CONVERGENCE PROGRAMME

OF THE

REPUBLIC OF CYPRUS

2006-2010

Ministry of Finance

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CONTENTS

INTRODUCTION

In accordance with the Council's Regulation (EC) 1466/97, the Republic of Cyprus submitted its first Convergence Programme (CP) in May 2004. This is the third update of the CP, drawn up in accordance with the updated guidelines set out in the "Guidelines on the format and content of the Stability and Convergence Programmes (2005 Code of Conduct)".

The fiscal consolidation effort, which begun in 2004, continues to be the key focal point of this Programme. Having complied with the Council's Recommendation under Article 104(7) to abrogate the excessive deficit procedure in 2006, the focus in this updated programme is to proceed with the consolidation of public finances over the medium term so as to achieve a close-to-balance budgetary position and place the government debt-to-GDP ratio on a distinct downward path, bringing it under the reference value. That will constitute a solid base for further addressing the sustainability in public finances over the long term, taking account of the impact of an ageing population on the government's expenditures and revenues.

A credible fiscal consolidation plan, aiming at ensuring fiscal discipline in a medium- and long-term perspective, is even more crucial now with the participation of Cyprus in ERM II and the plans for euro adoption by 1st January 2008.

The fiscal consolidation efforts will be underpinned by a sound macroeconomic framework and prudent monetary policy. The resurgence of economic activity in 2004-06 is expected to gather pace over the period 2007-2009, creating conditions conducive to fiscal consolidation. With the negative output gap closing gradually, fiscal policy will remain broadly restrictive, in cyclically-adjusted terms, over the programme horizon. Moreover, given the full employment conditions prevailing in the economy, the fiscal stance is expected to be compatible with the pursuance of conditions of internal and external economic stability.

As with the previous update—and in order to gain broad political support—the views of the political parties and other social partners were taken into account during the preparation of the CP. This CP will be submitted to the House of Representatives for discussion.

The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as feasible, credible and binding. Although a safety margin has already been incorporated in the design of the fiscal consolidation programme, the Government stands ready to introduce additional corrective measures, should this be warranted by adverse developments resulting from lower-than-expected economic growth and/or delays or failures to implement any of the envisaged fiscal measures. The Ministry will be monitoring closely the implementation process according to the timetable included in this Programme.

The CP was prepared by the Ministry of Finance and has benefited from comments by the Central Bank of Cyprus.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The overriding objective of economic policy is to enhance long-term growth and the standards of living of all citizens, maintain macroeconomic stability, implement structural reforms, which improve the functioning of the market mechanism, and to ensure that the government sector provides, adequately and efficiently, services to the public. Within the overall government finance constraints and targets, fiscal policy will focus more on growth, through the redirection of resources to growth-enhancing activities and prioritization of expenditure programmes. A more efficient and leaner government that can tackle effectively these challenges will be important in this process.

Despite the relatively good performance of the economy—as exemplified by the fulfilment of several key Lisbon targets—efforts to reform further labour, product and financial markets, in line with the country-specific Broad Economic Policy Guidelines' (BEPGs') and Cyprus' Lisbon Programme, will be intensified.

Fiscal Policy

Fiscal policy is geared towards achieving the Medium Term Objective (MTO) set out in this programme. Particular emphasis is placed on the need to curtail current expenditure and to restructure public spending in favour of capital expenditure, research and education, which can boost the economy's growth potential. The policy is based on four key pillars:

- The introduction of a Medium-Term Budgetary Framework (MTBF) which will institutionalise expenditure rules, will give more independence to spending ministries and, at the same time, increase their accountability for achieving important quantifiable targets;
- The reform of the social welfare system in favour of those who are in greater need. "More for fewer people" through more targeted social spending is key in curtailing wasteful spending;
- The modernisation of the public sector, which will result in leaner and more productive Government services. Such a policy will limit expenditure growth and raise overall productivity;
- Improve further tax collection within the present system, by focusing on tackling tax evasion and improving tax administration.

Monetary and Exchange Rate Policy

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, in part, through the pegging of the Cyprus pound to an anchor currency, be it a basket of currencies until 1992 or a single currency, the ECU/euro, since 1992. As suggested by the overall positive economic performance of the country, particularly in the last two decades, where high growth, low unemployment and relatively stable inflation rates were recorded, the policy of using the exchange rate as a means to contain inflation and to anchor inflationary expectations has served the economy well, not only in terms of safeguarding price stability, but also by providing a stable macroeconomic environment, which is conducive to long-term growth.

With the participation of the Cyprus pound in ERM II, the monetary policy framework remains effectively unchanged. The fact that the Cyprus pound has been pegged to the ECU during 1992-98, and subsequently to the euro, without any tensions, suggests that the economy can cope inside a fixed exchange rate regime, provided policies remain prudent and focused on the objective stated in this Programme. With this updated Programme the authorities underscore their commitment to adopt the euro by 1st January 2008 and to continue with policies which will ensure fulfilment of the Maastricht criteria in a sustainable manner.

Structural Reforms

The promotion of structural reforms will enable Cyprus to develop a robust and flexible economy, exhibiting the desired resilience to external shocks, while enhancing the efficiency of the market mechanism and raising the production potential of the economy.

The programme of structural reforms, outlined in detail in the National Reform Programme, and updated in the recent Progress Report, aims at boosting productivity and competitiveness that will deliver high growth and living standards for the citizens of Cyprus.

Although the Government is active in addressing these challenges, it considers the role of the private sector as key. The private sector identifies opportunities and invests in profitable areas. Macroeconomic stability and a friendly business environment are key ingredients underpinning this effort.

Reforms are addressing key challenges in the following areas:

1. *Reforms targeted at enhancing competition and improving the overall business climate*

Reforms are needed to increase the flexibility of the economy and support external competitiveness, as well as to enhance competition and improve the overall business climate. Against this background, policies will focus on enhancing competition, through the strengthening of the Commission for the Protection of Competition, rationalising state aid, raising the efficiency of the public sector, re-strucuring of the semi governmental organisations with a view to enhancing their flexibility, ecouraging foreign direct investment, and reducing the regulatory and administrative burden.

2. *Increase the diversification of the economy*

More investment should aim at further diversifying the economy, which is dominated by services and in particular by tourism. This partial dependence on tourism renders the economy vulnerable to exogenous economic, and geopolitical shocks. Further diversification of the economy will enhance its production base and make the economy more resilient and competitive. The National Lisbon Programme has outlined policies to upgrade the tourism product, thus diversifying away from traditional tourism which Cyprus has enjoyed for a number of years. Further diversification towards other services, such as banking and financial services, business services as well as education and health, which are experiencing rapid growth, would provide promising business opportunities.

3. *Promote R&D and innovation and facilitation of ICT diffusion*

It is widely accepted that R&D and innovation and the wider utilisation of information technology are key in attracting foreign direct investment, boosting productivity and growth. The updated convergence programme provides for increased expenditure on R&D, mainly through the Research Promotion Foundation. Nonetheless, the increased expenditure must be accompanied by efforts to coordinate more effectively government-funded academic and private sector research programmes, so as to encourage innovation.

4. *Upgrading of basic infrastructures*

Upgrading of the physical infrastructure network—which, considering the country's relatively high standard of living, remains underdeveloped in some areas — is central in this ambitious attempt and should proceed swiftly, in accordance with environmental concerns. The programme allows for a continuation of the ambitious infrastructure programme, but at the same time it sets strict priorities for the most important projects which will be undertaken within the horizon 2007-10.

5. *Further human capital development*

Enhancing of physical and human capital is key in raising productivity and boosting the economy's potential growth. Development of human capital is especially important in an economy dominated by the services sector. Rapid changes in the communication and information-technology sectors and structures of production as well as the organisation of work and the labour market require constant upgrading of the educational and training systems, as well as more emphasis on lifelong learning.

6. *Reform of social security and health care systems in light of the prospective population ageing*

The issue has been widely discussed both at the national and EU level. The Government is working with social partners on possible parametric changes to the social security system and for a fundamental reform of the health care system. In addition to these plans, which are discussed at a greater length in Chapter 6, other polices are promoted, including schemes to encourage the participation of females in the labour market, the more active participation of older workers and the more effective management of economic migration.

2. ECONOMIC OUTLOOK

World Economy/Technical Assumptions

The world economy continues to expand briskly and is expected to maintain its momentum in 2007. World growth is projected to reach some 5% in 2006-2007, supported by buoyant economic activity across all continents and the robust expansion of world trade.

The recovery of the EU economy is gathering momentum, aided by strong performance in France, Germany, Spain and Poland, and several other smaller countries. Notwithstanding the challenging year ahead in Germany—due to the tax changes to be implemented in 2007—the buoyant economic performance across the continent is likely to sustain the recovery beyond 2006. Recent structural reforms in a number of countries appear to have paid off and encouraging developments in the labour markets have paved the way for a more sustained expansion during this cycle. Consequently, GDP growth in the EU is expected to reach 2.8% in 2006 and 2.4% in 2007, thus providing a favourable external environment for the Cyprus economy which is critical given its small size and open character.

The UK economy—the most important economic partner of Cyprus—has weathered a downturn and is currently expanding at a satisfactory pace. With a robust growth in the EU, the UK economy will continue to grow rapidly reaching 2.7 % in 2006 and 2.6 % in 2007. Growth in Middle Eastern and CIS countries, particularly Russia, will remain robust owing to increased oil revenues, thus providing a sustained boost to Cyprus' merchandise and non-tourist services exports, including outlays on business services.

In contrast, the US economy is facing challenging times ahead, which could have significant repercussions for world economic growth. Recent indicators point to a significant slowdown of the housing market, and signs of weaker consumer and business sentiment. According to IMF estimates, a gradual negative adjustment of the US economy is estimated to have a limited impact on growth prospects elsewhere. Under this scenario the US growth of 3½% in 2006 will decelerate to 2¾ % in 2007. The IMF estimates that an even more abrupt slowdown of the US housing market would subtract an additional 1 percentage point of growth. A simultaneous abrupt fall of the US dollar could trigger a protracted and deeper economic slowdown in the US, which would have more serious implications for world economic growth. With this in mind, the risks to the world outlook are increasingly tilted to the downside.

The projections for the macroeconomic outlook for Cyprus are based on the assumption of an unchanged exchange rate of the euro and Cyprus pound against major currencies from the average level of October 2006. It is assumed that the price of crude oil (Brent crude) will average $66 per barrel in 2006, and will rise to $68 per barrel in 2007. In subsequent years crude oil prices are assumed to remain at just under $70 per barrel.

As regards interest rates, the Convergence Programme assumes that interest rates in Cyprus converge towards the lower level of interest rates in the Eurozone. Given these projections for the world economy and the related technical assumptions, the external economic environment for Cyprus is envisaged to remain favourable over the coming year and into the medium term.

Cyclical Developments and Current Prospects in Cyprus

The economy of Cyprus has continued to perform relatively well in 2006, after a solid performance in 2005. GDP growth reached 3.9% in 2005 and is expected to decelerate slightly to 3.7% this year. On the supply side, the economy is performing well particularly in the secondary sectors—due to continued buoyancy of the construction sector despite expectations for a cooling off this year—and, more importantly, in the services sectors. From the demand side, continued strong private consumption and a further expansion of export activity are providing the impetus to growth. The satisfactory growth performance is being facilitated by fast employment growth, supported by inflows of foreign workers in key sectors of the economy.

From a sectoral view point, the tertiary sectors have continued to outpace the primary and secondary sectors. Strong demand for financial and other business services, health and education, as well as real-estate-related activities has heightened growth, offsetting the continuous below-potential expansion of the tourism sector. At the same time buoyant demand for agricultural exports and dwellings has sustained growth in these key sectors of the economy, resulting in a more balanced growth pattern. The tourism industry, which has been operating below potential for a number of years, has staged a recovery in 2006 as tourist revenues rose at a satisfactory rate.

Table I: Selected Economic Indicators 2004-2006

annual % change	**2004**	**2005**	**2006**
Real GDP growth rate	4.1	3.9	3.7
HICP	1.9	2.0	2.4
Unemployment rate (Labour Force Survey)	4.7	5.3	4.8
Current account balance (% of GDP)	-5.0	-5.6	-6.4

Private consumption continued to expand rapidly, albeit at a slightly slower pace compared to 2005. The strong growth of consumption, which is forecast to reach 4.6% in 2006, is attributed to further employment and real wage gains as well as to a buoyant credit market. Public consumption is expected to grow by around 4½% in 2006 as compared to 3.4% in 2005, reflecting somewhat higher social spending compared with 2005. Investment growth is set to expand to 5.7% in 2006, and will continue to be driven by construction and investment in machinery and equipment.

Exports growth has moderated somewhat to 3¾% in 2006, compared with 4¾% in the previous year. Tourist arrivals have continued to ebb in 2006, offset partly by higher per capita spending. At the same time, while exports of services grew at a satisfactory pace, re-export activity slowed down after a very strong performance in 2005. The continued sustained growth of services other than tourism is a significant development and reflects the continuing diversification of the economy.

