COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.2.2006
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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, 2005-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Cyprus was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Cyprus and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) Cyprus submitted its second update of the convergence programme covering the period 2005 to 2009 on 14 December 2005, later than the deadline of 1 December specified in the new Code of Conduct[3], reflecting the authorities' wish to incorporate the budgetary measures announced in the second week of December. The programme broadly follows the model structure for stability and convergence programmes specified in the code of conduct[4].

(2) On 5 July 2004, the Council decided that Cyprus was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit had to be corrected by 2005. In its opinion of 8 March 2005 on the previous update of the convergence programme, covering the period 2004-2008, the Council invited Cyprus to implement with vigour the measures envisaged to bring the deficit below 3% of GDP by 2005, ensure that the debt ratio started to decline by then, and pursue pension and health reforms.

(3) Supported by robust productivity and employment growth, Cyprus' real GDP growth (3½%) was among the highest in the EU over the last decade. Net borrowing vis-à-vis the rest of the world (the external deficit) has expanded (4¾% of GDP in 2004) due to competitiveness losses and increased competition in some of Cyprus' main export sectors. This was largely matched by the borrowing needs of the public sector, which posted a deficit above 4% of GDP in 2004. HICP inflation remained below 3% for most of the decade.

(4) The update envisages real GDP growth just above 4% over the period 2006-2009, based on an expected strengthening of final domestic demand and a positive contribution by the external sector. This is plausible until 2007, but slightly favourable in 2008 and 2009. As a result, cyclical conditions, as measured by the output gap, might be more favourable than implied by the programme's projections. The external deficit is projected to steadily decrease, from 5⅓% of GDP in 2006 to 2¾% in 2009.

(5) Annual HICP inflation, which remained at around 2% in 2005 in spite of higher energy and unprocessed food prices, is projected to hover around that level throughout the programme period. This projection appears realistic. Since ERM II entry on 2 May 2005, the CYP/EUR exchange rate has stayed close to the central rate. Government bond yields decreased in the course of 2005, falling below 4% at the beginning of 2006. The spread vis-à-vis euro area yields has narrowed to less than 100 basis points. Cyprus aims at achieving euro area membership on 1 January 2008.

(6) The current update estimates the 2005 deficit outcome at 2½% of GDP, compared with 2¾% of GDP in the Commission services' autumn 2005 forecast and just below 3% in the previous update. The difference with the previous update mainly reflects about 0.5% of GDP better than expected interest expenditure.

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3 Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

4 The programme provides all compulsory and most of the optional data prescribed by the code of conduct.

(7) Building on the deficit reduction to below 3% of GDP in 2005, the update aims at further consolidating public finances until 2009, when the deficit would approach 0.5% of GDP and the gross debt 53½% of GDP. After reaching 0.75% of GDP in 2005, the primary surplus is projected to rise gradually to 1¾% of GDP in 2009. The narrowing of the deficit reflects a cut in the expenditure ratio by around 4% of GDP that is less than fully compensated by a decline in the revenue ratio (by 2%). The adjustment is based on structural cuts in current primary expenditure, savings on interest expenditure and a combination of structural and one-off measures on the revenue side. The more gradual adjustment over the period 2006-2008 compared to the previous programme reflects slightly lower GDP growth.

(8) According to the Commission services' calculations on the basis of the programme using the commonly agreed methodology, the structural deficit (i.e. the cyclically-adjusted general government deficit net of one-off and other temporary measures) would improve from around 3% of GDP in 2005 to about 0.5% in 2009, i.e. by more than 0.5 percentage points of GDP per year on average, against the background of a gradually closing output gap. The lack of improvement in the structural balance in 2007 reflects the anticipated deterioration of Cyprus' net position vis-à-vis the EU budget, as temporary compensating grants associated with accession to the EU are terminated in 2006. The update clearly identifies its medium-term objective (MTO) as a structural deficit of 0.5% of GDP, and targets to achieve it in 2009. As this MTO is more demanding than the minimum benchmark (estimated at a deficit of close to 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level as it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(9) The risks to the budgetary projections in the programme appear broadly balanced. Given Cyprus' strong specialisation in tourism, the risks for the macroeconomic scenario are mainly associated with geopolitical developments in the region. Moreover, the macro outlook in 2008 and 2009 is slightly optimistic and tax projections seem somewhat favourable. However, the Cypriot government has so far over-achieved the budgetary targets and the update reiterates its commitment to adopt additional measures if needed to achieve the projected adjustment.

