation of the ten year Strategic Plan for Tourism, the envisaged favourable external environment and the maintenance of the competitiveness of the Cypriot goods and services, as well as the expected further enhancement of the outward orientation of the private services sectors, beyond tourism. Exports of services other than tourism are expected to be a major growth propellant of the economy, rising at an annual rate of 8,8% in real terms over the period 2006 to 2008.

Gross fixed capital formation is forecast to expand by around 6%, in real terms over the period 2006-2008, as compared to an increase of 2,3% during the period 1999-2003. The significantly higher growth of fixed investment is expected to mainly result from:

- Continuing pressure for rationalisation to confront the competitive forces of the internal market of the EU.
- Wage moderation and improved profitability.
- Improved expectations among investors due to the envisaged recovery of the economy and EU accession, as well as the fiscal consolidation.
- Liberalisation of the utilities sectors (particularly energy and telecommunications).
- Significant increase in investment in infrastructure projects, that will, inter alia, result through the planned construction of the new airports in Larnaca and Paphos, the new port in Larnaca and a number of marinas through the Build Operate Transfer (BOT) method.
- Complete liberalisation of direct and portfolio investment in Cyprus by residents from third countries (undertaken as from October 2004), except in the cases provided for differently in sector specific legislation.

- More effective allocation of the financial resources towards productive investments resulting from the liberalisation of financial markets.

Private consumption is forecast to increase at an average annual rate of 4% in real terms over the period 2006-2008, as compared to 3,4% on average during the 1999-2003 five year period. The higher growth of private consumption is mainly attributed to the continued healthy growth of real earnings and the envisaged improvement of the climate of confidence among consumers.

In contrast, the rate of increase of government final consumption is expected to moderate. More specifically, the government final consumption is expected to increase by around 3% in real terms over the period 2006-2008, as compared to 5,5% during the period 1999-2003, as a result of the implementation of the fiscal consolidation programme, which inter alia, provides for a containment of the rate of increase in public employment to 1% as compared with higher rates of increase in the preceding years and the containment of defence and other consumption expenditures.

From the sectoral point of view, the private tertiary sectors will continue to be the main engine of growth, given that the comparative advantages of Cyprus tend to favour the development of the services sectors. The share of the services sectors to GDP is anticipated to grow further and reach 77,4% in 2008 as compared with 76,6% in 2003, whereas the share of both the primary and secondary sectors would correspondingly decline from 4,4% and 19% in 2003 to 4% and 18,6% in 2008, respectively. Within the services sector, there is expected to be continuing restructuring and diversification of production, including an increased shift towards export-oriented private services such as communications, finance, business services, private education and health. This diversification process will benefit from the abolition of all restrictions on direct and portfolio investment, not only for EU residents, but also for residents of third countries, as well as from the removal of impediments to free market access in the utilities sectors. And as a consequence of the expected diversification and restructuring of services, the share of the sector of restaurants and hotels to GDP is projected to show a small decline.

The labour market will continue functioning within nearly full employment conditions. The gainfully employed population is expected to increase by 1,3% annually during the period 2006-2008, leading to the creation of additional employment opportunities, particularly in the sectors of private services, reflecting the continued trend of restructuring the production base of the Cyprus economy towards the benefit of these sectors. The registered unemployment is expected to decline to 3% of the economically active population by 2008.

The stronger investment performance, combined with greater use of new technologies and the promotion of structural reforms and a generally supportive development policy is expected to shift the production frontier outwards and result in an annual increase of labour productivity by around 3% during the period 2006-2008. The rate of increase in real earnings is expected to be contained to about 2%, whereas the annual rise in nominal unit labour costs to be limited to around 1% over the same period, that is, below anticipated inflation.

Monetary sector developments for the period 2006-2008 are envisaged to evolve in line with price and exchange rate considerations discussed above and the evolution of the real economy. In particular, based on the identity embodied in the relationship between money, on the one hand, and prices, real GDP and the velocity of circulation of money, on the other, broad money is estimated to increase by an average of 8,5% annually. The evolution of credit, both domestic and private, is assumed to broadly evolve in line with nominal GDP. These projections are consistent with a healthy evolution of the overall macroeconomic conditions under the medium-term programme, in that they do not introduce inflationary pressures in the economy.

The country's external transactions are expected to improve gradually over the medium term leading to a decline of the current account deficit to around 2% of GDP in 2008 from 3,4% in 2003 and a higher deficit in 2004. The improvement is expected to reflect the improvement of the public finances as well as the relatively favourable trend of the external demand over the medium term, including the gradual recovery of the tourism demand. The further enhancement of the export orientation of private services, beyond tourism, is expected to constitute an increasingly important contributory factor to that end.

Concerning the financial account, FDI flows, will continue financing to a large extent the current account deficit, thereby allowing official foreign exchange reserves to remain at a comfortable level.

3. GENERAL GOVERNMENT BALANCE AND DEBT 2004-2008

Policy Strategy

The Government's main policy goal is to implement strictly the fiscal consolidation programme devised in the first part of 2004, thus, gradually eliminating the excessive deficits recorded during the past three years and placing the debt to GDP ratio on a distinct downward path. It is the objective of the fiscal consolidation programmme to achieve a situation of "close to balance" in the government accounts over the medium-term. This programme is compatible with the continuous efforts of the government aimed at improving the functioning of the product, capital and labour markets in Cyprus and securing an internationally competitive environment for business and industry.

The successful implementation of the fiscal consolidation programme which aims at improving the structural fiscal position of the government will enable the automatic stabilizers to operate freely thus avoiding the breaching of the 3% Maastricht criterion during adverse cyclical conditions.

The anticipated reduction in central government's indebtedness is a key financial policy objective, which aims at preparing for the growing expenditure pressure on public finances arising from the ageing of the population. The programmed reforms in the civil service and the Social Security Funds will improve their financial position and support the operation of the welfare system.

Ultimately, the adoption of a firm and credible medium-term fiscal strategy, and the achievement of a tangible and sustainable improvement in the fiscal performance will maintain and further strengthen an environment conducive to price stability leading to the improved competitiveness of the Cypriot economy.

The adherence to the Stability and Growth Pact requires public finances satisfying the medium-term objective of 'a close to balance or in surplus' budgetary position. Taking into account the deterioration in public finances over the preceding three years, this Programme targets to reach a deficit figure of 0,9% of GDP by 2008. This pace of adjustment towards the above target appears appropriate, especially if consideration is given to the projected short and medium-term outlook for the Cyprus economy. Relevant to these considerations is the effort to design and put forward concrete fiscal measures that, while addressing the fiscal deficiencies are neither detrimental to the main growth and sustainable development drivers of the Cyprus economy, nor to the implementation of structural reforms.

The strategy towards early ERM II participation and euro adoption and the design of the fiscal consolidation programme are mutually supportive. The intention of the Cyprus Government to enter the euro area as soon as possible after EU accession, if possible in 2007, remains unchanged and, accordingly, early participation in the ERM II mechanism is foreseen. In terms of fiscal adjustment, this also requires the general government deficit to satisfy the 3% reference value and the government debt to be on a distinct downward path by 2005. Thus, the above intention needed also be reflected in the length and pace of the projected fiscal adjustment path.

Also, other factors that have affected the design of the specific medium-term budgetary objectives include the overall macroeconomic framework, the possibility of dealing with adverse cyclical developments and the impact of structural reforms, especially of institutional reforms in the budgetary process (e.g. imposition of expenditure ceilings) and the government investment needs.

Overall, a tight fiscal stance emanates from the corrective measures envisaged in this Convergence Programme. These measures were reflected in detail in the 2003-2007 Convergence Programme submitted in May, 2004. In line with the above, the fiscal adjustment scenario projects a steady adjustment in government balances, with the general government deficit expected to decline by 1,9 percentage points (p.p.) of GDP in 2005 to 2,9% from 4,8% of GDP in 2004, whereas gross debt is expected to be contained at around 71,9% of GDP in 2005 compared to 74,9% of GDP in 2004. Public debt is projected to decline as a percentage to GDP as from 2005 onwards and be placed on a sustainable downward path for the rest of the Programme horizon and reach approximately 58,1% of GDP by 2008. Further fiscal adjustment is expected to contribute to the reduction of deficit by another 0,8 p.p. of GDP over the remaining time period (2007-2008).

It should be stressed that, as in the May 2004 Programme, the envisaged fiscal adjustment places particular emphasis on containing public consumption expenditures, while concurrently improving revenue performance. The latter will be achieved through measures aiming at improving tax compliance and administration and raising fees for the provision of government services.

It is important to note that measures aimed at reforming the structure of the social security funds will reverse the anticipated decline in the surplus recorded in these accounts and will contribute to the medium-term financial viability of the social security scheme.

As illustrated in Table II expenditure and revenue enhancing measures are expected to contribute to reducing the general government deficit by 1,9 p.p. of GDP in 2005, 1,2 p.p. in 2006, 0,2 p.p. of GDP in 2007 and finally 0,6 p.p. of GDP in 2008. A total adjustment of 3,9 p.p. of GDP on the basis of the included corrective measures is forecast over the Programme time horizon. Expenditure containing measures are set to account for the bulk of the adjustment, contributing a total of 2,3 p.p. of GDP over the programming period, whereas the cyclical component, improved tax compliance and administration and revenue enhancement measures are projected to raise revenues by a total of 1,6 p.p. of GDP over the same period. As regards 2005, the crucial year from a policy objective perspective, expenditure containing measures are forecast to yield savings of 0,8 p.p. of GDP, whereas measures on the revenue side are projected to return 1,1 p.p. of GDP.

Table II: Components of Fiscal Adjustment

in percent points of GDP	2004	2005	2006	2007	2008	Total Adjustment 2005-2008
Expenditure containment	1,6	0,8	0,8	0,1	0,6	2,3
Cyclical component, tax compliance, administration improving measures & revenue enhancing measures	-0,1	1,1	0,4	0,1	-	1,6
General Government Net Borrowing	**-4,8**	**-2,9**	**-1,7**	**-1,5**	**-0,9**	**3,9**

In the estimates presented in this Programme, central government spending for 2004 is in line with the Budget and its four Supplementary Budgets. It is worth mentioning that during 2003 fourteen Supplementary Budgets were approved increasing the expenditure limit by over 6 p.p. of GDP. In contrast, during 2004 only four Supplementary Budgets were approved increasing the expenditure limit by less than 1 p.p. of GDP.