Labour market conditions remain tight with the unemployment rate declining to 4.7% of the labour force in the first half of 2006. Labour shortages in a number of key sectors (e.g. in hotels and restaurants, trade and construction and at the occupational level in technical and low skilled occupations) have been addressed, to a large extent, by an increased supply of foreign workers and Turkish Cypriots. Overall, the demographic trends observed in recent years are changing fundamentally the structure and working of the labour market in Cyprus (Box 1). Indeed, it is estimated that total employment will increase by around 1½% in 2006, including a significant further increase of foreign workers and Turkish Cypriots. The rapid growth of the working age population and of employment in several sectors, have been instrumental in supporting strong demand and curbing wage growth. At the same time, these changes have increased markedly the de facto flexibility in the labour market.

Inflation, measured by the Harmonized Index of Consumer Prices (HICP), accelerated significantly in the first months of the year on the back of rising oil prices, peaking at 2.8% in July 2006. Since then it has declined markedly to 1.7% in October 2006, along with the falling oil price. Based on the current estimates it is forecast to finish at 2.4% in 2006, although the impact of the falling oil prices will be further carried over in the first half of 2007 (Appendix 1 provides a detailed forecast for inflation over the programme period). Excluding energy costs and prices of other volatile items, such as seasonal fruits, inflation remains subdued with no signs of emerging second round effects. Restrictive fiscal policies, the credible peg of the Cyprus pound to the euro, as well as declining prices in several categories—most notably of clothing and telecommunications—and intense competition in other key retail segments of the market are exerting a significant downward pressure on core inflation.

The banking sector has continued to display dynamism and to experience intense competition. Monetary and credit aggregates have risen rapidly over the past year, with borrowing and lending in foreign currencies soaring in anticipation of a smooth transition to the euro in 2008. In October 2006, Narrow Money (M1) registered an annual growth rate of 25%, while M2 expanded at an annual rate of 14.9% compared with 9.3% in the corresponding period of 2005.

Bank credit to the private sector expanded by 15½% in the same period. It is noteworthy that the share of foreign currency borrowing by residents—mainly euro—out of total credit has increased from 9½% in 2003 to 17,4% in October of 2006.

Considerable capital inflows, resulting mainly from borrowing in foreign currency due to lower euro interest rates, contributed to excess liquidity conditions in the banking system during 2006. In this context, the restrictive fiscal stance contributed towards easing inflationary pressures. Indeed, such conditions supported by credible macroeconomic policies have led to strong buying of government paper by institutional investors. Bond yields, which followed a distinct downward path since 2001, fell noticeably in 2006. Treasury bill average yearly yields on short-term paper fell by 170 basis points in 2006 compared with 2005, while yields on 10-year bonds also declined by 100 basis points.

However, the sharp rise in oil prices in the summer months placed upward pressure on domestic prices and costs and with a change in inflationary expectations, market interest rates tended to rise from July onward. The Central Bank also raised its key interest rates at the end of the summer by 25 basis points, citing concerns arising from money and credit expansion.

The prevailing conditions of excess liquidity in the banking system in 2006 have delayed the intended lowering of reserve requirements by banks needed as part of the convergence and harmonisation of the monetary policy framework with that of the ECB, although the target for complete alignment by the end of 2007 remains unchanged.

The current account is expected to register a deficit of some 6.4% of GDP in 2006. Higher imports and slower-than-expected export growth are behind the deterioration of the current account. The rather persistent deficit masks a number of potentially transitory factors that could prevail including soaring oil prices and income outflows by foreign firms. These developments suggest that the “underlying” current account deficit has remained broadly unchanged in the past 2-3 years. Specifically, rising oil prices led to an increase for imports of fuels and lubricants by some 1% of GDP and 2% of GDP in 2005 and 2006 respectively. Similarly, foreign firms have recorded income outflows amounting to some 4% of GDP; these are recorded as income outflows in the current account, but at the same time as FDI inflows in the financial account. At the same time, net FDI flows have reached some 4¼% of GDP in 2005, and almost 3% of GDP for first half of 2006 compared with –½% the same period of the previous year.

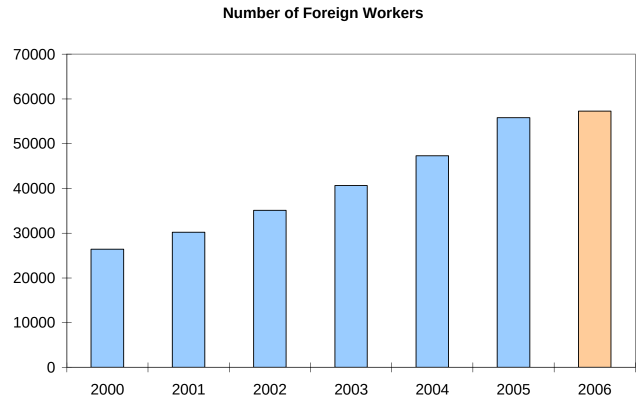
Box 1: Inflows of Foreign Workers: Stylised Facts and Potential Impact on the Economy

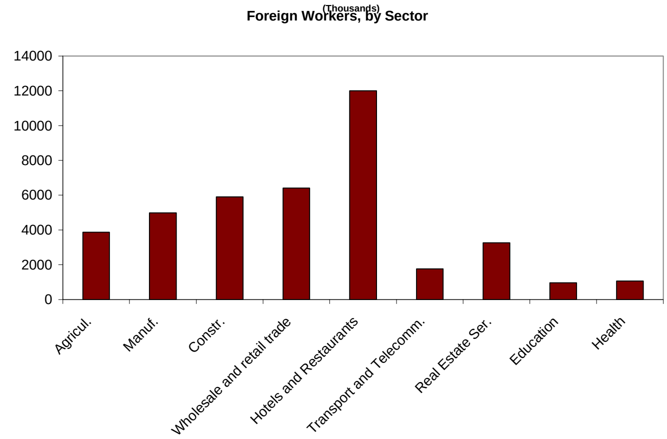
A key characteristic of the labour market in Cyprus in recent years has been the changing composition of the labour force. These demographic changes have important implications both for the working of the labour market and for the economy as a whole.

- The share of foreign workers in the total labour force has doubled to around 16 percent. The number of foreign workers is estimated to have reached 60 thousand in 2006, which is significant by the standards of a small country (Text Diagram).

- The majority of foreign workers are employed in households (not shown in the diagram), in hotels and restaurants, in wholesale and retail trade, and in construction (Text Diagram).

- The inflows of foreign workers have altered noticeably the job pyramid in Cyprus. Foreign workers, typically with little or no skills, have entered the labour market enabling Cypriots to move to higher skilled jobs.





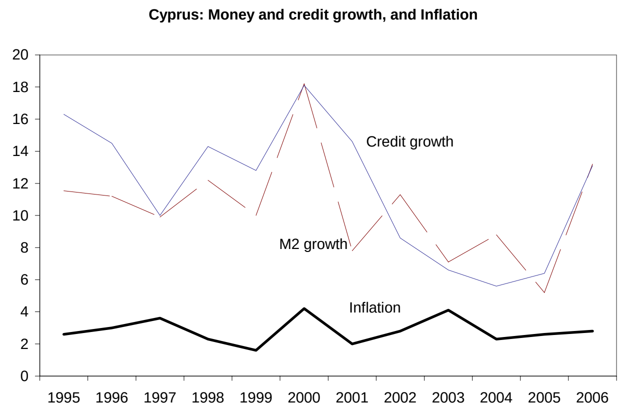
- The increased supply of labour, often at conditions below those prevailing for Cypriots, has created a more flexible labour market environment and has led to a differentiation of salary structures, especially for newcomers most of whom are foreigners.

- Recent empirical analysis of the impact on wages has revealed a significant slowdown of the growth rate of wages of unskilled labour as a result of the inflows of foreign workers. In contrast, skilled workers have benefited from these structural changes (Michael et, 2006, Economics Research Centre Paper 11-06). This is in line with evidence from other countries (Borjas et al, 1992, 1996, 2003, Friedberg and Hunt,1995)

Box 2: Credit and Monetary Growth and Macroeconomic Consequences

There is often concern that rapid credit growth in Cyprus will lead to higher inflation and a boom/bust pattern of real economic activity, and periodically stifle growth performance. During 2006 the rate growth of credit to the private sector has reached over 15% and that of broad money around 13.5% renewing concerns about potential adverse macroeconomic consequences.

- Data for the past 10 years reveal no strong link between the rate of growth of credit to the private sector and the rate of change of consumer prices (see Text Figure). In periods of rapid growth of credit to the private sector the demand for imports often recorded substantial rises, implying that some inflationary pressures were transmitted to the current account of the balance of payments, with some limited impact seen also on the domestic component of the CPI.



- Notwithstanding, broad money in most years has exhibited a faster rate of growth than nominal GDP and generally has not been reflected in higher inflation. That is, the moderately fast growth of the money stock has been associated with a distinct long-term downward trend in the income velocity of circulation of money.

- Periods of rapid growth of credit have not led to any overheating of the economy necessitating strict corrective measures that significantly curtail the real growth rate. A considerable part of the current upsurge in credit expansion is for financing housing construction and purchases. While real estate prices rose sharply in 2005 and early 2006 they have recently tapered off and are not likely to lead to any "hard landing" for the economy.

- The Central Bank of Cyprus took a number of steps to address the rapid credit growth, including higher interest rates, postponing the planned lowering of reserve requirements, and issuing circulars with specific instructions for banks to address some of these issues.

- In addition, as outlined above episodes of higher inflation have usually been associated with shocks arising from surges in oil prices and higher indirect tax rates.

The above reveals that in adjusting to these shocks, especially for the higher energy prices impacting in 2006, consumers have not lowered their real consumption, but have availed of credit and reduced their saving balances to help cushion oil price shocks. In this sense, faster credit expansion has contributed to sustaining the real growth of the economy in the face of oil price shocks. As debt levels increase, however, this channel is likely to weaken implying a stronger impact on consumption and GDP.

Of course, policy-makers are more concerned that with the increasing allocation of credit to financing housing purchases and consumer spending, insufficient loanable funds are being directed toward financing non-housing capital formation, especially export-oriented activities, and in the process will dampen the medium to long term growth potential of the economy.

Medium-term Scenario 2006-2010

The Convergence Programme is based on a medium-term macroeconomic scenario that takes into account the positive effects stemming from the implementation of fiscal and structural reforms and other policies included in the National Lisbon Programme. The following key assumptions are made:

- Tourist arrivals will increase by 3½%, and per capita tourist spending by around 1% in nominal terms annually over 2006-10[1].
- The value of exports of services other than tourism will rise at an annual average rate of 7% over the period 2007-10.
- Nominal earnings will rise by 4½-5% per annum and real earnings by 2-2½% during 2007-2010, in line with prospective productivity gains. Hence, real unit labour costs will remain broadly unchanged over the same period.
- Employment will expand by 1½% per annum as a result of an increasing inflow of foreign and Turkish Cypriot workers.
- Public sector employment will expand by some 1% annually in 2006 –2010.

Based on these assumptions, and notwithstanding some risks to this scenario (Box 3), it is forecast that GDP will expand by an average of 4%—slightly above the assumed potential growth of 3¾% (Box 4)—thus closing the output gap by the end of the programme period. With growth at or somewhat above potential, the unemployment rate will ebb to 4½% by 2010 (LFS definition).

It is envisaged that domestic demand,—reflecting mainly a buoyant investment activity and a strong growth of private consumption,—and to a lesser extent exports will be the main drivers of growth in the medium term. Private consumption will continue to grow at around 3¾% per annum on account of wage and employment gains and low interest rates. Investment will expand by about 4¼% per annum—compared with an average increase of 5% in 2000–04; low interest rates and a stable macroeconomic environment, prospective euro adoption in 2008, liberalisation in a number of sectors (e.g., energy and communications), and plans to upgrade physical infrastructure in various segments of the economy (including in transport and energy), will keep investment activity buoyant in the near to medium term.

In contrast, Government consumption growth will moderate as a result of the implementation of the fiscal consolidation programme which, inter alia, envisages stricter controls on public sector employment growth, as well as the containment of other current expenditures. More specifically, government final consumption is expected to increase by around 3% in real terms over the period 2006-09.

Exports of goods and services are forecast to rise by around 4-4½% per annum in constant prices on the back of buoyant tourist demand and improvements in the quality of the tourist product, which will boost revenues and profit margins. Exports of services, other than tourism, are expected to continue to perform well, expanding at an annual rate of some 5% in real terms over 2006–10. However, the growth of re-exports is set to decline significantly from the high levels seen in the last 2 years to

[1] This implies that the total number of tourist arrivals will reach 2.9 million by 2009 and total receipts from tourism will amount to some 11.5% of GDP, compared with 12.8% in 2005 and 21% in 2000.

around 5-6 percent. This important revision will result in lower overall export and import growth, but will have a minimal impact.