(10) Taking account of the estimated outcome for 2005 and of the balance of risks to the budgetary targets, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2005, in line with the Council recommendation under Article 104(7). From 2008, it also seems sufficient to provide a safety margin against breaching the 3% of GDP deficit reference value with normal macroeconomic fluctuations, and to ensure that the programme's MTO (-0.5% of GDP) is almost reached in 2009. The pace of adjustment towards the programme's MTO implied by the programme is broadly in line with the Stability and Growth Pact.

(11) Government debt is estimated to have been 70½% of GDP in 2005, above the 60% of GDP reference value. The update projects a steady decline in the debt ratio, to 53½% in 2009, as a result of rising primary balances, high nominal GDP growth, and, from 2006, debt-reducing stock flow adjustments (decumulation of sinking funds). The risks to these developments appear broadly balanced. The debt ratio seems to be on a sufficiently diminishing path.

(12) With regard to the sustainability of public finances, Cyprus appears to be at high risk on grounds of the projected budgetary costs of ageing populations. Implementing rigorously the planned consolidation of public finances over the medium term will alleviate the risks to long-term sustainability and, as recognized in the programme, substantial pension and healthcare reform measures will also be necessary to contain the projected high increase in age-related expenditure in the period up to 2050 and to reduce the risk to long-term sustainability.

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, Cyprus is on track to correct its excessive deficit by the deadline set by the Council and does the necessary to achieve its MTO, while the debt ratio is on a declining path from 2005 onwards. The programme also projects a declining external imbalance.

(14) The National Reform Programme of Cyprus, submitted on 11 November 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances (i) promoting R&D and innovation and facilitation of ICT diffusion; (ii) upgrading of basic infrastructures; (iii) enhancing human capital development and (iv) social cohesion. The budgetary implications of the actions outlined in the National Reform Programme are reflected in the budgetary projections in the update of the convergence programme. The envisaged measures in the area of public finances are consistent with the priorities foreseen in the National Reform Programme. In particular, the update outlines measures to monitor and better control public spending.

In view of the above assessment, the structural adjustment planned over the programme period after bringing the deficit below 3% of GDP in 2005 is to be welcome. In the light of the recommendations made by the Council under Article 104(7) of 5 July 2004, it would be appropriate for Cyprus to:

– in line with the updated convergence programme, ensure through measures of a permanent nature that budgetary consolidation towards the programme's medium-term objective is sustained after the excessive deficit has been corrected;

– control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances.

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, 2005-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [14 March 2006], the Council examined the updated convergence programme of Cyprus, which covers the period 2005 to 2009.

(2) Supported by robust productivity and employment growth, Cyprus' real GDP growth (3½%) was among the highest in the EU over the last decade. Net borrowing vis-à-vis the rest of the world (the external deficit) has expanded (4.8% of GDP in 2004) due to competitiveness losses and increased competition in some of Cyprus' main export sectors. This was largely matched by the borrowing needs of the public sector, which posted a deficit of 4.1% of GDP in 2004. HICP inflation remained below 3% for most of the decade.

(3) On 5 July 2004, the Council decided that Cyprus was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit had to be corrected by 2005. In its opinion of 8 March 2005 on the previous update of the convergence programme, covering the period 2004-2008, the Council invited Cyprus to implement with vigour the measures envisaged to bring the deficit below 3% of GDP by 2005, ensure that the debt ratio started to decline by then, and pursue pension and health reforms.

