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DECEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF CYPRUS (2004-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The updated Cypriot convergence programme covering the period 2004-2008 was submitted on December 7, 2004. The programme complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[2]. The text model structure provided in Annex 2 of the code of conduct is followed but the update consists of (the first) six chapters and not seven. Also, the tables indicate CPI inflation instead of HICP inflation. For Table 7 external assumptions for 2008 are missing.

The update provides the fiscal consolidation path and macro-economic scenario for the period 2004-2008. Projected GDP growth and inflation for 2004-2006 are close to the Commission services autumn 2004 forecast. Medium term projected GDP growth at 4.5% is based on strengthening of domestic private demand accompanied by a rebound in exports (especially tourism, a mainstay of the economy). Other than the scenario discussed above (the "central scenario"), the update contains three alternative scenarios for the macroeconomic and budgetary projections: an "upper", "lower", and "higher interest rates" scenario, with different assumptions on average GDP growth (+- 0.5% percentage point) and higher interest rates (+0.5% percentage point). The projections given in the so-called "central" scenario can be considered as the reference scenario for assessing budgetary projections because, on the basis of currently available information and given historical growth rates, it seems to reflect plausible growth assumptions whereby the output gap is gradually closed.[3]

Cyprus continues to perform well in terms of inflation, which reached 1.9% in 2004, compared with 4% in 2003 when inflation was pushed by increases in VAT rates and excise duties. Despite a growth rebound from 2004 onward, inflationary pressures are expected to remain subdued with inflation projected to slightly increase to 2.4% in 2005 and then move back toward 2% by 2008. Despite low inflation, long-term interest rates increased in the first half of 2004 and only slightly decreased towards the end of the year. Monetary policy continues to be geared towards price stability through a peg of the Cyprus pound to the euro, and the update envisages keeping the current monetary policy framework, whereby the pound is pegged to the euro in place until the eventual membership in the euro area. The authorities confirmed the intention to enter the euro area as soon as possible.

The update aims at reducing the government deficit to below the 3% of GDP reference value in 2005, in line with the Council recommendation under Article 104(7). It foresees

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1 This technical analysis, which is based on information available up to 9 February 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence] programme, which the College adopted on 16 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Willem Noë (willem.noe@cec.eu.int)

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

3 It should be noted at the outset that future economic developments in Cyprus remain subject to unusual uncertainty. In case of future reunification, the economic situation of the entire island would fundamentally shift.

the general government deficit to sharply decline from 4.8% of GDP in 2004 to 2.9% in 2005 and to decline more gradually thereafter, to 0.9% in 2008. Since interest expenditures are projected to remain constant at around 3.5% of GDP the primary surplus path is similar to that of the deficit, improving from -1.3% in 2004 to 2.5% at the end of the programme period. To this end, the update envisages a series of mostly structural measures to restrain expenditure, which is where most of the slippage occurred in past years, and to increase revenue. Expenditure limits contribute 2.3 percentage points to the overall deficit reduction of almost 4 percentage points of GDP over the period 2004-2008. The adjustment path reflects the government commitment to improve public finances with the intention to adopt the euro by 2007. This is the main factor behind the frontloading of the fiscal adjustment which would reduce the general government budget deficit by 1.9 percentage points of GDP in 2005. It should also be noted that with 2004 GDP growth in line with previous programme projections, through expenditure restraint but also higher revenues the update estimated a 2004 deficit of 4.8% of GDP, instead of 5.2% of GDP in the previous programme. The 2004 deficit is now estimated even lower at 4.3% of GDP, despite delays in a number of measures originally planned for 2004 and now to be implemented in 2005. Compared with the previous programme, the current update broadly confirms the planned adjustment against a broadly unchanged macroeconomic scenario. The fiscal consolidation objective for 2005 is unchanged, despite somewhat lower anticipated GDP growth. At the same time, the downward deficit path for 2006-2007 is slightly tightened further, although projected growth and the planned measures are mostly unchanged.

The programme objective to reduce the general government deficit by 3.9 percentage points over the period 2004-2008 is ambitious but does not appear unachievable within this time frame, also given the plausible growth assumptions. The risks to the budgetary projections in the update appear broadly balanced. In particular, the main downside macro-economic risks are the economic outlook in the US and EU (notably the UK and Germany, main tourist source countries), tensions in the Middle East, and oil price developments. The main risks for the implementation of the adjustment path will be for 2005, given that the largest deficit reduction is targeted for that year. However, the update reiterates that additional measures will be taken if lower growth would risk leading to a higher deficit in 2005. Fiscal consolidation measures emphasize structural expenditure control, especially on government consumption. Furthermore, the 2004 deficit of 4.8% of GDP (now estimated at 4.3% of GDP), instead of a previously targeted 5.2% of GDP, facilitates the deficit adjustment for 2005. While expenditure should remain under control, the update prudently takes revenues from a number of measures as a safety margin to offset the impact of possible delays in other measures for 2005 and so to maintain the deficit target of 2.9% for 2005 as an “upper limit”. In addition, several of the planned measures for 2005 have now been successfully negotiated with the social partners. All in all, the planned deficit reduction for 2005 looks challenging but increasingly feasible.

In view of this risk assessment, the budgetary stance in the update seems sufficient to reduce the deficit to below 3% of GDP by 2005. For 2006-2008 the adjustment path risks are smaller, as projected adjustments are less significant. The adjustment path has however been revised downward while it is not clear how this tightening will be achieved, given that planned measures and GDP growth path have broadly remained the same. With this path, budgetary consolidation toward the medium term budgetary position of close to balance would be sustained after the excessive deficit has been corrected.

The general government debt level in 2004 reached 74.9% of GDP, above the 60% reference value. This peak is followed by a downward path to reach 58.1% of GDP by 2008. The decrease is mainly driven by increasingly positive primary balances and an annual nominal GDP growth above the average nominal interest rate on government debt in 2005-2008. In addition, the gradual phasing out of sinking funds leads to debt-reducing stock-flow adjustments (SFAs) of on average 1.6 percentage points from 2005 onward, following debt-increasing SFAs in 2000-2004. As indicated, the underlying GDP growth scenario is plausible but the projected debt path also depends on the ambitious fiscal consolidation for 2005 and following years.

The update only briefly spells out the government's structural reform agenda, which deals with labour, product and capital market policies; fostering a knowledge-based economy; and sustainable development. No estimate of budgetary impact is given for these policies[4]. In the context of preparing for ERMII and eventual participation in EMU, it observes that greater reliance has to be placed on structural policies to maintain competitiveness. However, the report mainly focuses on fiscal policy measures, stating that, alongside structural reform, a fiscal policy strategy is required to achieve sustainable economic growth and real convergence. It refers in this context to the Broad Economic Policy Guidelines (BEPG) as well as the Lisbon strategy. However, the discussion of structural market reform measures remains relatively meagre.

Cyprus presents some risks with regard to long-term sustainability of the public finances, reflected by the projected budgetary costs of an ageing population. A significant sustainability gap arises, even if the planned and necessary budgetary consolidation up to 2007 is fully implemented. The strategy outlined in the update is mainly based on the budgetary consolidation in the next few years and additional reforms of pension and health care system are to be implemented in the future. It is imperative to pursue the reform process in order to reduce the sustainability risks associated with the future evolution of age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.

Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, the fiscal consolidation programme aims to reduce the general government deficit in a credible and sustainable way within a multi-annual framework. The fiscal consolidation measures both on the expenditure and revenue side are mostly of a structural nature, and although there is still some uncertainty surrounding the implementation of some of the planned consolidation measures, the deficit objective path, particularly for 2005, is ambitious but does not look implausible.

In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), it would be appropriate for Cyprus to (i) implement with vigour the measures envisaged in the updated convergence programme to bring the deficit below 3% of GDP by 2005 and ensure that budgetary consolidation towards the medium term budgetary position of close to balance or in surplus is sustained after the excessive deficit has been corrected; (ii) ensure that the debt ratio will start to decline from 2005 onward; and (iii) pursue the reform process in the pension and health care system in order to reduce the sustainability risks associated with the future evolution of

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

age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec2004**	**3.6**	**4.0**	**4.4**	**4.5**	**4.5**
	COM	3.5	3.9	4.2	n.a.	n.a.
	CP May2004	*3.5*	*4.3*	*4.4*	*4.5*	*n.a.*
CPI inflation (%)	**CP Dec2004**	**2.1**	**2.6**	**2.2**	**2.1**	**2.0**
	COM	2.4	2.2	2.1	n.a.	n.a.
	CP May2004	*2.0*	*2.0*	*2.0*	*2.0*	*n.a.*
General government balance (% of GDP)	**CP Dec2004**	**-4.8**	**-2.9**	**-1.7**	**-1.5**	**-0.9**
	COM	-5.2	-3.0	-2.4	n.a.	n.a.
	CPMay2004	*-5.2*	*-2.9*	*-2.2*	*-1.6*	*n.a.*
Primary balance (% of GDP)	**CP Dec2004**	**-1.3**	**0.7**	**1.8**	**2.0**	**2.5**
	COM	-1.8	0.5	1.1	n.a.	n.a.
	CP May2004	*-1.6*	*0.7*	*1.4*	*2.0*	*n.a.*
Government gross debt (% of GDP)	**CP Dec2004**	**74.9**	**71.9**	**69.2**	**65.7**	**58.1**
	COM	72.6	72.4	69.4	n.a.	n.a.
	CP May2004	*75.2*	*74.8*	*71.5*	*68.4*	*n.a.*

Sources:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

1. INTRODUCTION

Cyprus submitted its first updated convergence programme covering the period 2004 to 2008 on 7 December 2004. The update has been approved and endorsed by the Cypriot Council of Ministers. However, given timing constraints it was not possible to submit the update to the House of Representatives prior to submission to the Commission. It incorporates measures taken in the 2005 budget and in the 2004 May convergence programme. The update complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". The text model structure provided in Annex 2 of the code of conduct is followed but the update consists of (the first) six chapters and not seven. Also, the tables indicate CPI inflation instead of HICP inflation. For Table 7 external assumptions for 2008 are missing.

2. MACROECONOMIC DEVELOPMENTS

Following an estimated real GDP growth of 3.6% for 2004, the macroeconomic scenario in the update projects a further pick-up for 2005 and 2006 to 4.0% and 4.4%, respectively, mainly driven by domestic demand but also increasingly supported by a rebound in external demand (see Table 1). These developments are in line with the Commission services autumn 2004 Forecast. For 2007 and 2008 the update foresees a growth rate of 4.5%. With these growth rates, the output gap steadily closes over the projection period. The macroeconomic framework appears plausible, given the historical growth performance, the expected rebound in tourism (a mainstay of the economy) also linked to steady growth in the EU for 2005 and 2006, and the pick-up in private domestic demand in an environment of increased consumer and producer confidence. The external assumptions of the macroeconomic scenario up to 2006 are in line with the Commission services autumn 2004 forecast.

At about 4.5% in 2004, unemployment in Cyprus is low and is expected to gradually inch down further as growth strengthens again.

Other than the scenario discussed above (the "central scenario"), the update contains three alternative scenarios for the macroeconomic and budgetary projections: an "upper" and a "lower" growth scenario and a "higher interest rates" scenario. In the "upper" growth scenario GDP growth is assumed to grow at 0.5%-points above the baseline, while in the low growth scenario GDP would grow by 0.5%-point less. In the higher interest scenario, the nominal interest rate is assumed 0.5%-points above the baseline. As indicated above, the update considers the "central" scenario as the reference scenario for assessing budgetary projections because, on the basis of currently available information and given historical growth rates, it seems to reflect plausible growth assumptions in line with the Commission services autumn 2004 economic forecasts whereby the output gap is gradually closed.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**
Real GDP (% change)	3.5	3.6	3.9	4.0	4.2	4.4	4.5	4.5
Contributions:								
- Final domestic demand	2.6	3.4	4.0	4.1	4.1	4.2	4.4	4.1
- Change in inventories	0.1	0.5	0.0	-0.3	0.0	-0.2	-0.4	-0.1
- External balance on g & s	0.7	-0.3	-0.2	0.2	0.0	0.4	0.4	0.5
Employment (% change)	1.1	1.4	1.3	1.2	1.3	1.2	1.3	1.3
Unemployment rate (%)	4.2	4.5	4.0	4.4	3.7	4.2	-	-
HICP inflation* (%)	2.4	2.1	2.4	2.6	2.1	2.2	2.1	2.0
GDP deflator (% change)	3.0	1.9	2.8	2.4	2.5	2.1	2.1	2.1
Current account**(%of GDP)	-4.5	-4.1	-4.4	-3.7	-3.7	-3.2	-	-

* For Cyprus: CPI inflation ** CP: '…a decline of the current account deficit to around 2% of GDP in 2008' (p.22)
Sources:
Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP)

The Commission services calculations according to the commonly agreed methodology provide an estimate of the output gap that is consistent with the update's macro-economic scenario. As can be seen from Table 2, the gradual narrowing of the output gap in the update is in line with the Commission services autumn 2004 forecast. For 2004 the gap starts out slightly larger than in the Commission forecast but then steadily declines in 2005-2006 and closes by 2007, only one year later than the Commission forecast, and turns marginally positive by 2008. Potential GDP growth in the update slightly outpaces the Commission forecast potential GDP growth (due to a slightly higher total factor productivity growth) but the differences are marginal.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	**CP[3]**	**COM**	**CP[3]**	**COM**	**CP[3]**	**CP[3]**	**CP[3]**
Potential GDP growth[1]	3.2	3.3	3.4	3.6	3.6	3.8	3.9	4.0
Contributions:								
- Labour	0.4	0.5	0.6	0.6	0.6	0.7	0.7	0.6
- Capital accumulation	1.3	1.3	1.4	1.4	1.5	1.4	1.5	1.5
- TFP	1.4	1.5	1.4	1.5	1.4	1.6	1.7	1.8
Output gap[1,2]	-1.1	-1.5	-0.7	-1.1	-0.1	-0.6	0.0	+0.5

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update (CP)