Box 3. Risks to medium-term forecasts

Overall, the risks to the outlook seem to be fairly well balanced over the medium term.

On the downside, there is the risk of:
- Geopolitical tensions in the Middle East;
- Disorderly correction of global imbalances leading to a further real effective appreciation of the euro and the Cyprus pound;
- Greater than expected global slowdown due to a hard landing in the United States which would impact negatively on export growth;

On the upside:
- The effects of fiscal and other structural reforms, and the positive impact from EU membership, may be underestimated, implying a higher growth potential of the economy in the medium term.

From the sectoral viewpoint, the private tertiary sectors will continue to be the main engine of growth, given that the comparative advantages of Cyprus favour the development of these types of activities. The share of the service sector as a whole to GDP is anticipated to grow further and reach 78.3% in 2010, as compared with 77.3% in 2005, whereas the share of both the primary and secondary sectors would correspondingly decline from 3.2% and 19.5% in 2005 to 2.8% and 18.9% in 2010, respectively. Within the service sector, continuing restructuring and diversification are expected, with an increased shift towards export-oriented private services in the areas of communications, finance, business services, private education and health. These will continue to benefit from the abolition of all restrictions on direct and portfolio investment, not only for EU residents but also for residents of third countries, implemented as from the last quarter of 2004, the conditions of enhanced competition in the utilities sectors and the utilisation of the comparative advantages of Cyprus.

In the labour market the medium-term scenario envisages further employment gains, mainly resulting from increased participation of foreign workers, and a slow (long-term) increase of the participation rate of, mainly, female Cypriot workers and old aged. With the gainfully employed population increasing by 1½% per annum, the unemployment rate will fall to 4.4% in 2010 from 5.3% in 2005. In general, labour market conditions are expected to remain tight but the projected increase of foreign and Turkish Cypriot workers will help ameliorate shortages in various sectors.

Productivity growth will accelerate to 2½–2¾ percent in the medium term, as a result of the strong investment undertaken in recent years, which will bring about greater utilisation of new technologies. Real earnings will rise in line with productivity growth, and nominal unit labour costs will increase by some 2% over the same period, in line with anticipated inflation.

Monetary developments, which will continue to reflect trends in the real economy, remain consistent with the goal of medium-term price stability. Based on the estimate for potential GDP growth roughly at 3¾% and of long-run inflation around 2%, and assuming that the velocity of circulation of money will continue to decline somewhat over the medium term, a simple quantity of money relationship suggests that the stock of broad money will expand by an average of 7½-8% annually.

The current account deficit will narrow over the medium term to around 4% of GDP in 2009 from 5.6% in 2005. Gross national saving will increase from 13.5% of GDP in 2006 to 16.1% of GDP in 2010, with higher public savings contributing 1¾% of GDP of the increase. Gross national investment will also increase by some ½% of GDP, mainly as a result of higher private sector investment as a share of GDP.

The upward revision for the medium-term current account deficit compared to previous forecasts reflects primarily the assumption for higher oil prices, which has a bearing on the level of imports of fuels and lubricants, as well as an expectation for further widening of the income balance as a result of improvements in profitability of foreign firms and an equivalent further increase of the inward FDI. It is estimated that income outflows pertaining to re-invested earnings of foreign firms have reached 4% of GDP in 2005. It is noted that these flows are recorded simultaneously as income outflows in the current account and FDI inflows in the financial account; in effect, suggesting an "underlying" current account deficit below 2% of GDP. Overall, it is anticipated that FDI flows will continue to finance, to a large extent, the current account deficit, thereby allowing official foreign exchange reserves to remain at comfortable levels.

Despite these underlying factors affecting the size of the current account, the large nominal appreciation of the euro-linked Cyprus pound has led to a loss of external price and cost competitiveness, arising largely from nominal exchange rate movements (Box 5). As a result export shares in tourism and goods markets have fallen, while import penetration has increased considerably. Overall, the effective appreciation of the Cyprus pound has induced the restructuring of the economy in favour of less labour intensive activities, where Cyprus has a comparative advantage. Indeed, this process has brought about diversification of the economy through expansion of alternative businesses within the services sector (e.g., tourism, banking, other financial services, real estate services etc), rather than across more traditional sectors.

Table II: Selected Economic Indicators 2007-2010

annual % change	2007	2008	2009	2010
Real GDP growth rate	3.9	4.1	4.1	4.1
HICP	2.5	2.4	2.0	2.0
Unemployment rate (Labour Force Survey)	4.8	4.7	4.6	4.4
Current account balance (% of GDP)	-5.8	-5.4	-4.8	-4.2

Box 4. The Output Gap: Should it close?

The estimated size of the output gap is crucial for the purpose of conducting macroeconomic policy. This is especially the case inside the EU given the rules stipulated in the Stability and Growth Pact (SGP) for the conduct of fiscal policy. However, several measurement issues render the accurate estimation of potential GDP in Cyprus a hazardous exercise.

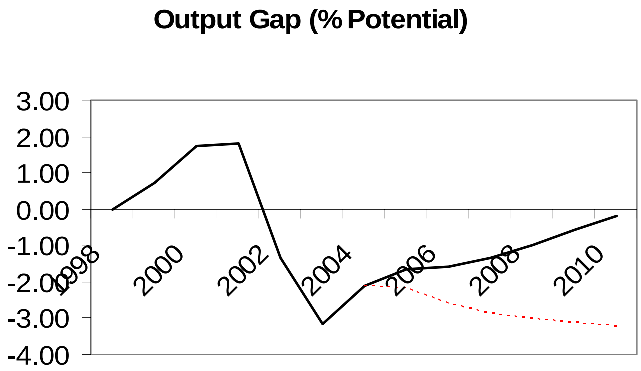
Recent trends and empirical studies have estimated potential GDP growth of around 4–4½%. In terms of simple growth accounting the contribution of labour should be not less than 1½%, capital 1–1½% and total factor productivity around 1½%, resulting in potential GDP growth of 4–4½%. There are, however, a number of crucial considerations which must be taken into account:

- Analysis of potential GDP from an aggregate viewpoint can be misleading. This is especially true in a services economy, such as Cyprus. Certainly, in the hotels and restaurants sector there is ample slack as a result of below-potential growth in recent years. In contrast, other financial services or real estate activities may be in a better position to raise output through higher productivity; the potential in these important sectors for the economy is considerable.

- The inflows of foreign workers have potentially boosted GDP potential, though the extent remains a key unknown. The productivity performance of foreign workers is variable, and the adjustments needed to absorb these people in the economy effectively, including investment in physical capital in some cases, is substantial and requires time.

- These profound changes in the structure of the economy and the composition of the labour force raise questions about the measurement of GDP. Various indicators, aside from the observed employment trends, indeed imply higher GDP than reported, including buoyant tax receipts and rapid monetary growth.

- Using the published GDP figures, however, and assuming a potential GDP of 4½% implies a persistent negative output gap (dotted line in the Text Figure). To achieve a closing of the output gap by 2010, a considerably more conservative estimate of potential GDP growth must be made (3¾% in the Text Figure).



Given this dilemma, the CP takes a more conservative approach, assuming a potential GDP growth of 3¾–4% in the medium term, thus allowing for a considerable safety margin in the fiscal projections.

Box 5. Competitiveness pressures: Domestically induced or imported?

Cyprus is a small open economy, with the sum of exports and imports as a share of GDP reaching 100 % of GDP. The Cyprus pound was pegged to the ECU for the period 1992-1999, and subsequently to the euro after 1999. Prior to 1992, the pound was pegged to a basket of currencies including, in addition to a number of EU currencies, the US dollar, Japanese Yen, and Swiss Franc.

The discussion usually centres on domestically produced price pressures which undercut external competitiveness in the traded sectors. For example, questions arise if real wages rise faster than productivity thus undermining price competitiveness in key sectors such as tourism, or other services. The typical policy prescription is to control wages, and/or invest in enhancing technology and/or foster greater competition.

Equally important, however, are the developments in foreign exchange markets, not only of the Cyprus pound against the euro, but of the euro against key currencies. In a monetary union, or, in a fixed exchange rate mechanism the behaviour of the anchor country, or bloc of countries is key. What is happening with third countries is also crucial. In this case the external value of the euro against the dollar and the pound sterling is key. Since the end of 2000, the euro has appreciated against the dollar by some 50%, or from $/€ 0.85 to $/€ 1.28 presently. Further the euro has appreciated against the pound sterling by some 15%, or from £/€ 0.59 to £/€ 0.67, and by some 35% against the Chinese Yuan, or from Y/€ 7,437 to Y/€ 10,113. Similar moves of the Cyprus pound against these key currencies have been observed owing to the peg of the Cyprus' currency against the euro. Moreover, the strengthening of the euro and, by association, of the Cyprus pound has taken the brunt of adjustment resulting from the underestimation of the Chinese Yuan and other Asian currencies.

Over the same period consumer prices have increased cumulatively by some 10 percent in the UK, 20% in the USA and 20% in Cyprus, a figure which includes significant VAT increases at the time of Cyprus' EU accession.

These figures suggest that the aforementioned bilateral exchange rate movements have been key determinants of real exchange rate movements. More importantly, these nominal exchange rate movements are due to the anchor currency's swings against the dollar, the pound sterling, something that members of the euro zone and ERM II must take as given. Relative prices have also had some, albeit smaller, effect on key bilateral real exchange rates.

What are the policy implications of these trends? Policy makers in Cyprus must control costs and prices, and continue the current fiscal consolidation effort. But that is not enough. Policies at the European level must also become more focused and coordinated so at to effectively achieve more stability in international currency markets. International policy coordination is also key in this regard, and has important implications for a small economy, such as Cyprus. Domestically policymakers should follow sound policies, deregulate, increase the efficiency of the public sector, but that is as much one can achieve. European and international policies are of key significance to minimise exchange rate volatility, while the private sector must bear the cost of adjustment in the long-term if it fails to achieve restructuring and effective efforts to improve efficiency.

Growth Implications of Major Structural Reforms

The interrelated structural reforms proposed within the framework of the National Lisbon Programme will contribute towards enhancing the growth potential of the economy via a quantitative and qualitative upgrading of the factors of production—labour and capital (basic infrastructure and private investment in higher value added activities),—as well through enhanced technological change and productivity gains, resulting from a more efficient functioning of the market mechanism.

Furthermore, with the planned entry of Cyprus into the European Monetary Union on January 1, 2008 a greater premium is being put on structural reforms to boost productivity growth so as to improve and to regain any lost competitiveness arising from the recent real appreciation of the euro-linked Cyprus pound (see Box 5). Otherwise, failure to significantly raise productivity growth could require a period of austerity entailing stricter wage restraint, which would dampen the growth performance of Cyprus and delay further real convergence. It should be emphasised that the boosting of productivity growth and the growth potential would make possible the achievement of a satisfactory rate of growth of the economy under conditions of price stability, and would contribute positively towards further bridging the gap to the more advanced member states of the EU.

The impact of these reforms on growth, particularly if all are implemented, is likely to be significant as they all aim at boosting productivity and potential growth. At the same time, they will have a positive effect on the competitiveness of the economy.

More specifically, reforms which aim at creating a stable macroeconomic environment including reforms of the social security and health care systems, which will importantly contribute to the sustainability of public finances, will foster confidence in the Cyprus economy and its ability to provide affordable and adequate pensions and health care for its citizens. This in turn should encourage sustained and buoyant consumer spending, negating the need for excessively high savings for financing future health care and other old-age related expenditures. In addition, stable macroeconomic conditions together with reforms creating a more friendly and competitive business environment, such as better regulation and the reduction of administrative costs on the private sector, should induce new investments including greater foreign direct investment, and in the process raise the capital stock and associated technological advances, thus increasing the economy's productive capacity.

Reforms to promote research and development, and in the labour market reforms, as well as enhancing human capital development are not only necessary to promote a more knowledgeable society and social cohesion, but are required to help contribute to significantly raising the growth potential of the economy. Indeed, against the background of the need for increasing diversification of the economy and globalization trends, including the inflow of immigrants to work in more labour-intensive industries, Cyprus industry needs to move upstream in the value-added chain requiring its labour force to be adequately skilled and trained to support new growth industries and services. In this sense, further human capital development taking account of globalization trends and the labour skills needed by the prospective dynamic sectors of the economy, will importantly contribute to Cyprus sustaining and even raising its growth rate over the medium and long term.

The expansion and upgrading of basic infrastructures is required to facilitate and support the private sector activity that will be propelling the growth of the economy. New and upgraded infrastructure in the energy sector, such as storage facilities holding higher energy stocks, new port facilities and a terminal for the import of natural gas and, a new electricity power generation plant, will be required to underpin the growth of the economy. And similarly the expansion and upgrading of transportation infrastructure, particularly of airports and seaports, will facilitate the further expansion of the tourist sector as well as support the operation of Cyprus as a flourishing regional hub for shipping, transit trade and business services.