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[5] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

(4) The current update estimates the 2005 deficit outcome at 2½% of GDP, compared with 2¾% of GDP in the Commission services' autumn 2005 forecast and just below 3% in the previous update. The difference with the update mainly reflects a 0.5% of GDP better than expected interest expenditure.

(5) The new programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[6]. The update was submitted 2 weeks beyond the 1 December deadline set in the code of conduct reflecting the authorities' wish to incorporate the budgetary measures announced in the second week of December.

(6) The macroeconomic scenario underlying the programme envisages real GDP growth just above 4% over the period 2005-2009. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions until 2007 and slightly favourable ones in 2008 and 2009. As a result, cyclical conditions, as measured by the output gap, might be more favourable than implied by the programme's projections. The programme's projections for inflation appear realistic.

(7) Building on the deficit reduction to below 3% of GDP in 2005, the update aims at further consolidating public finances until 2009, when the deficit would approach 0.5% of GDP. After reaching 0.75% of GDP in 2005, the primary surplus is projected to rise gradually to 1¾% of GDP in 2009. The narrowing of the deficit reflects a cut in the expenditure ratio by around 4% of GDP that is less than fully compensated by a decline in the revenue ratio (by 2%). The adjustment is based on structural cuts in current primary expenditure, savings on interest expenditure and a combination of structural and one-off measures on the revenue side. The more gradual adjustment over 2006-2008 compared to the previous programme reflects slightly lower GDP growth.

(8) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve on average by more than 0.5% of GDP per year, from a deficit of around 3% of GDP in 2005 to about 0.5% in 2009. The lack of improvement in the structural balance in 2007 reflects the anticipated deterioration of Cyprus' net position vis-à-vis the EU budget, as temporary compensating grants associated with accession to the EU are terminated in 2006. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of 0.5% of GDP and aims to achieve this position by 2009. As this MTO is more demanding than the minimum benchmark (estimated at a deficit of close to 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level as it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

[6] The programme provides all compulsory and most of the optional data prescribed by the code of conduct. Optional data on labour market developments (in particular, employment (hours worked) and labour productivity (hours worked)) and on the contributions to potential GDP growth are missing.

(9) The risks to the budgetary projections in the programme appear broadly balanced. Given Cyprus' strong specialisation in tourism, the risks for the macroeconomic scenario are mainly associated with geopolitical developments in the region. Moreover, the macro outlook in 2008 and 2009 is slightly optimistic and tax projections seem somewhat favourable. However, the Cypriot government has so far over-achieved the budgetary targets and the update reiterates its commitment to adopt additional measures if needed to achieve the projected adjustment.

(10) Based on the estimated outturn for 2005 and taking account of the balance of risks to the budgetary targets, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2005 as recommended by the Council. In addition, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations from 2008. Furthermore, it seems sufficient to ensure that the programme's MTO is almost reached by 2009, as envisaged in the programme. In the years following the correction of the excessive deficit, the pace of adjustment towards the programme's MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad times.

(11) The debt ratio is estimated to have reached 70.5% of GDP in 2005, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline to 53½% in 2009. The risks to the projected evolution of the debt ratio appear to be broadly balanced. In view of this risk assessment, the debt ratio seems to be sufficiently diminishing towards the reference value.

(12) With regard to the sustainability of public finances, Cyprus appears to be at high risk on grounds of the projected budgetary costs of ageing populations. Implementing rigorously the planned consolidation of public finances over the medium term will alleviate the risks to long-term sustainability and, as recognized in the programme, substantial pension and health care reform measures will also be necessary to contain the projected high increase in age-related expenditure in the period up to 2050 and to reduce the risk to long-term sustainability.

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, Cyprus is on track to correct its excessive deficit by the deadline set by the Council and does the necessary to achieve its MTO, while the debt ratio is on a declining path from 2005 onwards.