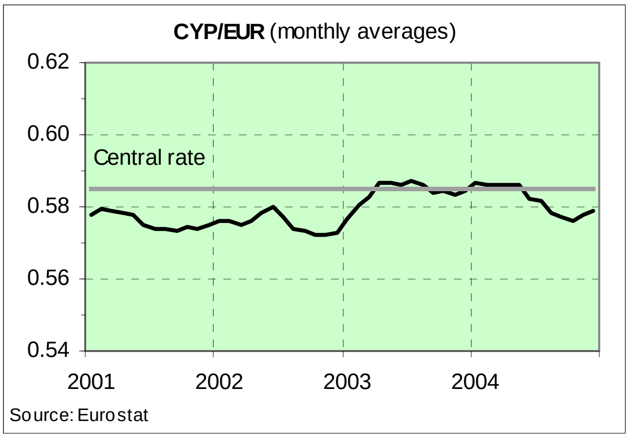
Sources:

Commission services autumn 2004 economic forecasts (COM); Commission services calculations

For 2004, the update estimates the current account deficit to increase to 4.1% of GDP, up from 3.5% of GDP in the previous year. This reflects mainly a rise in imports linked to strengthening private sector demand, and higher oil prices. The current account deficit increase occurring despite a reduction in the general government deficit, suggests an even stronger decrease in the private sector savings-investment balance, at least partly linked to the increase in private sector investment. For 2005-2008 the current account is projected to steadily decrease to 2% of GDP, concurrently with the decreasing general government deficit which is only partially offset by a diminishing savings-investment balance as private sector investment picks up, increasing the investment ratio. At the same time, the expected rebound in export markets (including tourism) and the envisaged continuation of structural reforms supported by full capital liberalisation are projected to increase competitiveness and support export performance, especially that of services (e.g. telecommunication and business services), which is projected at nearly 7% on average for 2005-2008. This scenario does not look unrealistic, but it seems somewhat optimistic, in particular on the projected export growth. Furthermore, the projected current account reduction path might not be so straightforward; private sector dissaving has sometimes prevented the current account deficit from declining (e.g. in 1998 and especially 2000). On the other hand, financing those deficits through non-debt creating flows including foreign direct investment (FDI) has not been a problem so far. From 2001 onward, inward FDI has increased concomitantly with capital liberalisation, and the liberalised capital market and structural reforms are expected to further help finance current account deficits. Moreover, the revision of balance of payments data methodology[5] has improved the historical picture as it resulted in lower registered current account deficits and a strong upward revision of FDI inflows for the past period. As a result, the coverage of the current account deficit by net FDI inflows increased to more than 200% in 2001 and above 100% in 2002 and 2003. For 2004, a small decline in coverage is expected.

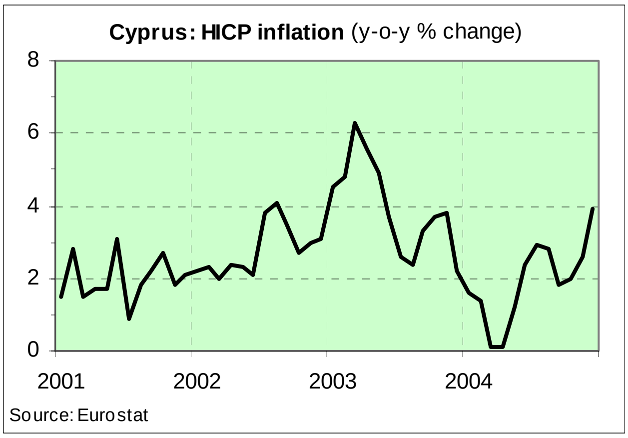
3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Monetary policy in Cyprus continues to be geared towards price stability through a peg of the Cyprus pound to the euro with a central parity of 0.585 CYP/EUR. While the official band allows for fluctuations of ± 15%, in practice, the pound is moving much closer to the central parity. The update envisages keeping the current monetary policy framework in place until the eventual adoption of the euro. The authorities confirmed the intention to enter the euro area as soon as possible, if possible in 2007 and, in line with a decision of the Cyprus Council of Ministers, the update foresees an early participation in ERM II.



Exchange rate stability has remained the primary focus of monetary policy decisions. In April 2004, political uncertainties linked to the reunification process together with the final stage of liberalisation of capital movement restrictions at the date of EU accession prompted the central bank to raise policy rates by 100 basis points, bringing the marginal lending facility to 5.5% or 250

[5] In 2002 Cyprus introduced a methodological revision to Balance of Payments statistics in line with IMF standards, and recently completed the historical revision for previous years. The most important feature was a change in residency definition that now includes the large international business sector in the resident category. This significantly boosted recorded services exports and at the same time led to higher registered reinvested earnings, recorded as increased inflows of FDI. The increased reported services exports are also attributed to an improvement in data quality due to a newly introduced method of collecting detailed information through the banking sector. See also Box 1.



basis points above the euro area corresponding rate. Following the hike, the pound started to gradually appreciate and reached a high of some 1.6% above parity by mid-October. On the backdrop of positive growth signals coming from the domestic economy, the central bank has so far preferred to keep policy rates unchanged.

Cyprus continues to perform well in terms of average inflation, which reached 1.9% in 2004, compared with 4% in 2003 when headline inflation was influenced by increases of the VAT rate and of excise duties. Continuing nominal effective appreciation, wage moderation and tighter monetary policy were main inflation dampening factors in 2004, while higher food prices contributed to a spike in year-on-year inflation towards the end of the year. The update expects that a favourable development of labour productivity and unit labour costs in the period 2004-2006 will contribute to maintaining low inflation, which is forecast by the authorities in CPI terms at 2.1% in 2004, 2.5% in 2005 and at 2.2% in 2006. Given the high oil dependence of the Cyprus economy, a continuous increase of oil prices represents an upward risk to this forecast.

Despite low inflation, long-term interest rates as determined by primary emissions sharply increased in the first half of 2004 and slightly decreased towards the end of the year. The primary emissions undertaken in February, June, November and at the end of December 2004 implied an increase of the spread vis-à-vis the euro area benchmark from some 100 basis points at the end of February to 220 basis points in June and to around 250 basis points by year-end. Factors that could help to explain the increase in the interest rate spread include the increase in short-term rates, the still high government financing requirements and a low liquidity of the markets absorbing the primary emissions in the context of an inactive secondary market with government bonds.

4. BUDGETARY IMPLEMENTATION IN 2004

The 2004 deficit target in the May 2004 programme was set at 5.2% of GDP for 2004, down from 6.3% of GDP in 2003, and with an expected GDP growth rate of 3.5%. This was in line with the Commission services autumn 2004 forecast. The update projects the deficit for 2004 to decrease to 4.8% of GDP, and, according to most recent estimates, the final outturn might even be better and attain 4.3% of GDP, with estimated GDP growth for 2004 remaining practically unchanged at 3.6%. This positive outcome is attributed to the successful impact of the fiscal consolidation measures, especially on the expenditure side but also on the revenue side, in conjunction with a more domestic-demand based growth composition leading to extra tax revenues. This was achieved despite negative revenue effects linked to delays in the introduction of a number of revenue measures initially planned for 2004. More specifically, it is estimated that the impact of expenditure measures contributed 1.6%-points of GDP to reducing the deficit in 2004. Collective consumption in particular is estimated to have declined by 1.5 percentage points of GDP in 2004. The update states that the reduction in the ratio of capital expenditure to GDP in 2004[6] is mainly due to a reclassification of expenditures which leaves the investment programme largely unchanged.