While implementation of all of these structural reforms can be expected to raise significantly the growth potential of the economy, they will also contribute to the adequate growth of domestic and foreign demand ensuring that actual economic growth is in line with potential and is sustainable. Domestic demand will be supported by buoyant consumer spending, strong private investment and considerable outlays on expanding and upgrading basic infrastructure. Foreign demand for Cyprus exportables is expected to be strong, driven by sustained external competitiveness resulting largely from structural reforms inducing relatively rapid productivity growth and utilizing the comparative advantages of Cyprus.

3. GENERAL GOVERNMENT BALANCE AND DEBT 2006-2010

Policy Strategy

The Government's main policy target continues to focus on the achievement of the country specific Medium-Term Objective (MTO) by the end of the programming period, thus contributing to the long-term sustainability of public finances.

The fiscal consolidation continues to rely on the following three pronged strategy:

- Containment of the expenditure growth below the nominal GDP growth.
- Improvement of the effectiveness of the revenue collecting departments.
- Improvement of the quality of public finances.

The containment of government expenditure growth below the nominal GDP growth is to be achieved, through the continued setting of ceilings on specific categories of expenditure. This is to be underpinned by the introduction of a medium term budgetary framework (MTBF)[2], covering a three year period starting from 2007. The purpose is to adopt a modern institutional framework linking medium – term targets to the annual budgetary process.

The improvement in the effectiveness of the revenue collecting departments is being achieved, through legislative and administrative changes, aimed at raising the compliance rate and broadening, further, the tax base.

The improvement in the quality of public finances also contributes to the fiscal consolidation process and plays an important role in creating a growth enhancing environment in the medium- term, while supporting structural reforms, in line with the Lisbon Agenda and national objectives.

In the same context, the further reduction of public debt as a percentage of GDP is important for the fiscal consolidation and the long-term sustainability of public finances.

The envisaged pace of consolidation toward the attainment of the country-specific MTO is appropriate, given the projected short- and medium-term outlook for a continuing recovery and sustained growth of the economy.

Continuous progress in terms of public finances is crucial in sustaining the nominal convergence process and low interest rate environment. Indeed, long-term interest rates have exhibited a downward trend during the last years, followed by a small correction recently. Although the entry of the Cyprus pound in the ERM II, acted as a catalyst in reducing the differential between interest rates of the euro area and Cyprus, the improved fiscal position was also a key factor. Reduction of interest rates and risk premiums, will contribute towards lowering government spending on interest payments, thus allowing expenditure to be redirected to more productive areas.

[2] On May 3, 2006 the Council of Ministers approved the basis and the guidelines for the introduction of a Medium Term Budgetary Framework. The first medium term budgetary framework covers the period 2007-2009.

Medium-term Objective

The general government nominal budget balance continued to improve for the third consecutive year and is estimated to fall to 1.9% of GDP in 2006 compared to 2.3% in 2005 and 4.1% in 2004. The fiscal consolidation process is projected to continue throughout the programming period with the nominal fiscal deficit estimated to decrease to 1.6% of GDP in 2007 achieving gradually a "close-to-balance" nominal fiscal position by 2010.

Although, the country's fiscal position has improved since the last update of the Convergence programme, the country-specific medium-term budgetary objective (MTO) remains unchanged at 0.5% of GDP structural deficit. The MTO is to be achieved through a steady annual improvement of the general government structural fiscal position over 2006-10. The structural improvement in 2006 continues to be substantial and is estimated at 1.2 percentage points of GDP. The general government deficit is expected to decline, in structural terms, by 0.6 percent of GDP in 2007, to 1.0% of GDP and subsequently, to decline further by 0.8 percent of GDP in 2008.

The annual structural adjustment in the first two years of the programming period exceeds the minimum annual adjustment of 0.5% of GDP prescribed by the Stability and Growth Pact. Towards, the end of the period covered by the updated Convergence Programme, the government structural position is projected to improve further and reach a "close-to-balance" position as from 2008. Evidently, the fiscal policy scenario presented in the current update of the Convergence Programme is front loaded rather than back loaded.

Table III: Components of Fiscal Adjustment and the Medium-term Objective

in percentage points of GDP	2005	2006	2007	2008	2009	2010	Total Adjustment 2007-2010
Expenditure measures	*0.7*	*0.4*	*-0.1*	*-0.8*	*-0.3*	*-0.5*	*1.7*
Revenue measures	*0.0*	*0.8*	*0.2*	*0.1*	*0.0*	*-0.2*	*0.1*
General Government Balance	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**	
Cyclically Budgetary Component	*0.8*	*0.7*	*0.6*	*0.5*	*0.3*	*0.0*	
Cyclically Adjusted Balance	**-1.5**	**-1.2**	**-1.0**	**-0.2**	**-0.1**	**-0.1**	**0.9**
One-off revenue measures	*1.3*	*0.4*[3]	-	-	-	-	
Cyclically Adjusted Structural Balance	**-2.8**	**-1.6**	**-1.0**	**-0.2**	**-0.1**	**-0.1**	**0.9**

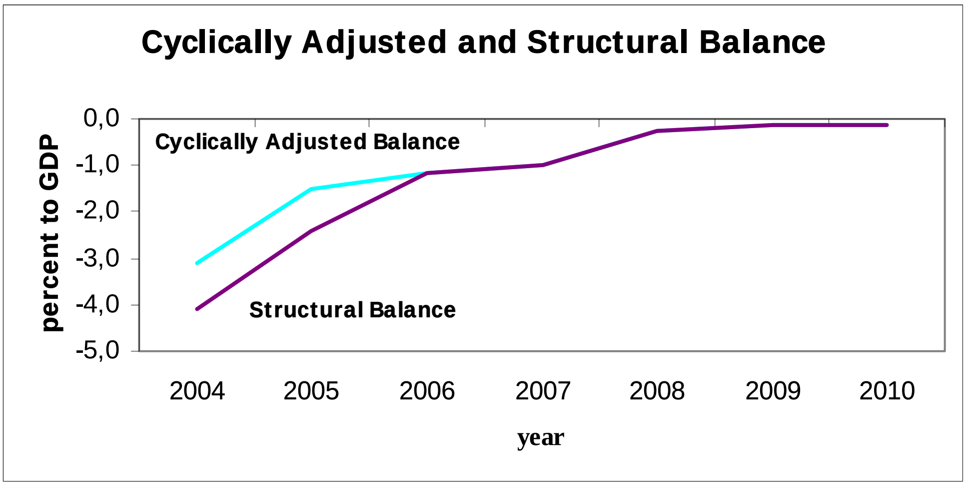
Note: The figures may not add up to the total due to rounding effects.

[3] The net position of Cyprus vis-à-vis the EU budget, following the commencement of the next financial framework for the programming period 2007-2013, which coincides with the termination of the provision of compensating grants during the period 2004-2006 through the EU budget, is anticipated to deteriorate in 2007. The estimated deterioration, having a fiscal impact in 2007, is estimated, on a net basis, to 0.4 percent of GDP. With a view to safeguard comparability over the programming period the compensating grants through the EU Budget, provided over the 2004-2006 period, are treated as one-off operations.

Expenditure containing measures are set to account for the bulk of this adjustment, contributing a cumulative 1.7 percent of GDP over the programming period 2007-2010.

Revenue measures only contribute a cumulative adjustment of 0.1 percent of GDP during 2007-2010. The developments on the revenue side are adversely affected by one-off measures, such as the tax amnesty and also from the termination of EU budgetary transfers from 2007 onwards as well as structural measures, such as the negative fiscal impact of the motor vehicles tax reform. The aforementioned revenue shortfalls will be offset by the assumed higher than one tax elasticity and other revenue-enhancing measures described later.

Compared with the last update of the Convergence Programme, the current update continues to rely, primarily, on an adjustment on the expenditure side. However, given the improved revenue performance of 2006, the necessary adjustment to achieve the set targets, is considerably lower (1.2 percentage points of GDP for the period 2007-2009 compared to 2.2 percentage points in the last update). The room created is used for enhancing Lisbon related expenditure and social spending, targeted towards low income earners, pensioners and people living in rural areas, in order to reduce the risk at poverty rate and improve income distribution and enhance social cohesion.



Actual Balances in 2006

The considerable improvement in government finances of 2005 continued throughout 2006, notwithstanding the absence of one-off revenue measures that favoured developments in 2005. It is estimated that the general government budget balance will continue to improve and fall below 2% of GDP from 2.3% in 2005 and 4.1% in 2004. On account of a primary surplus for a second consecutive year and the use of accumulated financial assets to finance government operations and repay foreign debt, general government gross debt is estimated to decrease to 64.7% of GDP, compared to 69.2% in 2005.

The improvement of fiscal performance in 2006 was primarily based on revenues, while the Convergence Programme 2005-2008 provided for an expenditure based consolidation.

Table IV: General Government Consolidated Accounts

in percent of GDP	2005	2006 est.	2007 proj.	2008 proj.	2009 proj.	2010 proj.
Current Revenue	41.2	42.1	42.2	42.3	42.3	42.1
Current Expenditure	40.0	40.4	40.3	39.5	39.3	38.8
Interest Payments	3.4	3.3	3.0	2.8	2.5	2.3
Current Balance	1.3	1.6	1.9	2.7	3.1	3.3
Capital Expenditure	3.6	3.5	3.5	3.5	3.4	3.4
General Government Net Borrowing	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**
Primary Balance	1.1	1.4	1.4	2.1	2.1	2.2
Government Gross Debt	**69.2**	**64.7**	**60.5**	**52.5**	**49.0**	**46.1**

The improved performance on the revenue side is, mainly, attributed to the following factors:

- Composition of growth was based on domestic demand rather than export demand and favoured increased revenue than originally anticipated. In particular, the continued surge in construction and real estate activity contributed significantly.
- Widening of the tax base for corporate and self employed taxation, due to the effect of the tax amnesty. This is reflected in higher reported income.
- Higher revenue from the taxation of undistributed profits compared to 2005, based on the legislation for taxation of deemed dividends[4].
- Higher dividends from semi-governmental organisations compared to 2005 (0.1% of GDP).
- Better revenue performance (improved efficiency of the revenue collecting departments – impact 0.1% of GDP).
- Increase of VAT rate levied on restaurants and hotels from 5% to 8% (0.1% of GDP).

On the negative side, reduction of the excise duty levied on heating oil by 3 cent per litre during the winter period of 2005/06 (-0.1% of GDP)

On the expenditure side, the restrictive policy on employment in the public sector was continued, leading to an increase of 1%, compared to higher growth rates in previous years.

At the same time subsidies were reduced in absolute terms.

[4] According to the legislation on corporate taxation, introduced in 2002 for the subsequent fiscal year, any profits not distributed within two years of their realisation are treated as deemed dividends and 70% of them are taxed at a rate of 15%. Therefore, undistributed profits of the fiscal year of 2003 were taxed in 2006.

The room created through the enhanced revenue performance and the restrictive employment and subsidies policies and the reduced burden on interest payments was utilised to provide targeted assistance to vulnerable groups.

Overall, during the year total revenue is expected to increase at a rate of 8.6% reaching 42.1% percent of GDP compared with 41.2% the year before, which included receipts from the tax amnesty.

More analytically, total taxes are estimated to increase at a rate of 6.8% increasing marginally their share to 27.3% of GDP as compare with 27.2% in 2005.

Taxes on production and imports are anticipated to reach 17.5% of GDP up from the 16.9% of the previous year, showing an increase of 10.2%. The increased share to GDP is attributed, apart from an improved effectiveness of the tax authorities to a buoyant consumption and import growth as well as to the increase of the VAT rate from 5% to 8% levied on restaurant and hotel services and to the gradual impact from the application of a 15% VAT rate on the sale of new buildings by developers, constructed with building permits issued after Cyprus accession to the EU.

Following, a recent decision[5] by the Supreme Court of Cyprus, which was based on a relevant decision of the European Court of Justice, but also taking into account the very high and distortive tax rates on motor vehicles, the Government considered necessary to introduce a radical reform on the taxation of motor vehicles including imported used cars. The objectives of the reform was to make the acquisition of motor vehicles affordable to lower and middle income classes, and achieve, at the same time, environmental goals. Consequently, in November 2006 the House of Representatives approved a reformed tax system for motor vehicles. The new tax structure envisages lower excise duties, registration taxes and circulation fees for motor vehicles and, at the same time, provides discounts on the sale of motor vehicles with low emissions of carbon dioxide. Furthermore, the new tax structure also provides discounts on the excise duty for used imported cars depending on the age of the vehicle.

Taxes on income and wealth are anticipated to increase to 9.7% of GDP compared with 9.3% in 2005 exhibiting an annual increase of approximately 11%. The increased share percentage of GDP by 0.4 p.p. is attributed to the application for the first time of a tax of 15% on 70% of undistributed profits and also to the buoyant growth of revenues accrued from the taxation of profits from the sale of immovable property, as a result of a booming construction and real estate sector.

Contrary to the above, capital taxes are anticipated to return to similar levels of years prior to 2004, as one-off revenue measures such as tax amnesty receipts wear off.