Actual Balances and Implications of the Forthcoming Budget

General government finances continued their deterioration in 2003, as the net borrowing rose from 4,5% of GDP in 2002 to 6,3%, while the general government gross debt increased to 69,8% of GDP compared with 65,2% in 2002 (Table IV). Although the rate of economic growth continued to be subdued in 2003 at 1,8%, estimates of the cyclically-adjusted budgetary balances (Table V) show that the higher deficit in 2003 was mainly attributable to an expansionary fiscal policy stance. Indeed, the growth rate of government expenditure accelerated by an average rate of 18% in 2003, while the net impact of the tax reform on the public finances was much more adverse than originally anticipated. As Table IV indicates total expenditure grew by 4,8 p.p. of GDP in 2003, while total revenues grew only by 3,0 p.p. of GDP.

An important factor accounting for the deterioration in public finances during 2003 compared to the anticipated outcome for the same year outlined in the 2003 PEP was the over-generous expenditure compensating measures introduced simultaneously with the approval of the tax reform along with the acceleration of the government development progamme. Development expenditures in 2003 rose by 20% compared with the previous year, with their share in GDP rising by 0,4 p.p., from 2002 to 2003. Additional factors affecting negatively the developments in public finances in 2003 were the excessive growth of other current transfers and purchases of goods and services which grew by more than 16% and 20%, respectively, compared with the previous year.

The cyclical economic downturn and the associated lower than anticipated income and corporate profits, the negative impact of the tax reform and an expansionary fiscal policy, all led to a considerable rise of the general government net borrowing in 2003 and a worsening of the structural deficit of the Government by nearly 1,7 p.p. of GDP.

On the basis of the existing trends and the prevailing policy stance, these unfavourable government finance developments were expected to continue into 2004 and beyond leading to a divergence away from the government deficit and debt targets specified in the 2003 Pre-accession Economic Programme. It was against this background that the Convergence Programme for the period 2004-2007 was prepared in order to reverse these unfavourable developments in the government finances and secure fiscal sustainability over the medium-term.

The general government deficit for 2004 is now estimated to decrease both in absolute terms and as a percentage of GDP as anticipated in this Convergence Programme. It is estimated that the fiscal deficit will be contained to around 4,8% of GDP exhibiting a decrease of the order of 1,5 p.p. of GDP compared to the outcome in 2003. The fiscal performance in 2004 compares well with the target of the Convergence Programme which was set at 5,2% of GDP.

The major factors that are influencing developments in the public finances in 2004 are the higher rate of growth of real GDP albeit still below potential and the impact of the fiscal consolidation measures, mainly on the expenditure side. More specifically, it is estimated that the impact of expenditure containment measures will contribute 1,6 p.p. of GDP to reducing the nominal fiscal deficit in 2004. Moreover, the recovery in economic activity, with real GDP growth reaching 3,6%, compared with 1,8% in 2003, in conjunction with a changing composition of growth in 2004 facilitated the achievement of the fiscal adjustment in the said year. It is estimated that the cyclical budgetary component of the fiscal deficit decreased from 1,3 p.p. of GDP in 2003 to 0,5 p.p. of GDP in 2004, while the cyclically adjusted fiscal deficit declined from 5,0% of GDP in 2003 to 4,3% in 2004 (Table V).

The budget for 2005 essentially embodies the application of the Convergence Programme for the coming year. Fiscal adjustment measures outlined in this Programme such as the annual expenditure ceilings on current and capital expenditure components have been rigidly adhered to, and the impact of the strict implementation of the fiscal consolidation programme in its first full year will be considerable in 2005.

The general government deficit for 2005 is projected to fall slightly below the relevant criterion of the Treaty of Maastricht leading to a substantial improvement compared to the estimated outcome for 2004 of 4,8% of GDP. Policy adjustment measures are estimated to contribute 1,9 p.p. of GDP to improving the estimated fiscal deficit position in 2005 (Table II).

Fiscal Consolidation Programme 2005-2008

The Government has committed itself to the rapid and resolute implementation of the fiscal consolidation programme for the period 2005-2008, which reaffirms the objectives of the Convergence Programme. These objectives include, as already stated, the sizeable reduction of the general government deficit to below 3% of GDP by 2005 and the setting of government gross debt on a distinct downward path.

The Government, acknowledging the fact that large deficits and rising public debt are highly undesirable and taking account of the effects of an ageing population on the long-term sustainability of public finances, decided to focus on a specific set of measures to reverse the current unfavourable trends and prospects. The aim of the measures is to effect a substantial reduction in the structural deficit, while concurrently raising the primary balance into a surplus, thus contributing to the reduction of the debt to GDP ratio.

Fiscal Sustainability

Henceforth, the aim of the updated Convergence Programme which covers the period 2005-2008 remains the steady reduction of the general government deficit to below 1% of GDP by 2008, the creation of a rising surplus in the primary balance to around 2,5% of GDP by the said year and the significant reversal of the upward trend of the ratio of debt to GDP. The final objective is to achieve over the medium term a general government net borrowing position close to balance and to place the debt to GDP ratio on a distinct downward path falling to around 58,1% of GDP, thus satisfying the corresponding Maastricht criterion by the end of the programming period.

In respect of the determined policy objective, the Ministry of Finance has prepared a specific set of measures, which upon implementation will improve substantially the structural position of the general government.

The timetable of implementation of the proposed fiscal consolidation measures as well as their impact as a percentage to GDP on general government net borrowing are outlined in the table below[3].

[3] It should be noted that Table III contains the most important measures planned for 2005 at microlevel. Their impact has been taken into account and are hence consistent with the fiscal projections at macrolevel.

Table III: Fiscal Consolidation Measures

Measures	Progress	Timetable	Budgetary Impact in p.p. of GDP	
Expenditure			2004	2005
Containment of general government sector employment increases, including the semi-governmental organizations	Public Service: This measure has been implemented. No additional posts were incorporated in the Budget Bill of 2005 for the Central Government. Semi-Governmental Organizations: This measure has been implemented. The Budgets of all Semi-Governmental Organizations were approved by the Council of Ministers with no additional posts.	1st January 2005	-	0,1

Measures	Progress	Timetable	Budgetary Impact in p.p. of GDP	
Expenditure			2004	2005
No contractual salary increases	Public Service: The Minister of Finance has repeatedly confirmed, in public, the Government's commitment to implement this measure. As expected the Unions have expressed their opposition. Semi-Governmental Organizations: The Minister of Finance has repeatedly confirmed in public the Government's commitment to implement this measure. As expected the Unions have expressed their opposition The Ministry of Finance proposed a package which provides for contractual salary increases in the public sector Semi-Governmental Organisations inclusive. These contractual salary increases are 0% for 2004-2005 and 2% for 2006. This proposal is made in the form of a package deal, with the precondition on Union agreeing to a gradual extension of the retirement age in the public sector from 60 to 63 years of age.		0,2	0,2
Containment of the annual rate of increase of current expenditures to under 3% in 2005 ➢ Agricultural subsidies – abolition of pre-accession aid to farmers ➢ Grants to semi - governmental organizations – 0% increase	This measure has been incorporated in the compilation of the Budget of 2005.	1st January 2005	-	-
Containment of the annual rate of increase of capital expenditures	This measure has been incorporated in the	1st January 2005	-	-

Measures	Progress	Timetable	Budgetary Impact in p.p. of GDP	
Expenditure			2004	2005
up to 4% in 2005	compilation of the Budget of 2005.			
Containment of defence outlays to £70m annually	This measure was implemented with the approval of the Budget of 2004.	1st January 2004	1,0	-
Containment of increases of current transfers (pensions, monetary allowances etc.) in accordance to the rate of inflation.	This measure has been incorporated in the compilation of the Budget of 2005. Monetary allowances granted to individuals with special needs were revised in accordance with the inflation rate.	1st January 2005	-	0,2
Abolition of the unemployment benefit granted to general public sector retired employees	A study to this effect is undertaken by the Minister of Labour and Social Insurance.	Expected to be implemented by 1st July 2005.	-	-
Increase of the retirement age of public sector employees from 60 to 63 years of age.	A study of the impact of this measure was undertaken by the Treasury Department evaluating the benefits that will be derived from the proposed reform. This measure will be implemented gradually.	1st July 2005	-	0,2
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	A study was undertaken by the ILO´s actuarial experts arriving at specific areas that need to be reformed. The study will be submitted to the Council of Ministers. Concurrently, negotiations are being carried out with the social partners. No consensus has been reached with respect to this measure. As an alternative measure the Government is considering to suggest an increase of the contribution rates of employees and self-employed persons in order to improve the financial viability of the scheme.	This measure is expected to be implemented as from 1st July 2005.	-	0,2
Increase of the public sector employees' contributions to the same level of private sector employees (from 3,2% to 6,4% of gross earnings and corresponding decrease from	This measure when introduced will apply to civil servants appointed after the date of introduction of the said measure.	-	-	-

Measures	**Progress**	**Timetable**	**Budgetary Impact in p.p. of GDP**	
Expenditure			2004	2005
9,4% to 6,3% of the government's contribution on gross earnings.				
Containment of compensation in consideration of overtime work in the public sector			-	<0,1
Introduction of specific criteria establishing eligibility for specific social benefit schemes	A proposal is being undertaken by the Ministry of Finance to this effect which will be submitted to the Council of Ministers during the first quarter of 2005	1st November 2005	-	-