Box 1: Effects of the changeover to ESA95

As indicated in the update (page 59, footnote 7), in November 2004 the Statistical Service completed the revision of National Accounts (NA) for the period 1995-2003. The revision is the result of methodological changes in the context of adopting the European System of Accounts ESA95. Furthermore, the revision also took into account the revised methodological treatment used by the Central Bank of Cyprus regarding the output of international (offshore) companies. The introduction of ESA95 methodology led to across-the-board upward revisions of nominal GDP for the period 1995-2003 of 1.5%-3.9% per year. On the expenditure side, the major revisions took place in the levels of private consumption (downward for 1995-1998, then upward), annual goods and services trade balance (annual deficits were reduced or turned into small surpluses, mainly because of strong upward revisions of exports of services linked, *inter alia*, to the revised methodological treatment regarding offshore enterprises), and government consumption (upward for 1995-1999, then downward). No substantial changes took place on real GDP. At the same time, all nominal government debt and deficit data remained unchanged; hence, changes in the debt and deficit ratios following the NA revision are entirely due to revisions in nominal GDP. The table below presents the impact of the revisions for the period 1998-2003[7]. It shows that the moderate upward revisions in GDP led to generally slight downward corrections of the government deficit and debt ratios. On average, the deficit ratios were lowered by 0.1 percentage point of GDP per year, while the downward revision in debt ratios is more substantial in absolute terms, with an average of nearly 2 percentage points Although the revision reduced the deficit and debt ratios, it did not lead to any of the ratios falling below the Treaty reference values of 3% GDP government deficit and 60% GDP government debt. Therefore, from this perspective there are no further consequences for the EDP procedure for Cyprus.

Table: Impact revision National Accounts on GDP and general government deficit and debt ratios.

	1998	1999	2000	2001	2002	2003	Avg 98-03
GDP							
Old	4704,2	5037,1	5525,3	5876,9	6162	6700,8	
Revised	4862,8	5214,2	5679	6103,6	6370,3	6801,7	
change (level)	**158,6**	**177,1**	**153,7**	**226,7**	**208,3**	**100,9**	
change (%)	**3,4**	**3,5**	**2,8**	**3,9**	**3,4**	**1,5**	**3,1**
Gen.govt.deficit	-204	-229	-134	-138,7	-283,9	-427,7	
Old (% GDP)	-4,34	-4,55	-2,43	-2,36	-4,61	-6,38	
Revised (% GDP)	-4,2	-4,39	-2,36	-2,27	-4,46	-6,29	
Difference	**-0,14**	**-0,15**	**-0,07**	**-0,09**	**-0,15**	**-0,09**	**-0,1**
Gen.govt.debt	2898,2	3123,7	3402,5	3776,7	4153,3	4751,5	
Old (% GDP)	61,61	62,01	61,58	64,26	67,4	70,91	
Revised (% GDP)	59,6	59,91	59,91	61,88	65,2	69,86	
Difference	**-2,01**	**-2,11**	**-1,67**	**-2,39**	**-2,2**	**-1,05**	**-1,9**
PM: Real GDP growth							
Old	4,8	4,7	5	4	2	2	
Revised	5	4,8	5	4,1	2,1	1,9	
Difference	**0,2**	**0,1**	**0**	**0,1**	**0,1**	**-0,1**	**0**

Sources: Statistical Service of the Republic of Cyprus; Fiscal Notifications 2001-2004; Eurostat NewCronos database.

[6] From 4.0% of GDP in 2003 to 2.8% of GDP in 2004, see table IV, p.39.

[7] Data on general government debt and deficits according to ESA95 in the Fiscal Notification for the moment run from 1998 onward only.

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

5.1. Evolution of budgetary targets in successive programmes

The objective of the fiscal consolidation programme in the update remains the reduction of the general government deficit to below 3% of GDP by 2005, although compared to the previous programme and the 2003 PEP the expected GDP growth for that year has been lowered. The deficit target for 2004 at 4.8% of GDP was still well above of the target set in the 2003 PEP of 3.7% of GDP, but represents an improvement on the previous programme's 5.2% of GDP for the year (see Table 3). The projected GDP growth path in the update is similar to the previous programme's path but lower than in the PEP. Nevertheless, the update sharpens the deficit targets after 2005 somewhat by aiming at a further deficit reduction to 1.7% of GDP in 2006 and 1.5% in 2007, against 2.2% in 2006 and 1.6% in 2007 in the previous programme, although the planned measures are mostly unchanged. At the same time, in light of the results of the measures so far, the update puts relatively more emphasis on the effects of measures reducing the expenditure-to-GDP ratio over the projected period.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007	2008
General government balance (% of GDP)	**CP Dec 2004**	**-6.3**	**-4.8**	**-2.9**	**-1.7**	**-1.5**	**-0.9**
	CP May 2004)	-6.3	-5.2	-2.9	-2.2	-1.6	n.a.
	PEP August 2003)	*-5.4*	*-3.7*	*-2.8*	*-2.2*	*n.a.*	*n.a.*
General government expenditure (% of GDP)	**CP Dec 2004**	**45.4**	**43.8**	**43.0**	**42.2**	**42.1**	**41.5**
	CP May 2004)	44.8	44.6	43.3	42.9	42.5	n.a.
	PEP August 2003)	*42.7*	*41.5*	*41.1*	*40.7*	*n.a.*	*n.a.*
General government revenues (% of GDP)	**CP Dec 2004**	**39.1**	**39.0**	**40.1**	**40.5**	**40.6**	**40.6**
	CP May 2004)	38.5	39.4	40.4	40.7	40.9	n.a.
	PEP August 2003)	*37.3*	*37.8*	*38.3*	*38.5*	*n.a.*	*n.a.*
Real GDP (% change)	**CP Dec 2004**	**1.8**	**3.6**	**4.0**	**4.4**	**4.5**	**4.5**
	CP May 2004)	2.0	3.5	4.3	4.4	4.5	n.a.
	PEP August 2003)	*2.0*	*4.0*	*4.6*	*4.6*	*n.a.*	*n.a.*

Sources:
Convergence programmes (CP); new MS: pre-accession economic programme (PEP)

Box 2: The excessive deficit procedure for Cyprus

On the basis of a general government deficit of 6.3% of GDP in 2003, above the 3% of GDP reference value, and of a debt ratio of 72.2%, the Council decided on 5 July 2004 that Cyprus had an excessive deficit and recommended that this be corrected by 2005 at the latest. In particular, Cyprus was recommended to: put an end to the present excessive deficit situation as rapidly as possible; implement with vigour the measures envisaged in the May 2004 convergence programme; in particular, to take effective action by 5 November 2004 in order to achieve their objective of bringing the deficit below 3% of GDP in 2005 in a credible and sustainable manner, as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004; ensure that the rise in the debt ratio is brought to a halt in 2004 and reversed thereafter as specified in the Council Opinion on the convergence programme. In addition, the Council invited the Cypriot authorities to ensure that budgetary consolidation towards the medium term budgetary position of close to balance or in surplus is sustained after the excessive deficit has been corrected.

On current information and on the basis of the measures detailed in the 2005 budget it appears that the Cypriot government has taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the recommendation under Article 104(7) to correct the excessive deficit by 2006 at the latest.

