COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Cyprus, 2004-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission. In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

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

The first convergence programme of Cyprus, covering the period 2004-2007, was submitted on 24 May 2004 and assessed by the Council on 5 July 2004. Cyprus submitted an update of its convergence programme on 7 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[3]. This evaluation warrants the following assessment:

– The updated Cypriot convergence programme covering the period 2004-2008 was submitted on 7 December, 2004. The programme complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[4]. 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

[1] OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

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

[3] COM(2002) 668, 27.11.2002.

[4] 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 27.6.2001 endorsed by the ECOFIN Council of 10.7.2001.

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[5].

– 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 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.

[5] 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 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 point 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[6]. 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.

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6 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.

– Cyprus presents some risks with regard to long-term sustainability of the public finances, of which the projected budgetary costs of an ageing population is an important element. 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 age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.

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

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Cyprus, 2004-2008

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [8 March 2005] the Council examined the updated convergence programme of Cyprus, which covers the period 2004 to 2008. The programme complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

(2) The programme contains four different scenarios for the macroeconomic and budgetary projections: a "central" scenario, an "upper" scenario, "lower" scenario and "higher interest rate" scenario. The so-called "central" scenario is considered as the reference scenario for assessing budgetary projections because, on the basis of currently available information, it seems to reflect plausible growth assumptions. It projects real GDP growth to pick up from 3.6% in 2004 to 4.3% on average over the rest of the programme period. The programme's projections for inflation also appear realistic.

(3) On 5 July 2004, the Council decided that an excessive deficit existed in Cyprus and recommended that this be corrected by 2005. 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). Compared to the May 2004 convergence programme the update maintains the deficit target for 2005 but sharpens the targets after 2005. It foresees the general government deficit to sharply decline

7 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

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 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. To this end, the update envisages a series of mostly structural measures to restrain expenditure 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.

(4) 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 estimated deficit outcome for 2004 has been better than expected. 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 in case of e.g. delays in other measures, to keep the target of 2.9% of GDP as an "upper limit" while at the same time expenditure is to be kept under strict control. 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 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.

(5) In view of this risk assessment, the budgetary stance in the programme seems sufficient to reduce the deficit to below 3% of GDP by 2005 and seems to provide a sufficient safety margin against breaching this threshold with normal macroeconomic fluctuations from 2006 onward. It is however not sufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme period.

(6) The debt ratio is estimated to have reached 74.9% of GDP in 2004, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 16.8

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[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.

percentage points over the programme period. The evolution of the debt ratio is partly driven by debt-reducing stock-flow adjustments linked to the gradual phasing out of sinking funds, the accumulation of which had earlier on led to debt-increasing stock flow adjustments.

(7) Cyprus presents some risks with regard to long-term sustainability of the public finances, reflected by the projected budgetary costs of an ageing population. 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.

(8) The economic policies outlined in the programme 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.

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In view of the above assessment and in the light of the recommendations made by the Council under Article (104(7), the Council is of the opinion that Cyprus should:

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

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 Nov 2004	3.5	3.9	4.2	n.a.	n.a.
	CP May 2004	*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 Nov 2004	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 Nov 2004	-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 Nov 2004	-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 Nov 2004	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.