Measures	Progress	Timetable	Budgetary Impact in p.p. of GDP	
Revenues			2004	2005
A. Introduction of a betterment charge on land appreciation due to zoning changes or modifications B. Increase of land and survey fees for issuing title deeds, mortgaging, acquiring and inspecting property C. Taxation on non-developed land inside Town Planning areas	A. A study to this effect is undertaken by the Ministry of Finance and the Ministry of Interior. B. A Bill has been prepared by Ministry of Interior and will be submitted to the House of Representatives by the end of 2004. C. A study to this measure is being prepared by the Ministry of Finance and the Ministry of Interior	A. A bill is expected to be submitted to Parliament and be approved by the end of the third quarter of 2005. B. This measure is expected to be implemented during the first quarter of 2005 C. This measure is expected to be implemented by the third quarter of 2005	- - -	- 0,1 -
Introduction of a mobile telecommunication tax	Ongoing discussions between the Ministry of Finance and the Ministry of Communications and Works.	A bill will be drafted based on the considerations of the two Ministries. The bill will come into force during the second quarter of 2005.	-	0,1
Improving the tax efficiency of the Revenue Collecting Departments	A law to this effect was enacted by the House of Representatives last July. An additional legislation providing that self employed persons must compile audited accounts with their tax returns has been submitted to the House of Representatives.	1^{st} January 2005	-	0,1
Legislation concerning bank secrecy and tax amnesty	The legislation for bank secrecy and tax amnesty was enacted by the House of Representatives. The Law on Bank Secrecy will be operational as from January 1^{st}, 2005.	December 2004	-	0,6

Measures	Progress	Timetable	Budgetary Impact in p.p. of GDP	
Revenues			**2004**	**2005**
Amendment of the legislation concerning the issuance of title deeds for buildings erected with minor irregularities	Legislation was enacted in July 2004 by the House of Representatives covering the buildings erected prior to 1990. An additional bill is expected to be approved by the end of the year covering post-1990 buildings	By the end of 2004	-	0,4
Regularisation of dividend income policy for semi-governmental organizations	Intensive negotiations between the Minister of Finance and the Semi-Governmental Organisations to obtain agreement on dividend income policy.	Agreement by the end of 2004, but actual receipt of dividends will be in early 2005	-	0,6
Improved utilization of government property	A study will be undertaken establishing the changes that need to be introduced, thus enabling the correct utilization of government property.	December 2005	**-**	**-**
TOTAL			**1,2**	**2,8**

Based on the above table, a total adjustment of 2,8 p.p. of GDP is envisaged in 2005. However, with a view of safeguarding the achievement of the 2005 fiscal target from a policy design perspective, a safety margin has deliberately been incorporated in the compilation of the measures for that year. This is quantified at 0,9 p.p. of GDP and aims at offsetting the impact of delays that might occur in the implementation of specific measures and any reduction in their expected budgetary impact.

Given the above, and in conjunction with the measures already applied estimated to impact positively by 0,6 p.p. of GDP, the forecast of a fiscal deficit of 2,9% of GDP in 2005 seems attainable.

It should be also noted that, given the experience gained so far from the implementation process of the various fiscal consolidation measures included in the first Programme and in the update has led us to refine the timetable of their implementation to reflect a more realistic path.

Special reference should be made on certain measures referred to in the above table. Concerning the tax amnesty measure, forecast to generate 0,6 p.p. of GDP in 2005, it should be highlighted that this one-off measure is expected to lead to a substantial widening of the tax base, thereby indirectly affecting positively public finances in a permanent manner.

Another measure envisaged to have a permanent improvement in government finances relates to the regularisation of dividend income policy for semi-governmental organizations, also forecast to return 0,6 p.p. of GDP in 2005 and on a permanent basis in subsequent years.

As regards the issuance of title deeds for buildings erected with minor irregularities, it should be noted that a gradual implementation is anticipated benefiting fiscal performance not only in 2005, but also in 2006 and 2007.

The implementation of the proposed fiscal consolidation measures will reverse the current trends and substantially reduce the structural deficit over the programme period. Lower structural deficits will feed into lower debt levels and together with reduced interest payments and interest rates will contribute to further reductions in actual net borrowing by the general government, and along with the beneficial effects on domestic economic growth, will create a positive virtuous circle. The envisaged containment in the growth of current expenditures from 2005 onwards will be particularly instrumental in contributing to the emergence of a rising current surplus or saving in the general government accounts. Furthermore, with the structural improvements programmed for the Social Security Scheme, the surplus in their accounts will be maintained, thus strengthening the financial viability of the Social Security Scheme over the medium-term.

Progress under the fiscal consolidation programme will be crucial in sustaining the nominal convergence process, especially with reference to interest rates. It is particularly noteworthy that as the government deficit in Cyprus rose sharply from 2,4% of GDP in 2001 to 6,3% in 2003 interest rates in Cyprus tended to rise relative to those in the euro area. This differential in interest rates was accentuated in the final months of 2003 and in the first part of 2004 as expectations of a further rise in the government deficit in 2004 to over 7% of GDP gathered momentum and as political uncertainty related to reunification efforts associated with the Annan Plan intensified. Furthermore, the Central Bank raised its interest rates on 30th of April, 2004 to deal with the uncertainty related to the liberalisation of the external capital account on entry of Cyprus into the European Union on May 1st.

However, with the alleviation of the political uncertainty and, moreover, with the institution of a revamped fiscal consolidation programme beginning with the submission of the Convergence Programme in May 2004 there has been a reduction in market determined interest rates since June 2004, a process which has halted the widening of the interest rate differentials with respect to the euro area.

Accordingly, it is expected under this Programme that the lower financing requirements and the increasing confidence associated with the implementation of fiscal consolidation will induce a further steady reduction in interest rates, which in turn will contribute to lowering government expenditures and the raising of revenues from the growth dividend. Thus, the greater confidence engendered by the evolving and significant results of the government's stabilisation efforts will allow both short and long term interest rates to converge toward rates in the euro area. In this connection, the achievement of the Maastricht criteria and sustainability in the area of government finances should help to preserve for Cyprus the satisfaction of the nominal convergence criteria in other areas, pertaining to interest rates, inflation and the exchange rate.

Table IV: General Government Consolidated Accounts

as a % of GDP	2002	2003	2004 est.	2005 proj.	2006 proj.	2007 proj.	2008 proj.
Current Revenue	36,1	39,1	39,0	40,1	40,5	40,6	40,6
Current Expenditure	37,0	41,4	41,0	40,3	39,6	39,5	39,0
Interest Payments	3,2	3,5	3,5	3,6	3,5	3,5	3,4
Current Balance	-0,9	-2,3	-2,0	-0,2	0,9	1,1	1,6
Capital Expenditure	3,6	4,0	2,8	2,7	2,6	2,6	2,5
General Government Net Borrowing	**-4,5**	**-6,3**	**-4,8**	**-2,9**	**-1,7**	**-1,5**	**-0,9**
Primary Balance	-1,3	-2,8	-1,3	0,7	1,8	2,0	2,5
Government Gross Debt	**65,2**	**69,8**	**74,9**	**71,9**	**69,2**	**65,7**	**58,1**

Structural Balance and Fiscal Stance

Efforts have been made to estimate the cyclically-adjusted balance of the general government fiscal stance based on projections of potential output derived from a study carried out by the University of Cyprus.

Over the programming period it is envisaged that the cyclically adjusted balance of the general government will improve considerably (Table V) from an estimated 4,3% of GDP in 2004 to 2,7% in 2005 and further to below 1% by the end of the programme period. This assessment factors out the business cycle effects by means of the deviation from the calculated potential output. It is estimated that potential annual output growth rate in Cyprus currently is around 4,5%. As GDP growth projections and potential output converge towards the end of the programming period the cyclical adjustment factor approximates zero over the medium-term.

The considerable turnaround anticipated in the structural fiscal position of the general government in 2005 is mainly attributed to the implementation of the fiscal consolidation measures. These measures aim at raising the revenue performance while at the same time containing the rate of growth of expenditures. The most important fiscal measures as far as their impact is concerned are the following:

(a) Revenue

- Tax amnesty (0,6 p.p. of GDP).
- Regularisation of dividend income policy for semi-governmental organizations, (0,6 p.p. of GDP).
- Issuance of title deeds for buildings erected with minor irregularities (0,4 p.p. of GDP)

(b) Expenditure

- Reduction of defence outlays (1,0 p.p. of GDP in 2004).
- Restrictive employment and wage policy for the broad public sector (0,3 p.p. of GDP).
- Increase of the retirement age in the public sector (0,2 p.p. of GDP in 2005 and 0,2 p.p. of GDP in 2006).
- Increase of the retirement age limit on the eligibility for outlays from the Social Insurance Fund (0,2 p.p. of GDP in 2005 and 0,2 p.p. of GDP in 2006).

Table V: Cyclical Developments

as a % of GDP	**2003**	**2004 est.**	**2005 proj.**	**2006 proj.**	**2007 proj.**	**2008 proj.**
GDP growth at constant prices	1,8	3,6	4,0	4,4	4,5	4,5
Actual balance	**-6,3**	**-4,8**	**-2,9**	**-1,7**	**-1,5**	**-0,9**
Net Interest payments	3,5	3,5	3,6	3,5	3,5	3,4
Potential GDP growth, % change	4,5	4,5	4,5	4,5	4,5	4,5
GDP output gap	-2,7	-1,0	-0,2	-0,1	0,0	0,0
Cyclical budgetary component	1,3	0,5	0,2	0,0	0,0	0,0
Cyclically-adjusted balance	**-5,0**	**-4,3**	**-2,7**	**-1,7**	**-1,5**	**-0,9**
Cyclically-adjusted primary balance	-1,5	-0,8	0,9	1,8	2,0	2,5

Debt Levels and Developments

Stock - Flow Adjustment

The analysis of the stock-flow adjustment is becoming an important inherent component in monitoring fiscal performance in EU Member States. Given the divergence in the evolution of debt and deficit figures, reconciling debt and deficit may provide substantive insight into various aspects of practices followed during the compilation of public finances, while reflecting significant institutional features of fiscal management.

The Ministry of Finance acknowledges the need for providing more information on the said adjustment thus enhancing fiscal transparency in the EU fiscal framework. To this end, though not explicitly dictated by the Code of Conduct, it initiates the provision of the requisite information on the stock-flow adjustment in the context of the preparation of its Convergence Programmes.