5.2. Budgetary targets in the updated programme

The update aims at reducing the deficit to below the 3% of GDP reference value in 2005, in line with the Council recommendation under Article 104(7). It foresees the general government deficit to sharply decrease further from 4.8% of GDP in 2004 to 2.9% in 2005 and then to continuously decline more gradually thereafter, to just 0.9% in 2008. Since interest expenditures are projected to remain constant at around 3.5% of GDP, the path of the primary balance is similar to that of the overall balance, improving from -1.3% in 2004 to 2.5% at the end of the programme period (see Table 4). The adjustment path reflects the government commitment to improve public finances with the intention to adopt the euro by 2007. This is the main factor behind the strong frontloading of the fiscal adjustment, reducing the general government budget deficit by 1.9 percentage points of GDP in 2005. To this end, the update envisages a series of mostly structural measures to restrain expenditure, which is where most of the slippage occurred in past years, and a combination of structural and one-off measures to increase revenue. Expenditure cuts contribute 2.3 percentage points to the overall deficit reduction of almost 4 percentage points of GDP over the period 2004-2008, although for 2005 the total downward fiscal adjustment is projected to come more from revenue than expenditure (1.1 and 0.8 percentage point, respectively).

Regarding expenditures, the major objective is to keep public expenditure growth below that of nominal GDP. The measures aim to reduce expenditure by 2.3 percentage points of GDP to 41.5% over 2004-2008, mainly through a decrease in terms of GDP of public consumption, transfers, and subsidies. Most of the expenditure measures are structural and implemented from 2005 onward. It should also be noted that general government gross fixed capital formation is reduced from 4% of GDP in 2003 to 2.1% by 2008. According to the update this reduction is attributable largely to a reclassification of expenditures while it leaves the investment programme intact.

On the revenue side, the update aims to increase revenues by 1.6 percentage points from 39.0% of GDP in 2004 to 40.6% of GDP by 2008, mainly through higher tax and social contribution revenues. Most, but not all, of the revenue measures are structural and implemented from 2005 onward. At the same time, it should be noted that because of delays in implementation, the update now plans for 2005 a number of revenue measures originally intended for 2004. These constitute additional measures to be implemented in 2005. Their impact on 2005 revenues, estimated at 0.9% of GDP, is prudently taken as a safety margin to offset the impact of possible delays in other measures for 2005. Since at the same time expenditure is to remain under strict control, this approach would maintain the deficit target of 2.9% for 2005 as an 'upper bound'.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	2008	Change: 2008-2004
Revenues	39.1	39.0	40.1	40.5	40.6	40.6	**1.6**
of which:							
- Taxes & social contributions	33.4	34.3	34.7	35.1	35.3	35.4	**1.1**
- Other (residual)	5.7	4.7	5.4	5.4	5.3	5.2	**0.5**
Expenditure	45.4	43.8	43.0	42.2	42.1	41.5	**-2.3**
of which:							
- Primary expenditure	41.9	40.3	39.4	38.7	38.6	38.1	**-2.2**
of which:							
Gross fixed capital formation	3.4	2.4	2.3	2.2	2.2	2.1	**-0.3**
Collective consumption	11.0	9.5	9.4	9.5	9.5	9.4	**-0.1**
Transfers & subsidies	21.6	22.4	21.9	21.2	21.1	20.9	**-1.5**
Other (residual)	5.9	6.0	5.8	5.8	5.8	5.7	**-0.3**
- Interest expenditure	3.5	3.5	3.6	3.5	3.5	3.4	**-0.1**
Budget balance	**-6.3**	**-4.8**	**-2.9**	**-1.7**	**-1.5**	**-0.9**	**+3.9**
Primary balance	**-2.9**	**-1.3**	**0.7**	**1.8**	**2.0**	**2.5**	**+3.8**

Sources:
Convergence programme update; Commission services calculations

Box 3: The budget for 2005

The main measures in the budget for 2005, for the revenue side, consist of implementation of legislation for bank secrecy and a tax amnesty on undeclared bank accounts (0.6% of GDP for 2005; regularisation of dividend income policy for semi-government organization (0.6% of GDP); and issuance of title deeds for buildings erected with minor irregularities (0.4% of GDP).

For expenditure, the main measures for 2005 include the introduction of overall annual ceilings for current expenditure increases to under 3% and for capital expenditures to under 4%; a freeze in public sector employment and wage increases (0.3 % of GDP) an increase in the retirement age in the public sector (0.2% of GDP); an increase in the retirement age limit on eligibility for outlays form the Social Insurance Fund (0.2% of GDP); the containment of current transfers and subsidies (pensions, allowances) in line with inflation (0.2% of GDP).

Prospects and results so far for the 2005 fiscal measures have been encouraging: recent estimates on the tax amnesty indicate revenues of more than 1% of GDP instead of planned 0.6% of GDP. On regularisation of the dividend income policy, an agreement was reached in December 2004 between the government and the Boards. For the retirement age increase the government reached in late December an agreement with the union, and a similar agreement was reached in mid- January with unions of the semi-governmental organisations.

The reduction of the general government deficit by 3.9 percentage points over the period 2004-2008 is ambitious but does not appear unachievable. The feasibility of the objective is underpinned by the better-than-expected outturn in 2004, the recent successful negotiations with social partners on a number of planned measures, and the measures planned for 2005. Furthermore, growth assumptions are in line with the Commission services autumn 2004 forecast. However, the test still lies especially in the targeted adjustment for 2005, which the update itself indicates as 'the crucial year'.

The risks to the budgetary projections in the update appear broadly balanced. In particular, the main downside macro-economic risks are the economic outlook in the US and the EU (notably the UK and Germany, main tourist source countries), tensions in the Middle East, and oil price developments[8]. The update further indicates that several planned measures for 2005 onward are to be 'studied' further, which leaves some uncertainty. On the other hand, the update projects for 2004 a deficit of 4.8% of GDP instead of a previously targeted 5.2% of GDP, while the outcome is now estimated to be around 4.3% of GDP. This positive result was achieved despite delays in a number of consolidation measures originally planned for 2004. These are now to be implemented in 2005, the budgetary impact of which is prudently considered as a safety margin for 2005 to keep the target of 2.9% of GDP as an "upper limit". Although expenditure overruns were a main problem in the past, the consolidation measures now emphasize structural expenditure control, especially on government consumption. In addition, several of the planned measures for 2005 have now been successfully negotiated with the social partners. The Commission services autumn 2004 forecast projected a deficit of 3.0% of GDP for 2005, given a slightly lower GDP growth forecast for that year. However, the update reiterates that 'additional measures' will be taken if lower growth would risk leading to a higher deficit in 2005. All this would facilitate the deficit adjustment to 2.9% of GDP for 2005. All in all, the planned deficit reduction for 2005 looks challenging but increasingly feasible. For the period 2006-2007 the adjustment path is slightly tightened to reach lower deficits compared to the previous May 2004 programme. However, it is not clear how this tightening will be achieved, given that the planned measures and GDP growth path have broadly remained the same.

Table 5: Budgetary targets and output gaps[1]

	2003		2004		2005		2006		2007	2008	Change: 2008-2004
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]	CP[1]
Budget balance[2]	-6.3	-6.3	-5.2	-4.8	-3.0	-2.9	-2.4	-1.7	-1.5	-0.9	3.9
Output gap[1,3]	-1.4	-1.7	-1.1	-1.5	-0.7	-1.1	-0.1	-0.6	0.0	+0.5	2.0

Notes:
[1]CP (convergence programme): Commission services calculations on the basis of the information in the programme
[2]in percent of GDP
[3]in percent of potential GDP
Sources:

[8] It should also be noted that future economic developments in Cyprus remain subject to unusual uncertainty: In case of reunification, the economic situation of the entire island would fundamentally shift. It can also be noted that the possibility of such an event strengthens the arguments for a rapid and sustained fiscal consolidation.