Other current revenue is estimated to accelerate and reach 5.4% of GDP in 2006 compared with 4.8% in 2005, exhibiting a growth of approximately 20%. The acceleration in other current revenues is attributed to the substantial growth of revenues of the Land and Survey Department, directly linked to the boom in the

[5] The Supreme Court of Cyprus ruled that imported used motor vehicles should not be charged with a higher excise duty tax than that levied on new motor vehicles. Furthermore, the Court ruled that the taxation of used motor vehicles should provide discounts on the excise duty depending on the age of the vehicle.

construction and real estate sectors, as well as the fee accruing from the administration of the two airports by a strategic investor, as from July 2006.

Total public expenditure is expected to increase at a rate of 7.4% in 2006 reaching 44.0% percent of GDP compared with 43.6% the year before. The increase in total expenditure in 2006 can be attributed, mainly, to higher social transfers.

The social transfers are expected to increase at rate of 8.4% above nominal GDP growth, due to the increased emphasis on social cohesion in line with the National Reform Programme. Specifically, health and cultural transfers are expected to increase at rate of 26.8% and 15.8% respectively. A significant impact to social transfers can, such as monetary allowances to low income households and other socially vulnerable groups, also be attributed to the increase of other social transfers at a rate of 7.2% and educational transfers at a rate of 6.4%.

The above was offset to some extent by a decelerated growth of collective consumption expenditure estimated to increase at a rate of 3.2% decreasing marginally as a percentage to GDP to 9.7% as compared to 10.0% in 2005

Similarly, interest expense and subsidies are anticipated to be contained to 3.3% and 0.6% of GDP, lower by 0.1 percent of GDP respectively, compared with estimates in last year's update.

Gross fixed capital formation is anticipated to stabilise at 3.1% of GDP in 2006 exhibiting an increase vis-à-vis its 2005 level of approximately 6%.

Implications of the Forthcoming Budget

The forthcoming budget for 2007, which has been approved by the Council of Ministers on the 6th of September 2006, was based on conservative estimates on revenue, which do not incorporate the extraordinary growth rates of 2006. The Budget of 2007 is based on the successful strategy implemented during 2004-2006. The main measures incorporated in the forthcoming budget are:

- Continuation of a restrictive policy on general government sector employment growth including the semi- governmental organisations.
- Continuation of a restrictive wage policy.
- Maintaining a ceiling on the rate of growth in both current and capital expenditure.
- Containing the rate of growth of current transfers (pensions, monetary allowances and other benefits) to the rate of inflation, through a more targeted social policy (see also *Box 7*).
- Extension of the increase of the retirement age of employees to cover the broader public sector, local authorities and semi-governmental organisations.
- Reduction of net interest payments by running down stock of debt financed by sinking fund deposits and by lower interest rates.
- Enactment of legislation in January 2006 requiring self employed persons to compile audited accounts, introducing self assessment and the compulsory issue of receipts and invoices to combat tax evasion.

- Adjustment of the contributions to the Social Security Funds for specific occupations in line with their actual level of earnings.

Given the anticipated deterioration of the net position of Cyprus vis-à-vis the EU budget, brought by the termination of the provision of compensating grants for the period 2004-2006 through the EU budget, the adjustment effort in 2007 requires a strict implementation of the fiscal consolidation programme, in order to maintain the path towards the medium term budgetary objective.

The general government balance is projected to improve further next year, and fall to 1.6% of GDP comparing favourably with the country-specific minimum benchmark which is estimated using the current methodology at 1.9% of GDP, thus providing a sufficient safety margin against the risk of breaching the 3% of GDP reference value with normal cyclical fluctuations.

Fiscal Consolidation Programme 2007-2010

Box 6. Main Changes to Fiscal Projections

The current update of the Convergence Programme includes some significant changes that impact on the fiscal consolidation process. These new parameters are:

- A better debt management that included the partial use of accumulated financial assets to finance government operations and repay existing debt led to an accelerated decrease of public debt-to-GDP ratio having an impact on the profile of interest payments.
- The excise duty tax rates on motor vehicles have been reduced considerably in 2006. The estimated fiscal impact is expected to materialise in 2008 as anticipated increased motor vehicle sales, which have been subdued recently, will compensate for lower excise duty taxes.
- Application as from 2008 of the reduced and minimum VAT rates on foodstuffs and pharmaceuticals and sale of property and restaurant and hotel services respectively. The Ecofin Council in February 2006 decided that the derogations on the application of the reduced and minimum rates of VAT on specific goods and services will not be extended.

The Government is committed to further implement the fiscal consolidation programme for the period 2007-2010. The objective is to maintain the effort so as to reach the country-specific medium-term objective by 2009 and a close-to-balance position by 2010 and to steadily improve the primary surplus to around 2.2% of GDP. Achieving these will ensure that the debt-to-GDP ratio is put on a distinct downward path, leading to a rapid decline of the debt to 46.1% of GDP by the end of 2010.

The measures included in the current update of the Convergence Programme exhibit a high degree of continuity with the measures incorporated in the last update; Box 6 lists the main changes to fiscal projections compared to last year's update.

It is acknowledged, that stricter implementation is required, in particular on the expenditure side, with a view to achieving the fiscal targets and enable a re-allocation of expenditures in favour of Lisbon related priorities and targeted social spending. Indeed the substantial improvement of the fiscal balance creates the necessary room to support the Lisbon objectives, while safeguarding in parallel, the gradual achievement of the MTO.

Table V: Cyclical Developments and one-off measures

as a percent of GDP	2005	2006 est.	2007 Proj.	2008 proj.	2009 proj.	2010 proj.
GDP growth at constant prices	3.9	3.7	3.9	4.1	4.1	4.1
Net Borrowing of General Government	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**
Net Interest payments	3.4	3.3	3.0	2.8	2.5	2.3
Potential GDP growth, % change	3.7	3.7	3.7	3.7	3.7	3.7
GDP output gap[6]	1.7	1.6	1.4	1.0	0.6	0.2
Cyclical budgetary component	0.8	0.7	0.6	0.5	0.3	0.0
Cyclically-adjusted balance	**-1.5**	**-1.2**	**-1.0**	**-0.2**	**-0.1**	**-0.1**
Cyclically-adjusted primary balance	1.9	2.1	2.0	2.6	2.4	2.2
One-off revenue measures	1.3	0.4	0.0	0.0	0.0	0.0
Cyclically-adjusted balance net of one-off and other temporary measures	**-2.8**	**-1.6**	**-1.0**	**-0.2**	**-0.1**	**-0.1**
Structural Improvement	1.6	1.2	0.6	0.8	0.1	0.0
Cyclically-adjusted primary balance net of one-off and other temporary measures	0.6	1.7	2.0	2.6	2.4	2.2

The timetable of implementation of the said measures as well as their impact as a percentage to GDP on general government balance, are outlined in Appendix II.

An important reform included in the current update of the Convergence Programme is the introduction of a MTBF. The main objectives of the MTBF are the following:

- Set binding expenditure ceilings for each ministry, allow them, within this framework, to determine their priorities and transfer resources within programmes, limit wasteful and end-of-year spending and improve the quality of public finances.
- Limit the practice of supplementary budgets.
- Determine the allocation of expenditures, in line with the policy priorities set in the National Reform Programme.
- Introduce, gradually, programme and performance –based budgeting.
- Put in place mechanisms to assess progress in achieving pre – set targets at the end of the period.

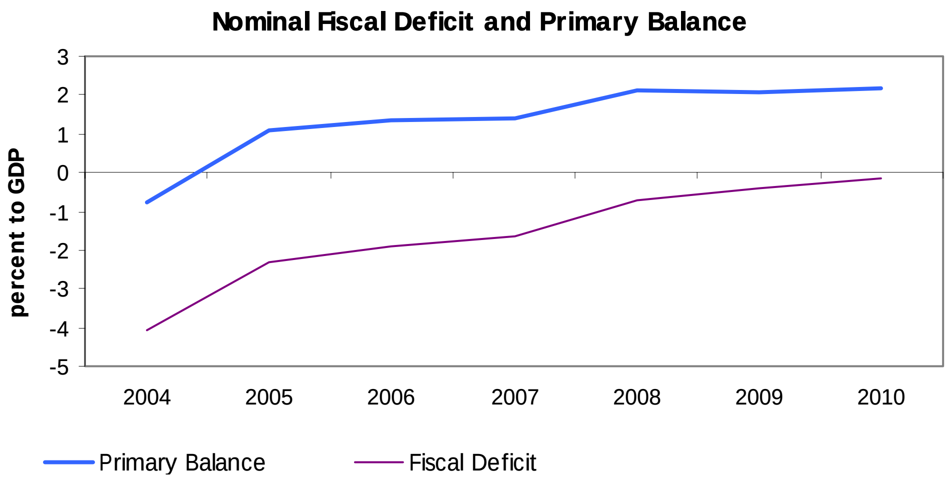
Considering the necessity to improve public expenditure control, the envisaged introduction of a MTBF is considered to be an essential element of the fiscal consolidation strategy in the coming years.

[6] As a percent of potential GDP.

From the analysis of the measures presented at micro level in Appendix II, which depicts the impact of the most important measures on the revenue and the expenditure side as a percent to GDP, the bulk of the adjustment emanates from the containment of expenditures below the growth of nominal GDP. On the revenue side, projections are somewhat conservative, as extraordinary increases in tax revenues witnessed in 2006 in specific categories of both direct and indirect taxation are projected to subside over the programming period. The key measures accounting for most of the adjustment on the revenue side are planned over the next two years: (i) improving the efficiency of the Land and Surveys Department implemented through administrative changes in 2006 estimated to increase revenue by 0.4 percent of GDP, (ii) following the expiration of the relevant derogation, application of reduced and minimum VAT rates on specific goods and services estimated to increase revenue by 0.8 percent of GDP as from 2008, (iii) reform of the taxation of motor vehicles in 2006 estimated to have a negative fiscal impact in 2008 of the order of 0.4 percent of GDP and (iv) termination of the provision of temporary compensating grants through the EU budget estimated to have a negative fiscal impact, on a net basis, of 0.4 percent of GDP as from 2007.

Forecast revenues, incorporated in the last Convergence Programme, attributed to the issuance of title deeds for buildings erected with minor irregularities, have been revised downwards. The revision was a result of the fact that, individuals as well as developing companies did not take advantage of the amended legislation as the buildings in question are usually used for collateral purposes, making it impossible for the buyers to obtain a title deed prior to the removal of the collateral.

The most important measures accounting for the bulk of the adjustment on the expenditure side, are planned over the next three years: (i) restrictive policy on general government sector employment growth, including the local government and semi-governmental organisations is estimated to have an impact of the order of 0.1 percent of GDP in 2007 rising to 0.4 percent by 2009, (ii) reduction of net interest payments brought by the reduction of stock of debt due to the running down of sinking fund deposits and the reduction of interest rates estimated to have an impact of the order of 0.3 percent of GDP in 2007 rising to 0.8 percent by 2009.



Structural Balance and Fiscal Stance

During the economic slowdown in 2002-03 output growth decreased and production fell significantly below full capacity. While the economy recovered subsequently, it continues to operate below full capacity, especially in the manufacturing and tourism sectors. To provide a clear picture of the underlying fiscal position, the following analysis takes into account the cyclical position of the economy relative to its full capacity, or potential level, and distinguishes between permanent and one-off measures which have been introduced, or are planned.

One-off measures

The improvement in the fiscal position of Cyprus economy in nominal terms during 2005 was attributed to some extent to one-off measures. During this year, the one-off revenue measures amounted to 1.3 percent of GDP and included temporary annual transfers from the EU Budget covering the period 2004-2006 (0.4 percent of GDP on a net basis annually) and receipts from a tax amnesty (0.9 percent of GDP in 2005)

Equally for 2006, part of compensating grants received from the EU Budget was also treated as one-off operation, in line with the treatment in 2004-2005.

The last Convergence Programme update included a one-off revenue forecast, from the issuance of title deeds for buildings erected with minor irregularities. The fiscal impact of this one-off measure was estimated at 0.3 percent of GDP annually for the period 2006-2009. The updated Convergence Programme does not include, over the remainder of the programming period, the forecast one-off revenue measure incorporated in the last update. The consolidation process and the projected achievement of a close-to-balance position by 2010 rely solely on structural measures.

The cyclically-adjusted balance and structural balance

Taking into account that, the estimates of actual budget balances are imperfect indicators for assessing public finances, indicators of cyclically adjusted budget balances have been incorporated in the compilation of the Convergence Programme 2006-2010, in order to take into account cyclical variations. The cyclically adjusted budget deficit fell from 1.5% of GDP in 2005 to 1.2% the year after, and is expected to decline further to 1.0% of GDP in 2007 and to 0.2% of GDP in 2008 (Table V). This analysis, which assumes that the potential GDP growth of Cyprus is currently around 3.7%, factors out the business cycle effects on revenues and expenditures, by means of the deviation from the calculated potential output.