The stock-flow adjustment in Cyprus averaged 2,6 p.p. of GDP over the four-year period 2000-2003. The accumulation of financial assets accounted for the bulk of this adjustment, contributing an average of 2,0 p.p. of GDP in the said period. It should be emphasised that the expansion of liquidities by 2,2 p.p. of GDP is the main determinant of this positively-signed adjustment, leading to a higher debt to GDP ratio than that prescribed by the deficit evolution. The disposal of a portion of state share in Cyprus Airways, the national air-carrier, and the sale of Cyprus Tourist Development Company in 2000 led to a negative stock-flow adjustment of 0,2 p.p. of GDP (-0,7 p.p. of GDP in 2000).

Concerning the item referred to as liquidities, essentially comprising cash deposits, it should be noted that it basically covers two types of operations. The first relates to the accumulation of a certain amount of deposits (cash) held at the Central Bank, to meet the government financing requirements and other unforeseen obligations, following the prohibition of financing by the Central Bank in mid 2002 (the balance from £62 million at the end of 2002 rose to £158 million at the end of 2003). The second function concerns the contributions made by the Government to a sinking fund deposit account held at the Central Bank. These contributions are financed by borrowing thus leading to an increase of government debt, while repayments of debt through the sinking fund contribute to the reduction of the government debt. The sinking fund account is only used for the future repayment of long-term loans issued domestically. This policy of accumulation of sinking funds was abolished in mid 2003 and therefore for any new issues of domestic long-term loans since then, no sinking fund contributions are made. Given the abolition of this practice, the amount of these sinking fund deposits is forecast to eventually approximate zero in 2008, when around CYP500mln or 5,5% of GDP will be used for the repayment of the said loans in that year alone. Both practices lead to an increase in the gross debt with a corresponding accumulation of assets thus leaving the net indebtedness and net borrowing requirements unchanged.

The following table presents the evolution of the stock-flow adjustment in the period 2000-2003 and projects the trend over the five-year period 2004-2008, only for the accumulation of financial assets component. The other two components are given under the prudent assumption of zero.

Table VI: Stock-Flow Adjustment

	2000	2001	2002	2003	Average 2000-2003	2004	2005	2006	2007	2008
Difference due to time of recording:cash and accruals										
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	0.6	0.2	0.5	0.7	0.5					
2. Difference between cash and accruals interest expenditure	0.0	0.0	0.0	0.0	0.0					
3. Total (1+2)	0.6	0.2	0.5	0.7	0.5	0,0	0,0	0,0	0,0	0,0
Accumulation of financial assets										
4. Liquidities	2.4	3.8	0.8	1.8	2.2	1,8	-1,3	0,1	-0,7	-4,4
5. Securities other than shares	0.0	0.0	0.0	0.0	0.0	0,0	0,0	0,0	0,0	0,0
6. Loans	0.0	0.0	0.0	0.0	0.0	0,0	0,0	0,0	0,0	0,0
7. Shares and other equity	-0.7	0.0	0.0	0.0	-0.2	0,0	0,0	0,0	0,0	0,0
8. Of which: privalization proceeds	0.0	0.0	0.0	0.0	0.0	0,0	0,0	0,0	0,0	0,0
9. Total (4+5+6+7)	1.8	3.8	0.8	1.8	2.0	1,8	-1,3	0,1	0,7	-4,4
10. Pm. Total excluding privatization proceeds and liquidities (9-8-4)	-0.7	0.0	0.0	0.0	0.2	0,0	0,0	0,0	0,0	0,0
Valuation effects and residual adjustments										
11. Redemption effects	0.0	0.0	0.0	0.0	0.0					
12. Exchange rate adjustment	0.1	0.0	0.2	0.1	0.1					
13. Other	0.0	0.0	0.0	0.0	0.0					
14. Total (11+12+13)	0.1	0.0	0.2	0.1	0.1	0,0	0,0	0,0	0,0	0,0
15. STOCK-FLOW adjustment (3+9+14)	2.4	4.0	1.5	2.5	2.6	1,8	-1,3	0,1	-0,7	-4,4

Source: ECFIN calculations on September 2004 reporting of government deficits and debt levels (table 3A) and ECB data for the years 2000-2003, Ministry of Finance of Cyprus calculations

It should be noted that, in 2004 there was over-financing and hence accumulation of liquid assets due to the issue of Euro Medium Term Notes (EMTN) of £290mln. This is evident from the balance of the Government General Account which during the first days of November was in surplus accounting for 3,7% of GDP (£266 million on 18/11/2004), which is expected to be retained by the end of the year. It should be also pointed out that up to mid 2002, the government used as a source of financing an advance account, held at the Central Bank of Cyprus.

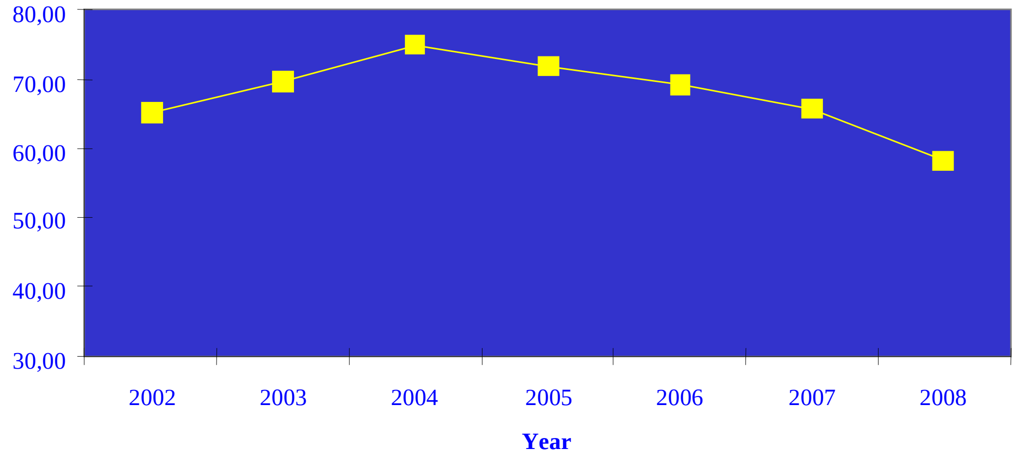
On the basis of the information provided by the above table, it clearly follows that the reversal and the negative stock-flow adjustment, expected to take place over the period 2005-2008 is attributed to the running down of the sinking fund deposits directed towards the repayment of development stock peaking in 2008. Overall, the preceding analysis provides evidence that the large stock-flow adjustment in Cyprus largely reflects institutional deficiencies in the process of debt management. It also rules out any irregularities as regards the quality of financial assets (idle cash though coming with a significant cost cannot be of poor quality) or the quality of public finances.

Debt Levels and Developments

Public debt and public debt management has taken on a new importance as increased attention is now given to debt indicators as a measure of monitoring the sustainability of public finances in the context of the Growth and Stability Pact. This development highlights the need for greater focus on public debt developments, especially following the termination of Central Bank financing of government operations since mid-2002.

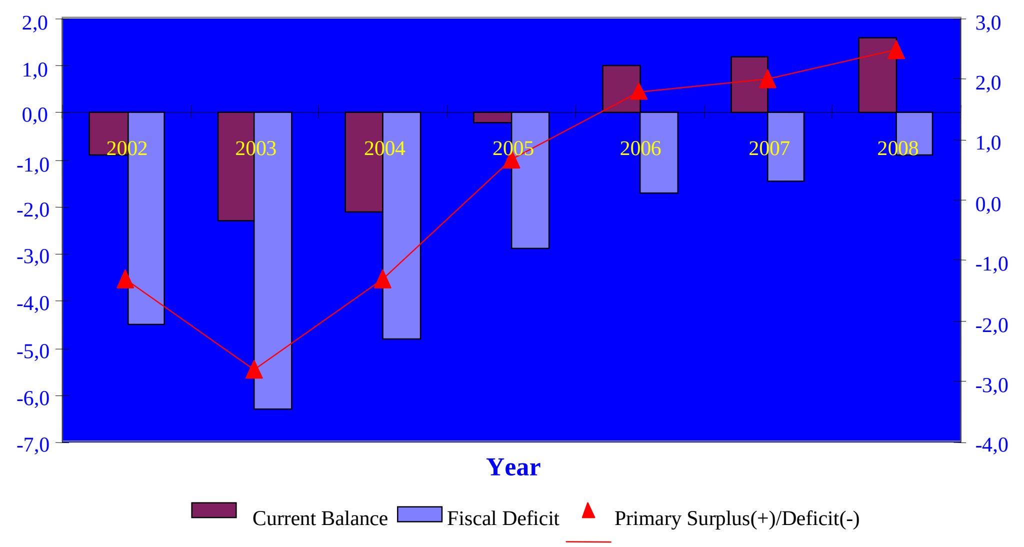
The level of government debt, excluding intragovernmental debt, rose to 69,8% of GDP during 2003. Of this, 8 percentage points corresponded to debt created for the accumulation of the sinking fund deposits that are steadily being run-down and are expected to be largely eliminated by 2008. The implementation of the anticipated fiscal consolidation measures will reverse the increasing trend exhibited by the public debt, which will reach a peak of 74,9% of GDP in 2004, and is expected to follow a decreasing trend from 2005 to 2008 reaching 58,1% of GDP by 2008.

Graph 2: General Government Consolidated Gross Debt (% of GDP)



In more specific terms, the reversal in the trend of the debt to GDP ratio and its placing on a distinct downward path is attributed, on the one hand to the turnaround of the primary balance and on the other to the rundown of sinking fund deposits. As is evident from the Table VII below the primary balance in 2005, in contrast to the preceding years, is anticipated to be in surplus reaching 0,7% of GDP. The primary surplus is projected to increase steadily over the programming period and rise to approximately 2,5% of GDP by 2008, thus contributing to the reversal of the current trends of debt to GDP ratio. Cumulatively, over the programming period (2004-2008) the primary balance totals a surplus of 5,7% of GDP.

Graph 3: Fiscal Magnitudes (% of GDP)



With regard to the financing of the public debt, it is noted that during the second half of 2003 investors exhibited a reluctance to commit to medium and long-term government debt, in particular during the last quarter of the year. During the first two quarters of 2004 this trend increased in intensity, reaching a peak in April 2004. Short-term debt levels at 2003 were at 13,6% of total net public debt, while they are expected to peak to a still moderate level of 16,8% during 2004, followed by a reduction to 15,4% in 2005. The sharp increase in the first half of 2004 in the desire of investors for short-term debt is attributed to the following factors:

- Political uncertainty surrounding the Cyprus problem during the first months of 2004.
- Absence of an active secondary market for government debt.