Commission services autumn 2004 economic forecasts (COM); Commission services calculations

Taking account of the balance of risks to the budgetary targets, the budgetary stance looks on track to correct the excessive deficit and to bring the deficit below the 3% of GDP reference value by 2005 as envisaged in the update, in line with the Council recommendation under Article 104(7). That the target of 2.9% of GDP for 2005 is close to the 3% of GDP reference value, but there is a 'safety margin' for 2005 of 0.9% of GDP in case of e.g. delays in other measures, additional measures might become necessary to ensure the target is kept in case GDP growth for 2005 threatens to be lower that foreseen. For 2006-2008 the targeted deficits are progressively lowered further, thereby reducing the risk of breaching the 3% of GDP reference value. With this path, budgetary consolidation toward the medium term budgetary position of close to balance would be sustained after the excessive deficit has been corrected. The path is hence also in compliance with the short-term country specific BEPG recommendation on the reduction of the general government deficit on a sustainable basis.

The deficit reduction in 2006-2008 to, respectively 1.7%, 1.5% and 0.9% of GDP should provide a sufficient safety margin against breaching 3%.

From Table 5 it can be seen that the update projects a narrowing of the output gap along with the reduction of the deficit, in line with the Commission services autumn 2004 forecast.

5.3. Sensitivity analysis

Other than the scenario discussed above (the "central scenario"), the update considers three alternative scenarios for the macroeconomic and budgetary projections: an "upper" scenario, a "lower" scenario and a "higher interest rates" scenario, with different assumptions for the period 2005-2008 on average GDP growth (+- 0.5 percentage point) and higher interest rates (+0.5 percentage point). As compared to the "central scenario", the "upper" scenario leads to annually reduced government deficit and debt ratios by 0.2% point and 1.0% point of GDP on average, respectively. The "lower" scenario results in average increases in the deficit and debt ratios of 0.3% point and 0.8% point. The "higher interest rates" scenario also gives somewhat higher deficit and debt ratios of 0.4% point and 0.2% point on average; the impact of an interest rate rise on debt is moderated by the fact that a considerable part of the debt comprises fixed interest-rate borrowings. The differences between the alternative scenario deficit and debt outcomes are therefore relatively small, with variations in GDP growth relatively having the strongest impact.

6. EVOLUTION OF THE DEBT RATIO

The general government debt level in 2004 reached 74.9% of GDP, above the 60% reference value. The update indicates that this peak in the debt-to-GDP ratio should be followed by a relatively steep downward path to reach 58.1% of GDP by 2008. This strong decrease is mainly driven by increasingly positive primary balances and an annual nominal GDP growth above the average nominal interest rate on in 2005-2008. Furthermore, debt-reducing stock-flow adjustments (SFAs) further push the debt ratio down, reversing earlier debt-increasing SFAs in 2000-2003 (see Box 4). It is mainly these SFAs together with a lower projected deficit and upward revision in GDP (see Box

1) that account for the slightly higher debt ratio for 2004 and for the decreasing gap in 2005-2006 with the debt levels in the Commission services autumn 2004 forecast.

Box 4: The contribution of the stock-flow adjustment to the evolution of the government gross debt in Cyprus.

Given the definitions of government deficit and debt for budgetary surveillance in the EU – in particular the fact that the deficit is a net concept compiled on an accrual basis, while debt is gross and depends on effective cash flows – the yearly debt increase does not exactly correspond to the deficit. The discrepancy between deficit and debt developments is known as stock-flow adjustments (SFA).

For Cyprus, SFA over the last years has been quite significant, contributing to a faster increase in the gross debt level than one could expect given the deficit figures. The SFA in Cyprus is among the highest in the EU and the highest of the new Member States. The average SFA for 2000-2004 was 2.9% of GDP, peaking to 4% of GDP in 2001 and 2004. *Ceteris paribus*, the government gross debt ratio would be almost 15% points lower than it was at the end of 2004 in case the SFA was nil over the last five years.

Analytically, the SFA can be divided in three parts: (i) differences between cash and accrual bases for recording transactions, (ii) differences in gross and net recording of transactions with financial assets and (iii) valuation effects and residual adjustments.

(i) The government deficit on a cash basis has been around 0.5% of GDP higher than the official deficit, on average. In the medium term, differences between cash and accrual accounting tend to cancel out. The persistent difference between cash and accrual accounting seems to be mainly explained by the nominal increase in the transactions leading to cash-accrual differences (such as lags in payment of expenditure or in effective collection of taxes). If that is the case, the discrepancy is normal and should not be understood as an indication of low-quality data. However, there is a need to closely monitor the evolution of this variable to ensure that the deficit compiled on an accrual basis is not underestimated. The update assumes that differences between accrual and cash accounting will be zero over the next four years.

(ii) The accumulation of financial assets by the government has been almost exclusively in the form of deposits with the Central Bank of Cyprus (CBC). From 2000 to 2003, the accumulation of deposits has been averaging 2.1% of GDP per year. According to recent data, government deposits in 2004 increased by around 3% of GDP as against 4.1% of GDP indicated in the update. According to CBC data, the central government deposits with the CBC at the end of 2004 was around 12% of GDP, which is significantly higher than in other Member States. This accumulation of liquid assets has occurred for three reasons. The first relates to the prohibition of government financing by the central bank since mid-2002, a development that led authorities to accumulate a sufficient amount of deposits to meet liquidity requirements. The second factor pertains to the functioning of the sinking funds for the repayment of long-term loans. Sinking fund accumulation (decumulation) of assets leads to an increase (decrease) in gross debt, leaving the net indebtedness and net borrowing unchanged. Third, over-financing in 2004 connected with the issuance of government paper in euro, as indicated in the update.

(iii) Valuation adjustments, in particular the revaluation of foreign currency-denominated debt, have not been significant. From 2000 to 2003 it did not exceed 0.2% of GDP per year, linked to the relative stability of the Cypriot pound vis-à-vis the euro. The foreign currency-denominated debt is around 30% of total debt, most of which is in euro. The update expects that the valuation adjustments will be zero in coming years.

According to the update, the policy of sinking funds accumulation was abolished in 2003. This will bring about a significant decrease in government deposits of more than 6% of GDP until 2008, lead to a decline in the effective financing needs of Cyprus and contribute to a reduction of the government debt ratio. Therefore, the SFA is expected to become negative.