A similar picture is also presented for the cyclically-adjusted balance net of one-off measures (Table V). The cyclically-adjusted balance net of one-off measures was slashed by 1.7 percent of GDP in 2005 compared to the previous year and by 1.2 percent of GDP in 2006 resulting in an estimated structural deficit, net of one-off measures, around 1.6% of GDP in 2006. The adjustment effort continues throughout the period 2007-2010 and the cyclically adjusted balance, net of one-off measures, is forecast to decline from a deficit of 1.0% of GDP in 2007 to 0.1% by 2010.

The cyclically-adjusted balance is projected to improve steadily to -0.1% of GDP by 2010, implying a cumulative adjustment of some 0.9 percentage points of GDP over the 2006-2010. The same adjustment is measured in cyclically-adjusted terms, net of one-off measures.

Debt Management

Debt Levels and Developments

With the recent revision of the Stability and Growth Pact, the evolution of public debt has been brought to the forefront of fiscal surveillance. Countries with higher-than-average debt levels are subject to stricter consolidation requirements, while low public debt countries are allowed to sustain small scale fiscal deficits and set relatively less ambitious MTOs.

The level of government debt is expected to fall to 64.7% of GDP in 2006 compared to 69.2% in 2005. The debt-to-GDP ratio in 2007 is projected to continue its downward path and fall to 60.5% of GDP exhibiting a decrease of 4.2 percentage points of GDP. The distinct downward path of debt-to-GDP ratio is projected to continue to fall to 46.1% by 2010 in the coming years, due to the implementation of the fiscal consolidation programme and the running down of sinking fund deposits.

The anticipated ebbing of the debt-to-GDP ratio is mainly attributed to a significant improvement of the primary balance as well as the planned decumulation of sinking fund deposits.

The primary balance is estimated to continue to be in surplus and reach 1.4% of GDP in 2006 and improve further over the programming period peaking to around 2.2% of GDP by 2010.

A large share of public debt, estimated at 6.6% of GDP in 2006, corresponds to debt issued for the accumulation of assets of the sinking fund which, as already mentioned, is steadily being run-down and anticipated to be largely eliminated in 2008 (with the exception of some marginal amounts of 10 and 15-year bonds which will expire by 2018).

As a result, the debt-to-GDP ratio is anticipated to exhibit the largest decrease in 2008 falling by 8 percentage points of GDP mainly due to the deccumulation of sinking fund deposits.

Stock-Flow Adjustment

Other factors contributing to changes in government debt other than government deficits/surpluses is the Stock-Flow Adjustment (SFA). The main operations refer to the accumulation of financial assets, which cover two types of operations and are key in understanding debt dynamics in Cyprus. Firstly, the accumulation of government deposits, equivalent to 2.7 and 1.6[7] percent of GDP in 2005 and 2006 respectively, reflects a past tendency to over-finance the government borrowing requirements as well as operations related to the sinking fund account, partly due to better-than expected fiscal outcomes. Secondly, over the period of 2006-10 substantial debt-

[7] The figure corresponds to the government deposits as of October 2006.

reducing transactions reflect the running down of accumulated sinking fund deposits held at the Central Bank.

The magnitude of the SFA exhibits a rapid decrease and is anticipated to turn negative in 2006. The SFA was reversed from a positive 0.9 percent of GDP in 2005 to a negative 2 percent the following year. The negative contributions of SFA to changes in debt are projected to be maintained throughout the programming period safeguarding the downward path of debt-to-GDP at a satisfactory pace.

Table VI below presents the gross debt level and the contribution to change in gross debt for the period of 2005-2006, and projections covering the period 2007-2010.

Table VI: General Government – Debt Developments

as a percent of GDP	2005	2006 est.	2007 proj.	2008 proj.	2009 proj.	2010 proj.
Gross Debt Level	69.2	64.7	60.5	52.5	49.0	46.1
Change in Gross Debt	-1.2	-4.6	-4.2	-8.0	-3.5	-2.9
Contributions to Change in Gross Debt						
Primary Balance	1.1	1.4	1.4	2.1	2.1	2.2
Interest Payments	3.4	3.3	3.0	2.8	2.5	2.3
Nominal GDP Growth	6.4	6.5	6.7	6.7	6.3	6.3
Stock-flow adjustment	0.9	-2.0	-1.6	-4.8	-0.6	0.0
Net Financial debt	59.4	56.9	54.3	51.1	48.2	45.3
p.m implicit interest rate	4.88	4.71	4.70	4.69	4.71	4.71

Debt Management

Debt management focuses on a number of key issues in order to achieve a reduction in debt servicing costs while maintaining risk at acceptable levels. These issues are:

- Ratio of short term to total net debt ratio;
- Foreign to domestic debt ratio;
- Level of individual currency exposures;
- Debt distribution over time;
- Market structure and efficiency;

In 2005 interest rate yields exhibited a downward trend, attributed to improving fiscal conditions and the entry into the ERM II mechanism, which enabled the Central Bank of Cyprus to reduce interest rates by 125 basis points, without jeopardising macroeconomic stability.

In 2006 the downward trend exhibited by government bond yields was, partially reversed, as European interest rates were steadily increased, and the Central Bank increased interest rates by 0.25% in September, but they remained well below the 2004 levels. Bond yields have stabilized in the second part of the year and, barring any further increases in Central Bank rates, it is expected that the yields of government paper will remain broadly at current levels ranging from 2.6% for 13-week Treasury Bills, to 4.3% for 10-year Development Stock.

All borrowing requirements were met by domestic sources as the increased liquidity in the domestic economy allowed for advantageous borrowing terms, especially during the fist half of the year. For these reasons the planned issue of an Euro Medium Term Note (EMTN) bond to refinance the one that matured in June 2006 was not realized. The increased liquidity has also contributed in reducing the upward pressures on bond yields that were exhibited during the year.

During the period covered by the Convergence Program, the Government plans to maintain short-term debt (below one year maturity) at a level of 10% of total outstanding domestic debt. During 2006 this target was met.

Foreign debt has been steadily decreasing as a percentage of total net debt since 2004. Foreign debt amounted to 23.6% of net total debt during 2006. The policy regarding foreign debt levels is now under review due to the impending introduction of the euro on the 1st of January 2008, this is due to the fact that the largest part of the foreign debt is denominated in euro.

Investors continued their preference in favour of long-term debt. During the period 2005-2006 a major shift was observed, as investors who moved from treasury bills and 2-year bonds towards longer-term bonds issued by the government (mainly the 10-year development stock). This shift is attributed to the more stable fiscal conditions and the expectations for lower interest rates, in the future due to the impending introduction of the euro (the shift was more pronounced after the entry into the ERM II).

The maturity structure of the debt has improved considerably during the period 2005-2006 as investors have shifted towards longer term bonds, allowing the government to extend the maturity structure of the debt considerably and reducing significantly the refinancing risk faced by the government.

Work is still underway for implementing the necessary changes in the domestic bond market in order to improve the market structure and improve the efficiency of the government bond market. The decision has been taken for the introduction of a primary dealers system and work is underway for the implementation of such a system in 2007.

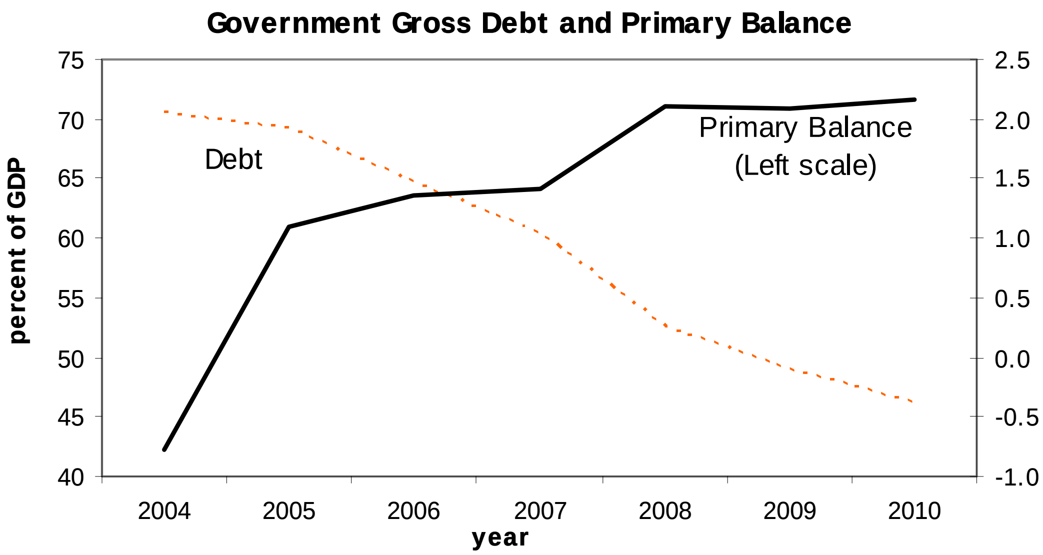
The short-term objectives of the current debt management strategy are the following:

- Set up a Primary Dealers system for the Government Bond market with the use of an electronic trading platform.
- Continue improving the flow of information between the responsible government departments and the Central Bank in order to achieve the smooth financing of the Governments' borrowing requirements.
- Put in place procedures and tools that will help in tackling unforeseen contingencies. The options available to the government are now under consideration.

- Continue the lengthening of the maturity of outstanding government debt so as to improve the terms of borrowing.

The medium, to long-term, objective is to reform the present debt management system so as to be able to adapt to changing market conditions, including the introduction of the euro. To proceed with these reforms a number of priorities have been identified, and include:

- Creating and maintaining channels of communication with other market participants and interested parties, especially foreign investors and institutions.
- Increasing the technical competence of the staff in the area of debt management.
- Improving the debt management and risk management arrangements.
- Improving decision-making mechanisms, in order to better respond to the changing market conditions.



Balance by Sub-Sector of General Government

The General Government sector in Cyprus comprises of the central government, the local authorities and the social security funds. The central government accounts for the bulk of the general government deficit, with the local authorities responsible for a marginal deficit of 0.1% of GDP as most of their operations and investment programmes are financed by transfers from the central government (Table VII).

The social security system, which is partly (basic pension) based on a pay-as-you-go principle, has recorded surpluses[8] reaching 3 percent of GDP in 2005, thus reducing the overall general government deficit.[9] The sizeable surplus of the social security fund is attributed to the fact that the system has not fully matured yet, as well as to the still favourable demographics. With the system maturing over the next decade and the expected demographic changes due to population ageing, the social security fund is projected to deteriorate and exhibit sizeable deficits over the long-term.

Table VII: General Government Budgetary Developments by Sub-Sector

in percent of GDP	2005	2006	2007	2008	2009	2010
Net lending by sub-sectors						
General Government	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**
Central Government	-5.2	-4.8	-4.3	-3.3	-2.8	-2.3
Local Government	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Social Security Funds	3.0	3.0	2.8	2.6	2.5	2.3

Budgetary implications of "major structural reforms"

The initiatives promoted within the framework of the implementation of the Lisbon Programme are financed through:

- National resources;
- EU funds; and
- Public Private Partnerships.

More specifically, the proposed policies require national funds amounting to around 2.0% of GDP in 2006 and 2.7% in 2007 and 2008, and similar percentages thereafter. It is noted in this respect, that for the overwhelming majority of the measures and actions planned for 2006 and 2007, and included in the Lisbon Programme, the relevant budgetary provisions have been included in the Budget Law for 2006 and the Budget Bill for 2007.

Furthermore, a number of infrastructure projects in the area of transport and the environment will be co-financed by Cohesion Funds, whereas a number of measures and actions aiming at enhancing the production base of disadvantaged areas and increasing the employability possibilities for targeted groups will be co-financed from the EU Structural Funds under the current EU programming period. In the next

[8] The government as an employer and as a contributory party to the whole scheme contributes annually approximately 3 percent of GDP.
[9] Interest earned by the Social Security Funds on debt issued by the Central Government is consolidated.

programming period of the EU (2007-2013), it will be the objective to co-finance a number of infrastructural projects in the areas of transport and the environment as well as measures and actions in other areas via the various instruments of the EU Cohesion Policy. Moreover, it is noted that important infrastructural projects, such as airports, marinas, storage depots for petroleum products and a terminal for importation, storage and vaporisation of liquefied natural gas will be undertaken through public private partnerships.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

The baseline, medium-term, projections presented in this Programme are based on a balanced assessment of the external environment, current trends and policies. However, there are both upside and downside risks to these central projections, which are broadly balanced.

The downside risks emanate from the following factors:

- Higher oil prices would impact the economy through negative terms of trade effects, confidence channels and lower growth in partner economies.
- Possible geopolitical tensions, in particular in the Middle East, which may affect tourism.

The upward risks emanate from the following factors:

- Possible underestimation of potential GDP growth and subsequently growth prospects in the coming years.
- Stronger confidence effects of the planned accession to the eurozone, in particular for the attractiveness of Cyprus as an international business centre.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

To assess the sensitivity of the projected general government deficit and debt figures, alternative assumptions for real GDP growth rates and interest rates have been incorporated in three distinct scenarios. All simulations assume that, while automatic stabilisers would be allowed to operate fully, expenditure targets could not be altered.