After the referendum in April 2004 and throughout the third quarter of 2004 there has been a steady shift towards longer-term bonds (2-year and 5-year development stocks) that is expected to continue into 2005.

Over the longer-term the policy is to reduce the levels of short-term debt to within a range of 10% to 15% of total net public debt.

Foreign debt has increased as percentage of total net public debt in 2004 to a level of 30% compared with 22% at the end of 2003. This was mainly due to a 500 million euro issue of a 10-year Euro Medium Term Notes (EMTN) in July 2004; it is noteworthy that the terms of issuance included Collective Action Clauses (CAC's) recently given explicit support by the European Commission.

In 2005 dependence on foreign markets to acquire long-term finance is expected to decline as there are no plans for new large issues of long-term debt in the foreign markets, leading to an expected reduction of the level of foreign debt levels to 28% of total net public debt. During the programming period two previous EMTN bonds will expire. One in June 2006 (280 million euros) and another in July 2008 (350 million euros).

The main policy guidelines regarding foreign debt are:

- The preferred currency of issuance will continue to be the euro (already euro-denominated debt represents more than 85% of foreign debt)

- Foreign debt levels will be kept under the 30% level of total net public debt

After declining during the first half of 2003, interest rates rose during the last six months of the year. In the initial months of 2004 there was a further increase in interest rates of more than one percentage point on all government instruments sold through auctions. The reasons for this sharp increase are:

- Rising government financing requirements.
- Low demand for government securities from investors for the reasons explained above.
- Delay in the political approval to increase limits and draw funds from the international capital markets during the first months of 2004[4].

During the third quarter of 2004 the upward pressure on interest rates was moderated due to the sustained improvement of public finances, the issuance of foreign debt in the form of a 10-year EMTN bond and a marked improvement in the demand for domestic government bonds. This has led to a stabilization of government bond interest yields during the third quarter and there is evidence of a downward trend during the final months of 2004. The reduced government financing requirements and the ability to borrow additional short-term funds through the ECP programme is expected to help maintain this downward pressure on interest rates through the last months of 2004 and in the first part of 2005.

The problems arising from the difficulty to attract sizeable long-term funds in the domestic market have led to a consideration of ways to strengthen the domestic market for public debt, both primary and secondary. It is considered that the most appropriate way would be to set up a primary dealership system that will help the government achieve its goals of lower borrowing costs, increasing liquidity and lengthening the domestic debt maturities.

[4] Borrowing limits from abroad had been reached in December 2003. Political approval for increased limits was granted on the 6th of May 2004.

An Ad Hoc committee comprising of representatives of the Ministry of Finance, the Central Bank of Cyprus, the Cyprus Securities and Exchange Commission and the Cyprus Stock Exchange has been charged with making a thorough study of the subject and providing a set of guidelines on the overall structure of the market and how the government should proceed. The committee is expected to issue its recommendations in the first half of 2005.

Currently, the institutional responsibility for debt management policy is under review. At present legal responsibility for debt management lies with the Central Bank, whereas in practice policies are formulated and implemented in collaboration with the Ministry of Finance. The Ministry of Finance has the decision-making powers on the timing and amounts of debt issued and on the terms of any loans undertaken or bonds issued.

The short-term objective of debt management is to identify and put in place appropriate procedures and skills required to achieve the timely flow of information which will allow the smooth financing of the government as well as the procedures and techniques needed for tackling unforeseen contingencies.

The medium to long-run objective is to create a structure with the necessary flexibility and know-how that will allow debt management to respond to the challenges of market-based government financing.

The main steps towards meeting these objectives are:

- Introducing a new structure for the primary and secondary market for government debt using primary dealers.
- Creating and maintaining channels of communication with other market participants and interested parties.

- Increasing the technical competence of the staff regarding debt management in the relevant departments.
- Creating a flexible decision-making unit that can respond in a timely manner to market conditions.
- Introduction (in 2004) of a new Financial Information Management Accounting System (FIMAS) connecting all government services which will help in the preparation of more accurate projections for financing needs in a more timely manner. This will itself lead to more credible debt issuance calendars on behalf of the government.

Table VII: General Government – Debt Developments

as a % of GDP	ESA code	2003	2004	2005	2006	2007	2008
Gross Debt Level		69,8	74,9	71,9	69,2	65,7	58,1
Change in Gross Debt		4,6	5,1	-3,0	-2,7	-3,5	-7,6
Contributions to Change in Gross Debt							
Primary Balance		-2,8	-1,3	0,7	1,8	2,0	2,5
Interest Payments	D41	3,5	3,5	3,6	3,5	3,5	3,4
Nominal GDP Growth	B1g	6,8	5,6	6,3	6,5	6,6	6,6
Other Factors Influencing Debt Ratio							
Of which: Privatization receipts		-	-	-	-	-	
p.m. implicit interest rate on debt		4,44	4,25	4,25	4,21	4,21	4,00

Medium-term Objectives

The medium-term objectives of fiscal policy are largely driven by the pursuance of the medium-term objective (MTO) of a-close-to-balance or in-surplus budgetary position. The achievement of the MTO will provide the requisite leeway that will allow the automatic stabilisers to operate freely, without distortions from discretionary fiscal policies.

As pointed out in the fiscal policy framework and objectives section, the achievement of the MTO within the time span of this Programme would have been an over-optimistic target, especially if one takes into account the large envisaged adjustment in structural terms. Therefore, this Programme was prepared in a cautious manner does not attempt to incorporate the MTO within its programming period. This does not imply, however, that the MTO cannot be within the reach of fiscal policy by 2008, since on the one hand a number of ‘reserve’ measures are in place, though not precisely quantified, and on the other hand, economic growth could exceed the projections envisaged in this Programme.

Some of the measures included in this Programme, are expected to be particularly instrumental in reaching the MTO by 2009. On the basis of these measures, one may also deduce the medium-term objective of fiscal policy. These measures relate to sustaining the containment of general government sector employment increases, the granting of contractual salary increases without any retroactive effect, the containment of the growth of current transfers to the rate of inflation and finally containing the growth of social benefits to the rate of inflation.

All the above suggest that structural efforts on the expenditure side of the budget are set to permanently affect the budgetary outcome and result in a close-to-balance deficit without recourse to additional fiscal measures. In this connection, these structural measures will be operating towards reducing deficits, not only in the first years of the Programme, but also in the subsequent years. For instance, the foreseen adjustment of 0,6 p.p. of GDP in 2008, is not forecast to be achieved by the introduction of new measures, but reflects the effects of structural measures already taken.

Balance by Sub-Sectors of General Government

The General Government Sector in Cyprus is comprised of the Central Government Sub-sector, the Local Authorities Sub-sector, and the Social Security Funds.

The general government deficit is mainly attributed to the Central Government's deficit as the Local Authorities Sub-sector balance exhibits a marginal deficit of 0,2% of GDP as most of their operations and investment programmes are largely financed by transfers from the Central Government (Table VIII). It should be pointed out that the containment in the Local Authorities net borrowing by 2006 is the result of an increase of central government transfers to these authorities.

The Social Security Funds sub-sector exhibits a considerable surplus thus reducing the overall deficit of the general government by approximately 3 p.p. of GDP[5]. The sizeable surplus in the Social Security Funds is attributed to the fact that the government as an employer of civil servants and as a third party to the whole scheme contributes annually approximately 2,8% of GDP leading to the creation of a surplus in the Social Security Funds.

Table VIII: General Government Budgetary Developments by Sub-Sector

% of GDP	ESA code	2003	2004	2005	2006	2007	2008
Net lending (B9) by sub-sectors							
1. General Government	**S13**	**-6,3**	**-4,8**	**-2,9**	**-1,7**	**-1,5**	**-0,9**
2. Central Government	S1311	-8,7	-7,2	-5,8	-4,8	-4,5	-3,8
3. State Government	S1312	-	-	-	-	-	-
4. Local Government	S1313	-0,2	-0,2	-0,2	-0,1	-0,1	-0,1
5. Social Security Funds	S1314	2,6	2,6	3,1	3,2	3,1	3,0

[5] Interest earned by the Social Security Funds on debt issued by the Central Government is consolidated.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

The economic developments projected in this Convergence Programme involve some uncertainty, even in the short term. Although the acceleration of global economic growth since the second half of last year has generated a mutually reinforcing growth momentum, it is not without risks. The United States, which has retained the role of the major engine of growth, is characterized by long-standing macroeconomic imbalances that may act as an impediment to growth later in the forecast period. High and volatile oil prices and other commodity prices might also have a dampening effect on global growth. Domestically, the important role of the tourist industry in the Cypriot economy is an additional source of uncertainty as this is easily affected by the geopolitical developments in the Middle East. Furthermore, the fiscal policy measures are expected to limit the output forecast over the medium-term to slightly below potential output, while at the same time the structural reforms under way will tend to raise the potential output of the Cypriot economy.

The attainment of the fiscal targets set out in the current fiscal consolidation programme assumes that the economy will grow by 3,6% in 2004, increase to 4,0% in 2005, rise to 4,4% in 2006 and further to its potential of around 4,5% per annum in real terms during 2007-2008.

In addition, the path of interest rates on government borrowing over the medium-term will be significant in determining the degree to which current expenditures can be contained. It is assumed that the average level of interest rates on new government borrowing will converge gradually toward interest rates in the euro zone over the period 2005 to 2008.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

Given the importance of the real growth rate and interest rates in determining the sustainability of fiscal policy, a sensitivity analysis as the one performed during the compilation of the 2003-2007 Convergence Programme was updated.

To assess the sensitivity of the government balance and government debt to different economic growth scenarios and also to interest rate changes, alternative assumptions have been taken into account, for real GDP growth rates and interest rates.

Assumption 1: the rate of annual real GDP growth is half a percentage point higher, on an annual average, than in the reference (central) scenario.