At 83% of total government debt in 2003, long-term maturity debt makes up the largest share of debt. At the same time, foreign debt (mostly in euro) increased to 30% of total debt in 2004 and is to stabilise thereafter. With a small and inactive secondary bond market[9] and capital liberalisation opening up investment alternatives, it has proven difficult to stimulate private non-bank investor interest in medium-to long term government debt, which until now has been mainly taken up by banks. The problem has become increasingly pressing but so far has not been effectively addressed. The update reiterates the proposal to restructure the secondary market by introducing domestic and foreign primary dealers for public debt, in order to provide much-needed liquidity and increase competition.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007	2008
		COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	**64.2**	**72.6**	**74.9**	**72.4**	**71.9**	**69.4**	**69.2**	**65.7**	**58.1**
Change in debt ratio (1 = 2+3+4)	2.5	1.7	5.0	-0.3	-3.0	-3.0	-2.7	-3.5	-7.6
Contributions:									
- **Primary balance** (2)	**0.5**	**1.8**	**1.3**	**-0.5**	**-0.7**	**-1.1**	**-1.8**	**-2.0**	**-2.5**
- **"Snow-ball" effect** (3)	**-0.6**	**-0.9**	**-0.2**	**-1.0**	**-1.0**	**-1.1**	**-1.0**	**-0.8**	**-0.7**
- Interest expenditure	3.4	3.5	3.5	3.5	3.6	3.5	3.5	3.5	3.4
- Real GDP growth	-1.9	-2.3	-2.4	-2.6	-2.8	-2.8	-3.0	-2.9	-2.8
- Inflation (GDP deflator)	-2.1	-2.1	-1.3	-2.0	-1.8	-1.7	-1.5	-1.4	-1.4
- **Stock-flow adjustment** (4)	**2.6**	**0.9**	**4.0**	**1.3**	**-1.3**	**-0.9**	**0.1**	**-0.7**	**-4.3**
- Cash/accruals	0.5		0.0		0.0		0.0		0.0
- Accumulation of financial	2.0		4.1		-1.3		0.1		-4.3
assets	0.0		0.0		0.0		0.0		0.0
of which: Privatisation proceeds	0.1		0.0		0.0		0.0		0.0
- Valuation effects & residual adj.									

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

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

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:
Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

Although not mentioned in the update (but noted in the 2003 PEP), the government's main contingent liability is guarantees on borrowing provided to semi-government organisations and domestic institutions. These guaranteed borrowings totalled just over £673.5 million or 9.9% of GDP at end-2003[10].

Cyprus has entered the EU with a debt ratio in excess 60% of GDP. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the graph. It compares the projections for the debt ratio in each year of the programme

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[9] With a market capitalisation of about 5% of GDP, the market is quite small.

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

(starting from the projection for 2004) with the values obtained for the same year by applying an illustrative “rolling debt reduction rule”. This rule describes a minimum reduction in the debt ratio over the previous five/four/three-year period; for example, the projection for 2004 is compared with the values obtained for the same year by applying the formula over the periods 1999-2004, 2000-2004 and 2001-2004[11]. If the debt levels projected in the update exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio. This is consistent with the idea that the minimum debt reduction should be ensured not year after year but over a medium-term horizon. The graph shows that the debt ratio is planned in the update to diminish over the entire period by more than implied by the rolling debt rule. Hence, the projected reduction of the debt ratio more than meets the convergence path indicated by the rolling debt rule, although it must be taken into account that the rise and decline of the debt ratio indicated in the graph is partly the result of debt-increasing and debt-decreasing SFAs.

[11] The “rolling debt reduction rule” in the graph is shown for successive five-year periods through a recursive application of the formula:

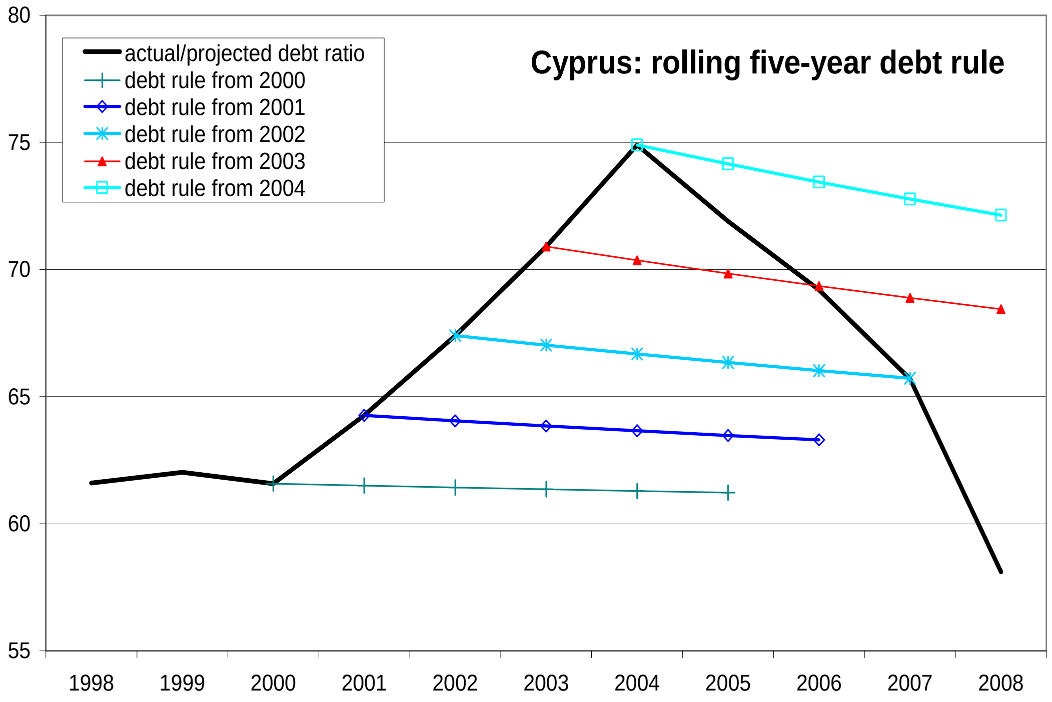
$$\left(\frac{D_t}{Y_t}\right)_{rule} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}\right] + \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio). The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

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

where DEF is the government deficit and y represents nominal GDP growth. Noting that 0.05*60 = 3, the formula for the “rolling debt reduction rule” describes the path for convergence of the debt ratio towards the 60% of GDP debt reference value consistent with a deficit equal to the 3% of GDP reference value. Consistency is achieved for a nominal GDP growth rate of 5% of GDP. For nominal GDP growth rates higher than 5%, the minimum debt reduction rule can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the minimum debt reduction rule necessitates deficits lower than 3% of GDP.

Graph 1: Rolling five-year debt rule



7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The update only briefly spells out the government's structural reform agenda. It deals with labour, product and capital market policies; fostering a knowledge-based economy; and sustainable development, while no budgetary impact is given for these policies[12]. In the context of preparing for ERMII and eventual participation in EMU, it observes that greater reliance has to be placed on structural policies to maintain competitiveness. However, the report mainly focuses on fiscal policy measures, stating that, alongside structural reform, a fiscal policy strategy is required to achieve sustainable economic growth and real convergence. In this context it refers to the Broad Economic Policy Guidelines (BEPG) as well as the Lisbon strategy, asserting that the fiscal consolidation measures also aim at promoting an environment favourable to business development and employment growth, diversification of the economy towards higher value added activities and a knowledge-based economy. However, it is not further specified how fiscal policy would support these objectives.