Empirical evidence shows that GDP growth is especially affected by geopolitical tensions in the region impacting directly on tourism and other services. The geopolitical tensions of 2001-2003 led to an average deceleration in the rate of growth by approximately to 2 percentage points. Contrary to the above, during “good” times GDP growth has accelerated by some 1 percentage point above potential. These, will form the basis of the sensitivity analysis to be carried out in this chapter.

Assumption 1: *Real GDP growth is one percentage point higher annually compared with the baseline scenario.* Other things being equal, the government deficit would be some 0.4 percent of GDP lower at the beginning of the programming period reaching 1.6 percent of GDP by the end of the programming period, thus resulting to a surplus of 1.5% of GDP by 2010. The public debt to GDP ratio by the end of the programming period would decline by an additional 1.6 percent of GDP compared with the baseline scenario.

Assumption 2: *Real GDP growth is two percentage points lower annually compared with the baseline scenario.* Other things being equal, the government deficit would be some 1 percent of GDP higher at the beginning of the programming period reaching 3.2 percent of GDP by the end of the programming period, thus resulting to a deficit of -3.3% of GDP by 2010. The public debt to GDP ratio by the end of the programming period would higher by an additional 3.2 percent of GDP compared with the baseline scenario.

Table VIII: Three Scenarios for Public Finances

in percent of GDP	**2007**	**2008**	**2009**	**2010**	**2007-2010 5– year Average**
Central Scenario					
GDP	3.9	4.1	4.1	4.1	4.1
General Government Balance	-1.6	-0.7	-0.4	-0.1	
General Government Debt	60.5	52.5	49.0	46.1	
Upper Scenario (GDP growth 1 of a percentage point higher)					
GDP	4.9	5.1	5.1	5.1	5.1
General Government Balance	-1.2	0.1	0.8	1.5	
General Government Debt	60.1	51.7	47.8	44.5	
Lower Scenario (GDP growth 2 of a percentage point lower)					
GDP	1.9	2.1	2.1	2.1	2.1
General Government Balance	-2.4	-2.3	-2.8	-3.3	
General Government Debt	61.3	54.1	51.4	49.3	

Currently, the interest rates prevailing in Cyprus are above those prevailing in the eurozone. This differential will gradually fade leading to decreased interest rates in Cyprus having a direct impact on fiscal developments.

Assumption 3*: Interest rates remain some 100 basis points below baseline each year during 2006-2010.* In this case, the government deficit would be some 0.06 percent of GDP lower in 2010, and the government debt-to-GDP ratio would be smaller by 0.46 percent of GDP by the end of the programming period.[10]

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

Table IX: Scenario with Higher Interest Rates Cumulative Differential

in percentage points of GDP with respect to the reference scenario	2006	2007	2008	2009	2010
General Government Net Borrowing	0.12	0.10	0.08	0.08	0.06
General Government Gross Debt	0.12	0.22	0.30	0.40	0.46

The sensitivity analysis presented here confirms the importance of growth assumptions on the outcome of the general government deficit and debt figures. Accordingly, the envisaged consolidation path is highly dependent on the realisation of the projected growth rates.

Comparison with Previous Update

Compared with the forecasts presented in the previous Convergence Programme, and mainly as a consequence of persistently higher oil prices, GDP growth has been revised slightly downwards to 3.7-4.1% over the medium term. Even though GDP growth has been revised downwards, the general government net borrowing as a percentage of GDP and the government debt to GDP ratio forecasts, indicate an improved fiscal position relative to the previous Convergence Programme. This is mostly due to the envisaged containment of public expenditure growth and the increased efficiency of the tax collecting departments, combined with the implementation of the fiscal consolidation measures described above, and partly owed to the increase in domestic consumption relative to foreign demand for goods in Cyprus, improving the public fiscal position through increased revenues from the tax system.

The general government deficit as a percentage of GDP is estimated at 1.9% in 2006 and is in line with forecasts presented in the last update of the Convergence Programme. As a result of the firm implementation of the fiscal consolidation measures described above, the general government net borrowing is projected to continue to exhibit a downward trend, falling to around 1.6% of GDP in 2007, some 0.2 percent of GDP lower than what has been anticipated in the last update of the Convergence Programme, and will continue being lower relative to the forecasts of the previous Convergence Programme ending up at -0.1% of GDP in 2010. The general government debt-to-GDP ratio is predicted to fall in 2006 around to 64.7% of GDP and at 60.5% of GDP in 2007, as a result of a rising primary surplus, and the running down of sinking fund deposits. These forecasts compare favourably to the predictions of 67% and 64% of GDP for 2006 and 2007, which was reported in the last updated Convergence Programme of 2005-2009. Public debt to GDP forecasts, remain lower than the previous Convergence Programme throughout the period 2006-2010, resulting at a gross debt level in the year 2010 of 46.1% of GDP. The lower debt-to-GDP ratios forecasts incorporated in the current update is attributed to the incorporation of the Financial Intermediation Services Indirectly Measured (FISIM) in the calculation of the GDP leading to a revision of the GDP levels and to the higher than anticipated in the last update of the Convergence Programme negative stock-flow adjustment.

Table X: Divergence from Previous Update

as a percentage of GDP	2005	2006	2007	2008	2009	2010
GDP Growth						
Previous Update	4.1	4.2	4.2	4.2	4.3	n.a.
Latest Update		3.7	3.9	4.1	4.1	4.1
Difference		-0.5	-0.3	-0.1	-0.2	-
Actual Budget Balance						
Previous Update	-2.5	-1.9	-1.8	-1.2	-0.6	n.a.
Latest Update	-2.4	-1.9	-1.6	-0.7	-0.4	-0.1
Difference	0.1	0.0	0.2	0.4	0.2	-
Gross Debt Levels						
Previous Update	70.5	67.0	64.0	56.9	53.5	n.a.
Latest Update	69.2	64.7	60.5	52.5	49.0	46.6
Difference	-1.3	-2.3	-3.5	-4.4	-4.5	-

5. QUALITY OF PUBLIC FINANCES

Policy Strategy

The improvement of the quality of public finances is a major goal in the context of the Lisbon strategy and is expected to play an important role in creating a growth supportive environment
On the expenditure side the major categories, which relate to the Lisbon Agenda are public investment in infrastructure, the promotion of the Information Technology Programme for the Public Sector, research and development, education and health.

On the revenue side the major goal is to preserve a business friendly environment by maintaining a tax system characterised by a low average and marginal tax rates and broad tax base.

Developments on the Expenditure Side

The improvement of the quality of public finances together with the achievement of fiscal targets set by the government will be significantly supported by the introduction of a medium-term budgetary framework (MTBF).

Through the application of the MTBF line ministries will be requested to contain their expenditure according to the ceilings set, and they will be at the same time encouraged to reallocate their expenditure in favour of growth enhancing activities that will in line with the priorities be set in the National Reform Programme.

In line with this approach, a redistribution of public expenses will be applied, in favour of growth supporting sectors such as R&D, innovation, infrastructure, education and health at the expense of consumption expenditure.

High priority sectors

In the Budget for 2007, total expenditure for *infrastructure* amounts to 2.2% of GDP. The actual growth of public investment in infrastructure is anticipated to be much higher than budgeted, due to the planned increase of the implementation rate of infrastructure projects which is currently only 70%. Infrastructure expenditure includes mainly the completion of a number of projects in the area of road transport, the promotion of schemes included in the Strategic Action Plan for Road Safety and the redevelopment of the two airports in Cyprus, using the BOT method. Public investment in infrastructure will be maintained at high levels as a percentage of GDP with the implementation rate increasing to 80% - 85% by 2010.

Total expenditure on *research and technology* is budgeted to increase by approximately 70%, attributed mainly to the creation of a technological park which aims at attracting high – tech businesses and the creation of a research centre on energy. Moreover, the budget of the Research Promotion Foundation is planned to increase substantially and reach 0.14% of GDP 2007 compared to 0.09% of GDP for 2006. The overall objective is to improve the position of Cyprus on the Innovation Scoreboard and to assist the government’s goal of achieving a level of R&D spending for the whole economy of 1.0% of GDP by 2010, while at the same time enhancing the quality of such spending.

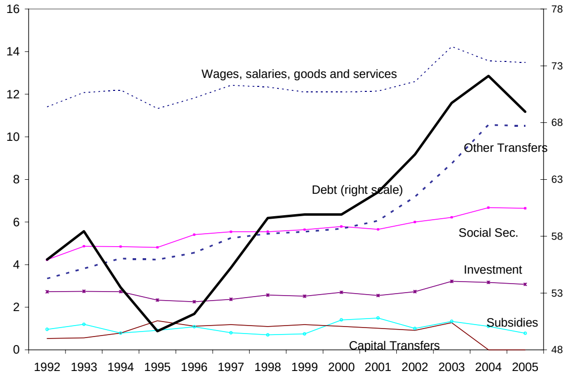
Total expenditure on ***education*** is budgeted to increase by approximately 5.7% in 2007 compared to 2006, reaching £426.8 million or 5% of GDP. Expenditure on education is focused mainly on the computerisation of schools, the construction and extension of school buildings, the creation of appropriate infrastructure for the operation of the first University of Technology, as well as the creation of new research and academic institutions. Expenditure on education will continue to rise to higher percentage of GDP levels.

Total expenditure on health is budgeted to increase by 6.6% in 2007 compared to 2006, reaching £268.1 million or 3% of GDP. In the forthcoming Budget for 2007, expenditure on health, refers mainly to the operation of two new general hospitals, the implementation of an agreement between Harvard University and the Republic of Cyprus on Public Health and the Environment and the promotion of the National Health Scheme. The improvement of the quality in the provision of health care will be achieved through the restructuring of public hospitals, the introduction of regulated competition among private and public health care providers as well as the introduction of performance linked remuneration schemes for general practitioners and specialists.

Contrary to the above, agriculture, security and defence, transportation and public administration show negligible increases or even decreases in certain cases.

Box 7. "More money for fewer people": Social Policy and Fiscal Consolidation inside EMU

During the past several years, while expenditure on wages and salaries and other goods and services remained high, and only edged up as a share of GDP over time, other current transfers have soared (Text Diagram). The trend was accompanied by a significant increase of the debt-to-GDP ratio which peaked to 72% in 2004. Since then, transfers have remained broadly stable as a share of GDP, and the debt ratio has declined to around 65% of GDP.



Peer pressure from the EU, and political determination to proceed with EU accession and the adoption of the euro, were instrumental in halting this worrisome trend.

The root cause of this problem was the untargeted nature of policy support measures, including special allowances to pensioners, child benefits, student grants, and other ad hoc payments provided without income or other social criteria to compensate households for "unforeseen" drop in their disposable incomes, or other negative shocks. Furthermore, temporary or expedient measures often end up as permanent entitlements adding to the sustained growth of social expenditures. This also reduces the "flexibility" of fiscal policy to react in bad times by cutting back on expenditures.

A study by the Centre for Economic Research of the University of Cyprus revealed that, income inequality actually increased over the period 1985-2003, instead of declining (Hadjyspirou, Nicolaidou and Pashiardes, 2006, Paper 04-06). The study showed that single parent households, households with more than 3 children, and pensioners were considerably worse off compared with households further up the income ladder, leading to a worsening income inequality.

The need to reverse this dynamic is evident so as to make social policy more effective in addressing poverty and reducing income inequality. All these call for an overhaul of the present system with a view of putting in place a social policy framework which is fair, transparent, effective and economic. Only, with such a system in place will it be possible to safeguard social cohesion, which is an important commitment of the present government as elaborated in more depth in the National Reform Programme of Cyprus.

Although this reform programme is at its early stages, while the precise details and methods are being worked out and debated with social partners, a number of new ideas on how to proceed are already being applied to new policy initiatives. For example, the latest "social package" which was approved by parliament in November 2006 includes specific measures targeting vulnerable groups including low income pensioners, other low income earners, and people in rural areas. To be eligible, people must return an income declaration, before they can receive the payment.

However, the project is not completed and will require considerable research and time to implement. First, the vulnerable groups will have to be identified and matched with specific criteria which can be used to enforce the new policies (e.g., by income, consumption, education etc). This complicated process will form the basis for the second stage, which involves working out the precise details of these new policy measures in order to achieve specific targets (e.g., lower poverty among pensioners).

Developments on the Revenue Side

Cyprus is one of the 3 EU countries with the highest degree of fiscal flexibility. Cyprus is marginally leading the way thanks to the high degree of revenue flexibility afforded by its exceptionally low rate regime.

The Cyprus tax system is characterised by low tax rates and a broad tax base. Indicatively, corporate tax rate is among the lowest in the EU not exceeding 10%, while personal income tax ranges from 20% to 30% on taxable income with an annual tax free allowance of £10.000. Overall tax burden as a percentage of GDP reaches 35.6% in 2006 and it is estimated to rise to 36.5% of GDP by 2010. Cyprus tax elasticity is calculated above 1.