On this assumption, with other things being equal, and under the assumption that the Government assumes a neutral policy stance, the government deficit by 2008, expressed as a percentage of GDP, is 0,2 of a percentage point lower and the public debt ratio 1,3 of a percentage point lower than in the reference scenario.

Assumption 2: the rate of real GDP growth is half a percentage point lower, on an annual average, than in the reference (central) scenario.

On this assumption, with other things being equal, and under the hypothesis that the Government assumes the same neutral policy stance, the overall deficit by 2008, expressed as a percentage of GDP, is 0,3 of a percentage point higher and the public debt ratio 1,3 of a percentage point higher than in the reference scenario.

Table IX: Three Scenarios for Public Finances

in percent of GDP	2004	2005	2006	2007	2008	2004-2008 4– year average
Central Scenario						
GDP	3,6	4,0	4,4	4,5	4,5	4,3
General Government Balance	-4,8	-2,9	-1,7	-1,5	-0,9	
General Government Debt	74,9	71,9	69,2	65,7	58,1	
Upper Scenario (GDP growth 0,5 of a percentage point higher)						
GDP	4,1	4,5	4,9	5,0	5,0	4,8
General Government Balance	-4,5	-2,6	-1,4	-1,3	-0,7	
General Government Debt	74,6	71,3	68,3	64,6	56,8	
Lower Scenario (GDP growth 0,5 of a percentage point lower)						
GDP	3,1	3,5	3,9	4,0	4,0	3,8
General Government Balance	-5,0	-3,1	-2,0	-1,8	-1,2	
General Government Debt	75,1	72,3	69,9	66,7	59,4	

Assumption 3*:* interest rates are 0,5 of a percentage point higher than in the reference (central) scenario.

In a scenario with higher interest rates over the programming period the government deficit, expressed as a percentage of GDP, is 0,4 of a percentage point higher and the government debt ratio is 1,0 percentage point higher at the end of the programme period.[6]

The impact of a rise in interest rates on government debt though significant, is moderated by the fact that a considerable part of the debt comprises fixed interest-rate borrowings made in previous years, so that the new interest rates will affect mainly the servicing costs for new debt issues.

[6] In this scenario real GDP growth is assumed to remain unchanged even though higher interest rates could be expected to have a moderating effect on real economic growth.

Table X: Scenario with Higher Interest Rates Cumulative Differential

in percentage points of GDP with respect to the reference scenario	2004	2005	2006	2007	2008
General Government Net Borrowing	0,0	0,1	0,2	0,3	0,4
General Government Gross Debt	-	0,1	0,3	0,6	1,0

Developments on the government finances in 2002 and 2003 and sensitivity analysis conducted on the government finances confirm that the magnitude of the real GDP growth rate is crucial to the outcome of the public finances. Accordingly, if the real growth rate of the Cyprus economy does not show a significant recovery over the medium-term it will be difficult to reduce the government fiscal deficit below 3% by 2008. Indeed, even with the full implementation of the fiscal adjustment measures required under the convergence programme, it is unlikely that the ratio of net general government borrowing to GDP will be contained below the 3% reference value by 2008 if real GDP growth were to experience only a modest recovery from the 2% annual levels recorded in 2002 and 2003.

Comparison with Previous Update

The previous Convergence Programme predicted a GDP growth rate of 3,5% for 2004 whereas current preliminary data put the figure at 3,6%. Developments in the labour markets were close to projections, while inflation was somewhat slower than anticipated. The general government net borrowing is estimated at 4,8% of GDP, 0,4 p.p. lower than what was predicted in the previous Convergence Programme.

The slowdown in the economic growth since the last quarter of 2001 came to a halt at the beginning of 2004. And in line with the international economic recovery an acceleration of the Cypriot economic growth performance reaching 4,0% in 2005 is forecast. This is slightly below the 4,3% predicted in the previous Convergence Programme, as a consequence mainly of the higher international price of crude oil.

As a result of the anticipated improvement in the economic prospects for 2005, in conjunction with the firm implementation of the fiscal consolidation measures described above, the general government net borrowing is projected to be reduced to around 2,9% of GDP, which coincides with the target of the previous Convergence Programme. The general government debt to GDP ratio is predicted to fall in 2005 and settle at around 71,9% of GDP as a result of a rising primary balance and the running down of sinking fund deposits. This forecast compares favourably to the prediction of 74,8% that was reported in the Convergence Programme of 2003-2007. The considerable revisions in the latest update of the debt to GDP ratios are attributed also to the fact that the GDP levels were revised upwards[7] improving the debt to GDP ratio by approximately 1,4 p.p.

[7] On November 11, 2004 the Statistical Service announced the completion of its revision of the National Accounts for the period 1995 to 2003. The National Accounts have been revised so as to adapt to the methodology of the European System of National Accounts of 1995 (ESA 95); Eurostat has provided assistance to the Cypriot Authorities and to the other nine new member states with specific projects addressed towards harmonization with ESA 95. The revision has resulted in the annual levels of nominal GDP being revised for the years 1995 to 2003 with the level for 2003 being increased by 1,5% to £6.801,7 million. As a consequence, the government debt to GDP ratio for the said year fell by 1p.p. from 70,8% to 69,8%.

Reflecting the better fiscal and government debt performance forecast for 2004 and 2005 and the downward revisions in the debt to GDP ratios the levels of the government deficit and debt to GDP ratios over the medium-term are now forecast to be lower as compared with the targets set in the previous Convergence Programme.

Table XI: Divergence from previous update

% of GDP	ESA code	2004	2005	2006	2007	2008
GDP Growth						
Previous Update	B1g	3,5	4,3	4,4	4,5	
Latest Update	B1g	3,6	4,0	4,4	4,5	4,5
Difference		0,1	-0,3	-	-	
Actual Budget Balance						
Previous Update	B9	-5,2	-2,9	-2,2	-1,6	n.a.
Latest Update	B9	-4,8	-2,9	-1,7	-1,5	-0,9
Difference		-0,4	-	-0,5	-0,1	
Gross Debt Levels						
Previous Update		75,2	74,8	71,5	68,4	n.a.
Latest Update		74,9	71,9	69,2	65,7	58,1
Difference		-0,3	-2,9	-2,3	-2,7	

5. QUALITY OF PUBLIC FINANCES

Policy Strategy

To achieve its major economic objectives of sustainable economic growth, under conditions of macroeconomic stability and social cohesion, the Government has long recognized that the maintenance of sound public finances is a pre-requisite. Also, in line with the Broad Economic Policy Guidelines (BEPGs) attention in being focused on how fiscal policies can contribute to the fulfillment of the Lisbon strategy. Furthermore, with the prospective ageing of the Cyprus population, it has become acknowledged that fiscal policies must be directed increasingly to strengthening the long-term sustainability of public finances.

The Cyprus authorities consider that alongside structural reform, a fiscal policy strategy is not only needed to ensure nominal convergence, but is also required to enhance real economic convergence. Cyprus can rely only to a limited extent on financing from the EU structural and cohesion funds and the EIB to upgrade the human and physical capital base and to effect structural reforms and, thus, the public sector budget will have to contribute substantially to such financing. At the same time the general government will have to cope with other expenditure pressures including co-financing requirements, while ensuring that the public finances are consolidated to underpin macroeconomic stability.

More specifically, the policy strategy relating to government revenues and expenditures over the Convergence Programme period, while geared essentially to achieving fiscal consolidation, aims also at promoting:

- an environment favourable to business development and robust employment growth;
- the diversification of the economy toward higher value added and knowledge-based activities; and

- a better life for its citizens, through inter alia improving the quality of public services, including health care and education.

Revenue Developments and Policies

Cyprus introduced a broad tax reform in 2003, leading to a more simplified and efficient system. In the field of direct taxation there was a significant reduction of marginal income tax rates and a narrowing of the tax base, as well as compliance with the EU Code of Conduct of Business Taxation. In indirect taxation there was a harmonization of the tax base and the adoption of the minimum levels of excise and VAT rates prescribed by the acquis. The tax reform, while shifting the tax burden from direct to indirect taxation, reduced the tax burden on capital and labour contributing positively towards the creation of a more favourable business climate and on incentives to work.

The tax reform was accompanied by increases in benefits and transfers to certain social groups disadvantaged by the adverse effects of the higher indirect tax rates. This meant that the overall effects of the tax reform which were intended to be neutral on the government finances contributed importantly to a further rise in the government deficit in 2003. These developments in the revenue and expenditure effects of the tax reform were outlined in the previous Convergence Programme.

As indicated above, the revamped fiscal consolidation programme for the period 2004 to 2008 aims to preserve the benefits of the reformed tax system by not changing taxation rates, but to enhance government revenue by improving tax administration and compliance and substantially revising upwards antiquated fees for the provision of government services and royalty charges.

Estimates in Table 2 of the Appendix show that tax revenues are expected to rise by 0,9 p.p. of GDP over the programme period, mainly as a result of the host of measures targeted at strengthening the tax administration and broadening the tax base, including the anticipated impact of the tax amnesty, as outlined above in Table III of the fiscal consolidation measures.

In sum, the tax policy strategy incorporated in this updated convergence programme aims at maintaining the growth-oriented stance of the current tax system, but is directed also to contributing to the soundness and sustainability of the government finances by raising the revenue yields of the tax system.

With respect to non-tax revenues, the Central Government has in the past contributed substantially to building up the capital base and developing the operations of semi-governmental organisations and, periodically, certain semi-governmental organisations have paid dividends to the Government. However, as part of the revenue strategy the government has sought to regularise such dividend payments to the government, without jeopardizing the investment programmes of the semi-governmental organisations. Indeed, substantial dividend income is expected from semi-governmental organisations in the coming years amounting annually up to the equivalent of 0,6 % of GDP.

Expenditure Developments and Policies

To achieve the targets of the Convergence Programme considerable reliance has been placed on reversing and containing the recent rapid growth of the ratio of current expenditure to GDP from 41,4% in 2003 to 39,0% by 2008. In contrast, the ratio of the government capital expenditures to GDP falls from 4,0% in 2003 to 2,5% by 2008. This reduction, which mainly occurs in 2004, is attributable largely to the reclassification of certain expenditures previously included in the development expenditures to ordinary or current expenditures. Notwithstanding, the Government's investment programme is being maintained to ensure the requisite expansion and upgrading of infrastructure facilities.