(14) The National Reform Programme of Cyprus, submitted on 11 November 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) promoting R&D and innovation and facilitation of ICT diffusion; (ii) upgrading of basic infrastructures; (iii) enhancing human capital development and (iv) social cohesion. The budgetary implications of the actions outlined in the National Reform Programme are reflected in the budgetary projections in the update of the convergence programme. The envisaged measures in the area of public finances are consistent with the priorities foreseen in the National Reform Programme. In particular, the update outlines measures to monitor and better control public spending.

In view of the above assessment, the Council welcomes the structural adjustment planned over the programme period after bringing the deficit below 3% of GDP in 2005. In the light of the recommendations under Article 104(7), the Council invites Cyprus to:

– in line with the updated convergence programme, ensure through measures of a permanent nature that budgetary consolidation towards the programme's medium-term objective is sustained after the excessive deficit has been corrected;

– control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**CP December 2005**	**3.8**	**4.1**	**4.2**	**4.2**	**4.2**	**4.3**
	COM Nov 2005	3.8	3.9	4.0	4.2	n.a.	n.a.
	CP December 2004	*3.6*	*4.0*	*4.4*	*4.5*	*4.5*	*n.a.*
HICP inflation (%)	**CP December 2005**	**1.9**	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**
	COM Nov 2005	1.9	2.3	2.1	2.1	n.a.	n.a.
	CP December 2004	*2.1*	*2.6*	*2.2*	*2.1*	*2.0*	*n.a.*
Output gap (% of potential GDP)	**CP December 2005**[1]	**-1.3**	**-0.8**	**-0.3**	**0.1**	**0.0**	**0.1**
	COM Nov 2005[5]	-1.1	-0.7	-0.2	0.4	n.a.	n.a.
	CP December 2004[1]	*-1.5*	*-1.1*	*-0.6*	*0.0*	*+0.5*	*n.a.*
General government balance (% of GDP)	**CP December 2005**	**-4.1**	**-2.5**	**-1.9**	**-1.8**	**-1.2**	**-0.6**
	COM Nov 2005	-4.1	-2.8	-2.8[6]	-2.4[6]	n.a.	n.a.
	CP December 2004	*-4.8*	*-2.9*	*-1.7*	*-1.5*	*-0.9*	*n.a.*
Primary balance (% of GDP)	**CP December 2005**	**-0.9**	**0.7**	**1.2**	**1.2**	**1.4**	**1.7**
	COM Nov 2005	-0.9	0.5	0.3	0.7	n.a.	n.a.
	CP December 2004	*-1.3*	*0.7*	*1.8*	*2.0*	*2.5*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP December 2005**[1]	**-3.6**	**-2.2**	**-1.8**	**-1.8**	**-1.2**	**-0.6**
	COM Nov 2005	-3.9	-2.5	-2.7	-2.6	n.a.	n.a.
	CP December 2004	*-4.3*	*-2.7*	*-1.7*	*-1.5*	*-0.9*	*n.a.*
Structural balance[2] (% of GDP)	**CP December 2005**[3]	**-4.6**	**-3.1**	**-2.1**	**-2.1**	**-1.5**	**-0.6**
	COM Nov 2005[4]	-4.9	-3.1	-2.7	-2.6	n.a.	n.a.
	CP December 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP December 2005**	**71.3**	**70.5**	**67.0**	**64.0**	**56.9**	**53.5**
	COM Nov 2005	72.0	70.4	69.1	67.4	n.a.	n.a.
	CP December 2004	*74.9*	*71.9*	*69.2*	*65.7*	*58.1*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the programme (one-off revenues of 1.0% of GDP in 2004, 0.9% of GDP in 2005, and 0.3% of GDP in 2006-2008).
[4] One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (1.0% of GDP in 2004 and 0.6% of GDP in 2005).
[5] Based on estimated potential growth of 4.0%, 3.5%, 3.5% and 3.5% respectively in the period 2004-2007.
[6] The 2006 deficit projection was made under a no-policy change scenario, since the 2006 draft budget was not available at the cut-off date of the Commission services autumn 2005 forecast, which also partially explains a higher deficit projection for 2007.
Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.