The update reiterates a number of planned reforms on healthcare and the pension system, with the introduction (already announced in 2001) of a National Health Scheme (NHS) by 2006 that aims at limiting government expenditure growth on health care from a current expenditure level of 3% of GDP to no higher than 4% of GDP by 2050, through, *inter alia*, increased implied competition pressure on public hospitals and efficiency gains. Although possible in theory, experience from other MS on health sector reform has not been encouraging to achieve such savings. On pension reform, the precise timing

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

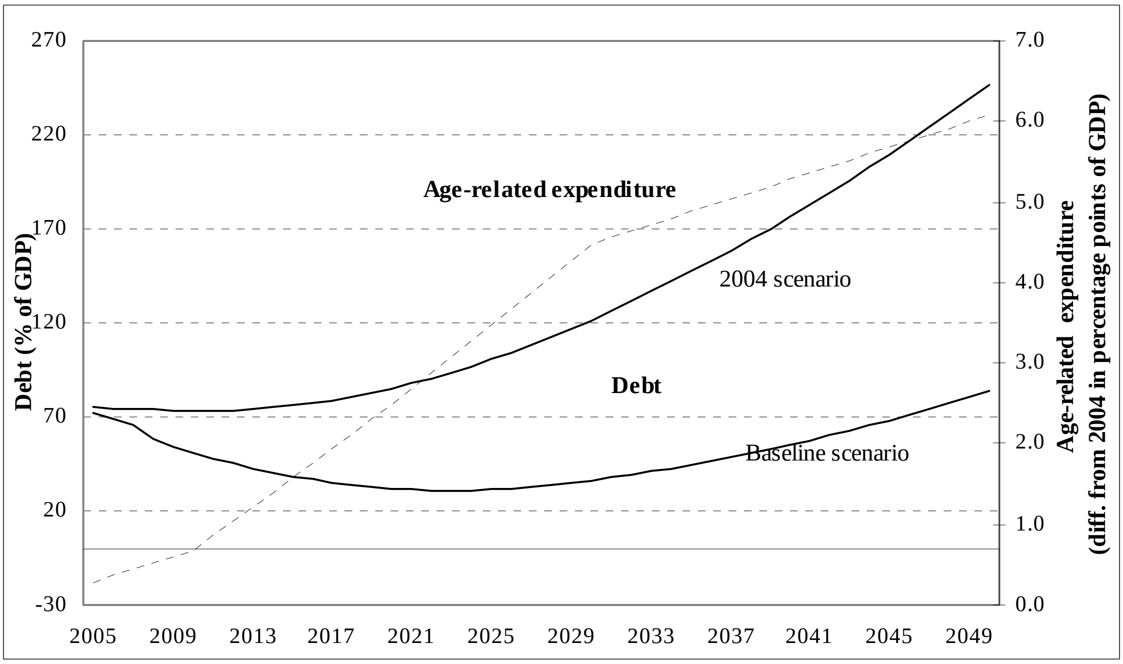
is left uncertain in the update. A number of possible parametric adjustments 'currently under discussion' are briefly indicated, although in the meantime progress has been made in negotiations with social partners to gradually increase the retirement age for public sector employees and the retirement age limit of the Social Insurance Fund.

Overall, the discussion of structural market reform measures remains relatively meagre in the report.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Cypriot public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the update is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

Long-term sustainability: summary results



Sustainability gap

	S1*	S2**	RPB***
Baseline scenario	0.6	2.7	4.8
2004 scenario	4.7	6.6	5.0

Notes:
* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -26.4%
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

The graph above presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 5.5% of GDP between 2008 and 2050 (see annex for a breakdown of different age-related expenditures). Gross debt is projected to decrease over the next 20 years and increase subsequently, reflecting the expected increase in future age-related expenditures.[13] The debt dynamic would significantly worsen if the expected consolidation path in the programme period did not materialise, putting debt on an explosive path (the 2004 scenario).

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050).[14] S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Cyprus should increase its tax ratio permanently by at least 2.7 percentage points.[15] This would lead to a sustainable negative debt ratio by the middle of the century[16]. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of around 4.8% of GDP on average, compared with a primary surplus of 2.5% of GDP projected for the last year of the programme period. If consolidation does not materialise, the sustainability gap becomes even higher.

These results are broadly in line with the analysis presented in the update, according to which a further substantial improvement of the budget balance up to 2007 is of paramount importance for ensuring a sustainable evolution of debt.

In interpreting these results, several factors may be taken into account.

First, while the assumptions in the update underlying the projected long-term sustainability appear realistic in general, the sharp increase in the participation rate in the last decade of the projection and labour productivity growth may seem somewhat optimistic.

Second, coping with ageing population would require the budgetary strategy to be accompanied with reforms in the pension and health care system. In this sense, a number of possible parametric adjustments (increase in the retirement age, pension indexation,

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[13] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

[14] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

[15] The S2 indicator is calculated on a gross debt basis. In the case of Cyprus, for illustrative purposes, should it be calculated on the basis of adjusted gross debt, the S2 tax gap (baseline scenario) would be somewhat smaller at about 2.6.

[16] The debt ratio of around -26.4% in 2050 in the baseline scenario according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower tax increase is compatible with the 60% reference value in 2050.

increasing the required period for eligibility to the old-age pension) and their timing are still being discussed. Nevertheless, the relatively small projected savings from pension reform could be considered a prudent reflection of constraints and uncertainty on the number of measures that can effectively be introduced.

In addition, to counteract relatively high increases in health-care expenditure, the government has planned for some time to launch a National Health Scheme (NHS) in 2006. It aims to limit government expenditure growth on health care from a current expenditure level of 3% of GDP to no higher than 4% of GDP by 2050, through, *inter alia*, increased implied competition pressure on public hospitals, efficiency gains, and the introduction of budgeting for the scheme. The scheme was already announced in the 2001 Pre-Accession Programme and is indeed expected to be introduced as scheduled.

Finally, in addition to savings on the above-mentioned items, the update projects savings on other than age-related expenditures. Although the latter are desirable, the update lacks concrete measures which could underpin their realisation and the projection presented in the update can therefore turn out to be too optimistic.

Cyprus presents risks with regard to long-term sustainability of the public finances, reflected by the projected budgetary costs of an ageing population. A significant sustainability gap arises, even if the planned and necessary budgetary consolidation up to 2007 is fully implemented.

The strategy outlined in the update is mainly based on the budgetary consolidation in the next few years and additional reforms of pension and health care system to be implemented in the future. It is imperative to pursue the reform process in order to reduce the sustainability risks associated with the future evolution of age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.

* * *

Annex 1: Summary tables from the convergence programme update

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	B1g	1,9	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

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

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	1,9	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	-2,6	-0,9	-0,5	-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

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	2009	2010	2020	2030	2040	2050	change
Total age-related spending	7.7	8.0	9.8	11.7	12.5	13.2	5.5
Pensions	4.2	4.4	6.0	7.8	8.5	9.2	5.0
Health care	3.5	3.6	3.8	3.9	4.0	4.0	0.5
*Total primary non age-related spending**	30.5						
*Total revenues**	40.6						

* constant

Results (as % GDP)	2009	2010	2020	2030	2040	2050	change
Programme scenario							
Gross debt	54.4	48.0	31.5	37.6	57.4	84.1	29.7
i + 0.5*	54.7	48.7	34.0	41.6	63.8	94.1	39.4
Adjusted gross debt	53.3	46.9	30.5	36.6	56.4	83.2	29.9
2004 scenario							
Gross debt	73.4	73.3	85.2	126.4	182.9	254.7	181.3
i + 0.5*	73.7	75.1	97.4	145.2	212.1	299.2	225.5
Adjusted gross debt	72.1	72.2	84.2	125.5	181.9	253.8	181.7

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

** Adjusted gross debt equals Gross debt (Maastricht) net of consolidated public pension fund assets in the general government sector accumulated for the strict purpose of covering pension-related expenditure.