The containment in current expenditures is not expected to diminish the quality of government services, but is directed more toward curtailing the rapid recent growth of social and other current transfers. For instance, public expenditure on education is on an upward trend and is budgeted to increase to over 5,2% of GDP in 2005 so as to help raise further the high educational attainments of the Cyprus population. The estimates in Table 2 of the Appendix reveal that social transfers and subsidies will bear the brunt of the current expenditure restraint, while collective consumption is expected to be approximately stable as a proportion of GDP.

In line with its endorsement of the Lisbon Strategy, Cyprus is to raise its investment in Research and Development and continue to take steps to enhance the adequacy of skilled human capital so as to help foster a knowledge-based economy. Among these steps is the initiative to establish an international research, education and technology institute, in co-operation with the Harvard University, as well as efforts to accelerate the expansion of the e-Government and to set the necessary legal and institutional grounds for the development of e-Commerce.

To ensure good quality standards and to effectively implement the acquis communataire, the government has established new independent organisations (e.g. Internal Audit, Office for the Commissioner for Data Protection, Office of the Commissioner for Public Aid, Regulatory Authority for Telecommunications and Postal Services etc) staffed with qualified personnel.

Expenditure Control

The quality of the public finances in Cyprus is being enhanced by improved expenditure control to ensure that actual expenditures are kept within budgeted appropriations and are directed to the purposes for which they are intended. In the past, the practice of frequently submitting supplementary budget requests of considerable magnitude has tended to undermine expenditure control and contribute to the unplanned and ad hoc nature of government expenditures. In 2004 the number and quantitative significance of supplementary budgets has been greatly reduced to just four Supplementary Budget requests amounting to £63 million, compared with fourteen totaling £431 million in 2003, the latter involving government expenditures equivalent to 6,7% of GDP.

For the first time in the government budget for 2005, limits have been placed on the growth of certain major expenditure components as compared with their budgeted levels for 2004, including 4% for capital expenditure and 3% for current expenditure items, such as social transfers. Also, the growth of pensions and monetary allowances is to be kept to below the rate of inflation in contrast to past practices where growth rates exceeded the rate of inflation considerably. These expenditure limits together with the minimization of Supplementary Budget Bills both in terms of numbers and quantitative significance should help considerably in improving expenditure control and the more careful planning of expenditure by line Ministries.

In addition, the introduction as from the beginning of 2004 of a new computerized accounting system (FIMAS) connecting all government services will provide better and more timely data for the monitoring of government expenditure and for improving debt management, thus strengthening expenditure control and containment.

6. SUSTAINABILITY OF PUBLIC FINANCES

In assessing long-term fiscal sustainability the demographic projections prepared by the Statistical Service were used and key assumptions were made about the macroeconomic framework, the labour market and trends over the long-term. The main assumptions are as follows:

- **Employment growth:** based on the demographic projections prepared by the CY Statistical Service until 2050 and assuming a gradual small increase of the employment rate of the female population and of old age persons and a small net migration, it is estimated that the annual employment growth would slow down, from 2,4% in 2000, to about 1,2% by 2005, to 0,8% by 2010, to 0,2% by 2020 and remain constant thereafter;
- **Male and female participation rates:** are forecast to exhibit a gradual increase over the long term. Projections were slightly revised compared to the previous Convergence Programme to better reflect the population structure and in particular, age specific participation rates.
- **Annual labour productivity:** increases are projected to accelerate from 2,6% in 2000, to about 2,8% by 2005 and 3,2% by 2010, owing to the positive effects of envisaged structural reforms and greater utilisation of advanced technologies. Thereafter, it is assumed that productivity gains would decline to an average of around 3% per annum;
- **Real wage and salary incomes:** these are projected to grow in line with labour productivity gains;
- **Real GDP growth:** GDP is projected to grow at an annual rate of approximately 4% up to 2010 and around 3% thereafter;
- **Inflation:** the average rate of inflation is projected to reach 2,6% in 2005 and to average 2% per annum thereafter;
- **Other government expenditure and revenues:** it is assumed that government expenditure and revenues as a ratio to GDP, excluding expenditures for old age pensions, health care and interest payments would remain constant after 2006.

Demographics

According to the demographic projections prepared by the Cyprus Statistical Service, the population in the government-controlled area is expected to reach 816.406 by 2050 compared to 705.539 in 2002. The percentage of those aged 15-64 to the total population is projected to fall to 61% by 2050, compared to 66,8% in 2002. For those aged 65+, the percentage to total population is projected to increase to 28,5% by 2050 compared to 11,7% in 2002. The above data indicates the ageing effect on the population which will affect the labour force supply. This is expected to be only to a limited extent offset by the inflow of immigrants.

No-reform scenario

(a) Social Security System

Without any policy adjustments to the current social security system and assuming that the National Health System will be introduced in 2006, the projections show increasing deficits in the public finances over the long-term, especially in the period after 2020. It is revealed that the ageing of the population of Cyprus places pressures on the government budget, particularly through the rising proportions of GDP required for government expenditure on old-age pensions and, to a lesser extent, on health care. Another factor leading to an increase of pension payments over the coming decades is the gradual maturing of the scheme.

The old-age (or demographic) dependency ratio - namely, population of 65 years and older in percent of the population of 15-64 years - is projected to nearly double to 31,5% by 2030 and rise further to 46,1% by 2050. As a result, the surplus of the social security funds will be transformed into a deficit by 2020.

While the social security system remains financially viable until about 2020, the longer-term projections show that by 2020, under an unreformed pensions system, expenditure on pensions will exceed contributions to the fund, while at the same time, the reserves of the pension scheme will diminish and become negative by 2030, adversely affecting investment income and therefore revenues of the pension scheme.

According to an actuarial analysis, without the parametric reforms to the pension scheme mentioned below, there should be an increase in contribution rates from 8.7% today to 14,8% over the next 50 years for the lower band and from 5,6% to 8,4% for the upper band. This amounts to a total contribution rate for old age pensions equal to 23,2% compared to the present total contribution rate of 14,3%.

More specifically, without reforms, the period of equilibrium of the lower band (the period over which the reserve is at least equal to 1 time the annual expenditure) falls below the threshold as from 2010 onwards. In the upper band, the reserves should be 9 times the annual expenditure and the threshold is reached after 2019.

With the parametric reforms, the viability of the system is improved and the last year of the period of equilibrium (i.e. the reserve ratio in relation with the annual expenditure) is extended to after 2050 for the lower band and to 2023 for the upper band. This is because the CPI indexing results in important savings in the lower band and modest savings in the upper band.

(b) Health

At the same time, the relatively high-income elasticity of health expenditure, the planned introduction of a National Health Scheme by 2006, which foresees no fee at the point of consumption, the likely increase of demand for cost-intensive health care, especially of the old aged and the ageing population, are factors expected to lead to relatively high increases in health care expenditures. However, the introduction of a National Health Scheme is also expected to lead to savings, inter alia, through the implied competition pressure on the public hospitals to become more efficient, efficiency gains through the anticipated improvement of primary health care, savings due to the introduction of the concept of the family doctor and the introduction of the global budgeting concept for the

National Health Scheme. The total impact of these factors on the evolution of health expenditure over the long-term is difficult to assess.

For the purpose of this exercise, projections were undertaken, based on the assumption that health care expenditure would exhibit a GDP growth elasticity of 1,1 between 2005-2010, which would decrease thereafter, gradually, to 1,03 by 2050, reflecting efficiency gains through the introduction of the National Health Scheme. Furthermore, based on the agreement between the Government and the social partners on the contribution rates of the Government (4,55% of earnings), employers (2,55% of earnings) and employees (2% earnings), it was estimated that the Government will cover roughly 52,5% of the total health care expenditure (including its contribution as employer) after the introduction of the National Health Scheme, planned to take place by 2006.

Based on the above-mentioned assumptions, it is estimated that the Government healthcare current and capital expenditure would rise from the current 3% of GDP to about 4% by 2050.

It emerges that over the long term, policy reforms are essential, especially for the pension scheme, with a view to improving long-term fiscal sustainability.

Policy Reforms Options of the Pension Scheme

The Government is focusing on the following reform options which are currently under discussion between the Government and the social partners:

Parametric Reforms:

- gradual increase of the normal pensionable age from currently 63 to 65 years over the period 2005-2011; the scope of further increasing the pensionable age to 67 years will be examined at a later stage;
- indexing of the lower band pensions based on a price index, instead of the wage index, as is currently the practice;

- increasing the number of years of contribution required for eligibility to the old age pension from 10 to 15.

The above reforms will definitely improve the sustainability of the system, but even so viability issues still arise. In this respect therefore, second tier reforms would be to increase contribution rates based on predetermined rules. In more specific terms, the policy option under consideration is to automatically increase contribution rates if the reserves of the Fund fall below a certain defined level. It should be noted that a gradual increase of contribution rates, as the Social Insurance Scheme is maturing is normal in partially funded pension schemes, such as the one in Cyprus. This possibility was already foreseen when the Social Insurance Scheme was originally designed. However, the increases have to be restrained so as to contain the negative impact on the competitiveness of the Cypriot goods and services.

An actuarial exercise revealed that an increase of the normal pensionable age to 65 years, combined with indexing of the lower band pensions based on a price index and increasing the number of years of contribution required for eligibility to the old age pension from 10 to 15 would lead to savings as shown in Table 6. Namely, as a result of the above reforms total revenues will exceed total expenditure on pensions until close to 2030, while the reserves of the pension scheme remain positive until 2050 when they become negative.

Apart from the above mentioned reform measures, the long-term sustainability of the public finances can be further improved through achieving surpluses in the fiscal accounts, (excluding pension and health care). In more concrete terms, it is believed that savings will gradually increase and reach 3% of GDP until 2050, mainly through restraining the increase of public expenditure (excluding pensions and health-care payments) below the increase of nominal GDP growth. The effects of the above mentioned measures are presented in Table 6.

Table 6 shows that notwithstanding the envisaged pension reforms, public deficit would nevertheless occurs amounting to 0,8% of GDP in 2010 and rising to 5,8% in 2050. At the same time, national pension fund assets become negative by 2050. Therefore, a gradual, until 2050, increase of the contribution rates from currently 14,3% of earnings is considered necessary, to neutralise the effects of the maturing pension scheme and population ageing on public finances and safeguard a viable financing of the pension scheme over the long-term.

APPENDIX : Tables

Table 1: Growth and Associated Factors

Percentages unless otherwise indicated	ESA Code	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
GDP growth at constant market Prices (7+8+9)	B1g	1,8	3,6	4,0	4,4	4,5	4,5
GDP level at current market prices (£ mln)	B1g	6801,7	7184,1	7650,9	8159,8	8706,2	9290,6
GDP deflator		4,8	1,9	2,4	2,1	2,1	2,1
CPI change (annual average)		4,1	2,1	2,6	2,2	2,1	2,0
Employment growth *		1,1	1,4	1,2	1,2	1,3	1,3
Labour productivity growth **		0,8	2,2	2,8	3,1	3,2	3,2
		Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	P3	2,6	4,5	4,0	4,0	4,0	4,0
2. Government consumption expenditure	P3	4,7	-2,7	2,0	2,8	3,9	2,2
3. Gross fixed capital formation	P51	-2,2	5,0	5,8	5,9	6,0	6,1
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	0,8	1,7	-0,2	-0,2	-0,5	-0,1
5. Exports of goods and services	P6	-1,4	4,7	6,2	7,0	7,1	7,1
6. Imports of goods and services (excl. aircrafts and defence)	P7	1,8	7,3	5,5	6,1	6,1	6,1
		Contribution to GDP growth					
7. Final domestic demand excl. change in inventories		2,1	3,4	4,1	4,2	4,4	4,1
8. Change in inventories and net acquisition of valuables	P52+ P53	0,3	0,5	-0,3	-0,2	-0,4	-0,1
9. External balance of goods and services	B11	-0,5	-0,3	0,2	0,4	0,4	0,5

* Population with occupations, domestic concept, persons, national accounts definition

** Growth of GDP per person employed at constant prices

Table 2: General Government Budgetary Developments

as a % of GDP	ESA code	2003	2004	2005	2006	2007	2008
Net lending (B9) by sub-sectors							
1. General Government	S13	-6,3	-4,8	-2,9	-1,7	-1,5	-0,9
2. Central Government	S1311	-8,7	-7,2	-5,8	-4,8	-4,5	-3,8
3. State Government	S1312	-	-	-	-	-	-
4. Local Government	S1313	-0,2	-0,2	-0,2	-0,1	-0,1	-0,1
5. Social Security Funds	S1314	2,6	2,6	3,1	3,2	3,1	3,0
General Government (S13)							
6. Total Receipts	ESA	39,1	39,0	40,1	40,5	40,6	40,6
7. Total Expenditure	ESA	45,4	43,8	43,0	42,2	42,1	41,5
8.Budget Balance	B9	-6,3	-4,8	-2,9	-1,7	-1,5	-0,9
9. Net Interest Payments		3,5	3,5	3,6	3,5	3,5	3,4
10. Primary Balance		-2,9	-1,3	0,7	1,8	2,0	2,5
Components of Revenues							
11. Taxes	D2+D5	26,3	27,2	27,5	27,8	27,9	28,1
12. Social Contributions	D61	7,1	7,1	7,2	7,3	7,4	7,3
13. Interest Income	D41	0,3	0,3	0,2	0,2	0,1	0,1
14. Other		5,4	4,4	5,2	5,2	5,2	5,1
15. Total receipts	ESA	39,1	39,0	40,1	40,5	40,6	40,6
Components of Expenditure							
16. Collective Consumption	P32	11,0	9,5	9,4	9,5	9,5	9,4
17. Social Transfers in Kind	D63	9,0	9,6	9,4	9,2	9,2	9,0
18. Social Transfers Other than in kind	D62	11,4	11,8	11,8	11,4	11,4	11,4
19. Interest Payments	D41	3,5	3,5	3,6	3,5	3,5	3,4
20. Subsidies	D3	1,2	1,0	0,7	0,6	0,5	0,5
21. Gross Fixed Capital Formation	P51	3,4	2,4	2,3	2,2	2,2	2,1
22. Other		5,9	6,0	5,8	5,8	5,8	5,7
23. Total Expenditures	ESA	45,4	43,8	43,0	42,2	42,1	41,5

Table 3: General Government – Debt Developments

as a % of GDP	ESA code	2003	2004	2005	2006	2007	2008
Gross Debt Level		69,8	74,9	71,9	69,2	65,7	58,1
Change in Gross Debt		4,6	5,1	-3,0	-2,7	-3,5	-7,6
Contributions to Change in Gross Debt							
Primary Balance		-2,8	-1,3	0,7	1,8	2,0	2,5
Interest Payments	D41	3,5	3,5	3,6	3,5	3,5	3,4
Nominal GDP Growth	B1g	6,8	5,6	6,3	6,5	6,6	6,6
Other Factors Influencing Debt Ratio							
Of which: Privatization receipts		-	-	-	-	-	
p.m. implicit interest rate on debt		4,44	4,25	4,25	4,21	4,21	4,0

Table 4: Cyclical Developments

as a % of GDP	2003	2004 est.	2005 proj.	2006 proj.	2007 proj.	2008 proj.
GDP growth at constant prices	1,8	3,6	4,0	4,4	4,5	4,5
Actual balance	**-6,3**	**-4,8**	**-2,9**	**-1,7**	**-1,5**	**-0,9**
Net Interest payments	3,5	3,5	3,6	3,5	3,5	3,4
Potential GDP growth, % change	4,5	4,5	4,5	4,5	4,5	4,5
GDP output gap	-2,7	-1,0	-0,2	-0,1	0,0	0,0
Cyclical budgetary component	1,3	0,5	0,2	0,0	0,0	0,0
Cyclically-adjusted balance	**-5,0**	**-4,3**	**-2,7**	**-1,7**	**-1,5**	**-0,9**
Cyclically-adjusted primary balance	-1,5	-0,8	0,9	1,8	2,0	2,5

Table 5: Divergence from previous update

as a % of GDP	ESA code	2004	2005	2006	2007	2008
GDP Growth						
Previous Update	B1g	3,5	4,3	4,4	4,5	
Latest Update	B1g	3,6	4,0	4,4	4,5	4,5
Difference		0,1	-0,3	-	-	
Actual Budget Balance						
Previous Update	B9	-5,2	-2,9	-2,2	-1,6	n.a.
Latest Update	B9	-4,8	-2,9	-1,7	-1,5	-0,9
Difference		-0,4	-	-0,5	-0,1	
Gross Debt Levels						
Previous Update		75,2	74,8	71,5	68,4	n.a.
Latest Update		74,9	71,9	69,2	65,7	58,1
Difference		-0,3	-2,9	-2,3	-2,7	

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

as a % of GDP		2000	2005	2010	2020	2030	2040	2050
1.	Total expenditure	36,6	43,0	41,0	42,6	44,4	44,2	43,8
2.	Old age pensions	4,1	4,3	4,2	5,8	7,7	8,4	9,2
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	3,6	2,2	2,9	3,7	3,8	3,6
5.	Other savings		0,0	-1,0	-2,0	-3,0	-4,0	-5,0
6.	Total revenues	33,8	40,1	40,2	40,7	40,3	39,3	38,0
7.	Of which: from pensions revenues	6,9	6,6	6,8	7,2	6,9	5,9	4,6
8.	National pension fund assets	37,0	37,6	39,4	40,9	26,4	0,5	-29,9
8a.	Budget Balance	-2,8	-2,9	-0,8	-1,9	-4,0	-4,9	-5,8
Assumptions								
9.	Employment growth	2,4	1,2	0,8	0,2	0,0	0,0	0,0
10.	Labour productivity	2,6	3,0	3,2	3,0	3,0	3,0	3,0
11.	Real GDP growth	5,1	4,3	4,0	3,2	3,0	3,0	3,0
12.	Participation rate males (aged 15-64)	78,9	80,0	80,8	79,3	81,5	81,6	85,1
13.	Participation rates females (aged 15-64)	52,5	55,0	55,0	54,2	57,5	60,1	67,5
14.	Total participation rates (15-64)	65,5	67,5	67,9	66,8	69,7	71,2	76,6
15.	Unemployment rate (ILO definition)	3,4	3,2	3,4	3,5	3,5	3,5	3,5

Table 7: Assumptions on the External Economic Environment

VARIABLE	ASSUMPTIONS FOR			
	2004	**2005**	**2006**	**2007**
(annual averages)				
Interest rates (in % p.a)				
-euro area: short-term (3 months money markets)	2,1	2,6	3,5	3,8
-euro area: long-term (10- year government bonds, lowest one prevailing in euro area)	4,2	4,6	4,8	5,0
-U.S.A.: short term (3 months money markets)	1,6	2,9	3,6	3,9
-U.S.A.: long-term (10 year government bonds)	4,3	4,7	5,3	5,5
Exchange rates (“-“ depreciation)				
USD/€ (level)	1,23	1,24	1,24	1,24
Nominal effective exchange rate of the Cyprus pound (% change)	1,0%	n/a	n/a	n/a
Exchange rate per Cyprus pound: (levels)				
US Dollar	2,11	2,16	2,16	2,16
Pound Sterling	1,17	1,20	1,20	1,20
Euro	1,71	1,73	1,73	1,73
GDP (in real terms, % change)				
-World, excluding EU (in PPP terms)	5,7	4,8	4,6	4,5
-USA	4,4	3,0	2,9	3,0
-Japan	4,2	2,1	2,3	2,0
-EU-25	2,5	2,3	2,4	2,4
World Trade (% change)				
World import volumes, excluding EU	11,6	8,8	8,3	8,0
World import prices (goods, in USD)	10,4	3,7	0,5	0,5
Commodity prices				
Oil prices (Brent, level in USD/barrel)	39,3	43,3	43,3	43,3
Non-oil commodity prices (in USD, % change)	12,9	-2,9	-0,5	-0,5