6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

The EU faces a major budgetary challenge in view of ageing populations over the coming decades. The analysis of the 2005/06 updates of the stability and convergence programmes revealed that six Member States, including Cyprus, face a high risk with regard to the long-term sustainability of public finances in view of the budgetary impact of ageing populations. Achieving a planned budgetary consolidation over the medium-term as outlined above in chapter 3 should contribute substantially to reducing the sustainability challenge.

The projected demographic changes, with the old-age dependency ratio doubling over the coming decades in the EU, have led to growing concerns regarding the long-term sustainability of public finances. Implementing the planned consolidation of public finances over the medium term will reduce the risks to long-term sustainability, while other parametric reforms will 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.

A Commission communication of 22 December 2004 concluded that, on the then available information and on the basis of the measures detailed in the 2005 budget, it appeared that the Cypriot government had taken effective action to achieve the 2005 deficit target. The spring 2006 forecast of the Commission services shows a deficit clearly below the reference value in 2005 and expected to fall further by 2007 on a no-policy change basis (including small one-offs in 2006 and 2007). Still, it emerges that over the long-term, policy reforms are essential, especially for the pension scheme and the healthcare system, with a view to securing long-term fiscal sustainability.

Reform of the Social Security System

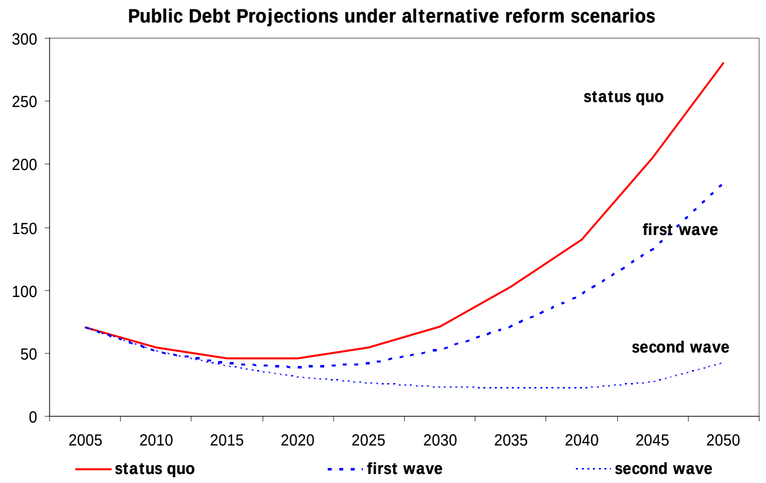
Since the publication of the last Convergence Programme, work has continued at different levels:

- New long-term projections have been submitted to the EPC in January 2006 and published by the Ageing Working Group in early 2006;
- The first round of actuarial assessments of alternative parametric reforms was completed, by the Ministries of Labour and Social Insurance and the Ministry of Finance;
- These measures were put on the table during discussions with the social partners, with a view to implementing some reforms toward the beginning of 2007;
- The discussions are proceeding and the main trade unions are undertaking independent actuarial studies to assess the impact of the various policies which are being discussed.

Under discussion are a number of measures which could be implemented in 2 stages. The first-wave reforms will include:

- Tightening of pension eligibility criteria by increasing the number of years of contributions required to obtain full old age pension;
- Tightening of the criteria for early pension entitlement at 63;
- Increase of social security contribution, and;
- Reduction of the level of the supplementary pension part relative to basic pension (2 measures).

The second wave of reforms will require further increases in contribution rates and other parametric reforms, including an upward revision of the notional income base for the self-employed persons. The projected debt-GDP ratio under these alternative scenarios is shown in the Text Figure. Under the no-change scenario the debt-to-GDP ratio will soar to 250% by 2050. By contrast, first-wave reforms will ameliorate the long-term fiscal sustainability, implying a debt-to-GDP ratio of 150% during the same period. However, second-wave reforms, mainly involving further increases in contribution rates, appear to stabilize the ratio during the 45 year horizon.



Reforms of the Healthcare System

Improvement of the quality of the health care system and the effective tackling of the anticipated increases in public health expenditure constitute important challenges to the Cyprus economy.

In order to tackle these challenges, the Government of Cyprus is proceeding with the introduction of a National Health Insurance Scheme (NHIS) and the restructuring of the public hospitals into autonomous establishments, under the wider public sector.

As regards the implementation of the NHIS, a Strategic Plan has been prepared by external consultants, namely McKinsey & Company a world known organization, which has been delivered to the Cypriot authorities on the 8th of November 2006.

The Strategic Plan proposes, mainly, the following:

- A phased introduction of the NHIS. It will begin with primary care which is envisaged to be introduced by late 2008 whereas the inclusion of secondary care into the NHIS will follow at a later stage. The phased approach is anticipated to facilitate a smooth changeover from the current system
- Development of remuneration schemes for general practitioners and specialists, providing incentives for high quality health care and contained costs.

- With relation to the funding of the Scheme, and in order to close the potential gap between the costs and the revenues of the NHIS, a number of levers are being suggested; increase of contribution rates, introduction of so called "sin – taxes", apply co-payment, reduced covered of certain services etc

These reforms, as outlined in more detail in the National Reform Programme, will be proceeded by the granting of autonomy to public hospitals as envisaged in the relevant law. The Government considers this it as a necessary first step, directly linked with the successful implementation of the NHIS. Through it, hospitals will be granted operational independence granting them the necessary flexibility on issues relating to recruitment of personnel, budget etc. In parallel public financial support will be phased out.

APPENDICES

APPENDIX I: HICP Inflation Prospects for 2006-2010

During the past six years inflation in Cyprus has been mainly driven by exogenous factors, namely oil prices and indirect tax changes. These indirect tax changes have been related to the harmonization of minimum tax rates as part of the accession process of Cyprus to the EU:

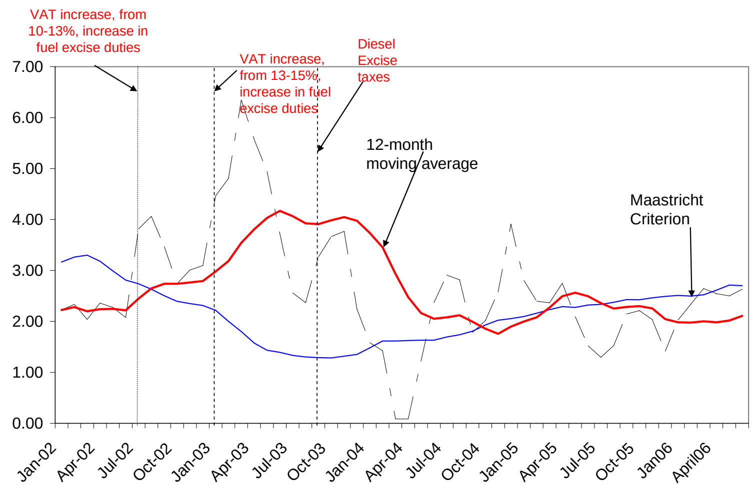


Figure 1 shows that inflation fluctuations have been, to a large extent, associated with specific changes in indirect taxes. Two important observations are worth mentioning.

First, during these three key episodes—in July 2002, in January 2003 due to increases in the standard VAT rate and excise taxes, and October 2003 due to increases in excise taxes—prices increased by less than the full amount of the tax. Second, inflation was affected only very briefly displaying, as one would expect, very strong mean reversion. The diagram shows clearly that inflation declined rapidly after the tax hike, implying considerable price flexibility in some key sectors. In fact, inflation declined faster that had been expected given the anticipated price increases. It is clear that core inflation remained unaffected in this process, hovering around 2%.

Against this background, inflation is projected to average some 2.4% in 2006, and to remain at that level in 2007-08. It is forecast to ebb to around 2% thereafter. This implies the 12-month moving average inflation to reach 1.9% in June 2007, and to gradually increase thereafter to 2.24% at the end of 2007. It will continue to rise somewhat before finishing at 2.38% at the end of 2008. The following assumptions have been incorporated in the projection:

- Fuel and electricity prices will remain at their August-September 2006 level throughout the forecast horizon, consistent with the external assumption on oil prices;
- Prices of clothing and footwear, and telecommunications (categories 3 and 8 of the HICP) will remain unchanged over the forecast horizon, in contrast to the recent past which experienced significant price declines;
- The other categories are assumed to increase in line with recent (2005-onwards) trends;
- For indirect taxes, two large changes are taken into account. Firstly, the reduction of indirect taxes for cars enacted in October 2006, which should have a negative -0.3 percentage point impact on inflation. Secondly, the abolition of

the reduced/zero VAT rates following the ECOFIN Council decision of February 2006. These tax changes will basically affect inflation through their impact on food prices and prices of hotel accommodation and restaurants;
- The forecast incorporates VAT increases in a some subcategories of Food, and Hotels and Restaurants, as several items within these categories are already taxed at 15%, and will therefore remain unaffected by the tax changes;[11]
- A 70% pass-through rate is assumed, which is likely to overstate the likely inflation outcome in 2007-08;
- The two small adjustments to the minimum excise duties for diesel (which will have to be undertaken in 2008 and 2010) will have a negligible impact on inflation.

The forecast presented here, which is purely based on trend extrapolation, is consistent with an assessment of inflation based on a more structural view of the economy:

- First, it has to be noted that the projections assume that consumer demand will be unaffected by the tax changes.
- Real wage increases will be contained, broadly in line with productivity growth, and consistent with historical price-wage behavioural relationships. Recent collective bargaining agreements seem to point to lower nominal wage increases, especially in a number of ailing sectors.
- Inflows of foreign workers are putting downward pressure on wages in several key sectors. As capital adjusts, productivity will increase thus putting further restraint on prices.
- Monetary policy is withdrawing liquidity from the market, and has raised the cost of borrowing in recent weeks. The tightening of policy rates by the ECB is expected to have a negative impact on domestic private consumption, as more and more loans are euro denominated.
- Finally, the pursuing of the medium-term fiscal objective will continue to exert a negative impact on aggregate demand in the medium term.

[11] Sugar, jam and honey, non-alcoholic beverages, mineral waters and soft drinks, and alcoholic beverages will not be affected by the tax increase (the total weight of these items is 10.37 out of 18.63. In hotels and restaurants a smaller share is unaffected consisting of bars, nightclubs which constitute only a weight of 2.05 out of 12.61 for category 11).

APPENDIX II: Fiscal Consolidation Measures

Measures	*Progress*	*Timetable*	*Budgetary impact in percent of GDP*[12]		
			2007	*2008*	*2009*
Expenditure					
1. Maintaining a restrictive policy on general government sector employment growth, including the local government and semi-governmental organisations. This policy provides that any employment increases so as to cover the needs of the educational, land and survey department, town planning and health services and those arising from the implementation of the acquis will be limited.	Central Government: This measure is being implemented through the Central Government Budget. Semi-Governmental Organizations: This measure is being implemented through their budgets. Local Government: This measure is being implemented through their budgets.	2007-2010	-0.1	-0.3	-0.4
2. Restrictive policy in providing salary increases to civil servants of Central Government and employees of local government and semi-governmental organisations.	Public Sector: In conjunction with the gradual extension of the retirement age in the public sector from 60 to 63 years of age, moderate contractual salary increases in the public sector and semi-governmental organisations were agreed. These contractual salary increases were 0% for 2004-2005, 2% for 2006 and 1% for 2007. The restrictive wage policy will continue over the period 2008-2010.	2007-2010	The fiscal impact is included in the expenditure measure 1 above		

12 The budgetary impact is estimated in percent of GDP vis-à-vis the base year of 2006.

Measures	*Progress*	*Timetable*	*Budgetary impact in percent of GDP*[12]		
			2007	*2008*	*2009*
3. Maintaining a ceiling on the growth rate of current expenditures (excluding wages and salaries and debt servicing costs) compared with the previous year.	This measure was implemented during the compilation of the Budgets of 2005-2007. The nominal growth rate of budgeted current expenditure incorporated in the Budgets ranged from 3% to 1% during the period 2004-2007. The imposition of ceilings on the growth rate of current expenditures is anticipated to be followed during the compilation of the forthcoming budgets of 2008-2010, taking into account the obligations of Cyprus derived from the Stability and Growth Pact (SGP). The measure is being incorporated in the medium term budgetary framework of 2007-2009.	2007-2010	0.3	-0.1	0.1
4. Maintaining a ceiling on the annual rate of growth of capital expenditures compared to the previous year.	This measure was implemented during the compilation of the Budgets of 2005-2007. The nominal growth rate of budgeted capital expenditure incorporated in the Budgets ranged from 6% to 3% during the period 2004-2007. The imposition of ceilings on the growth rate of capital expenditures is anticipated to be followed during the compilation of the forthcoming budgets of 2008-2010, taking into account the obligations of Cyprus derived from the SGP. The measure is being incorporated in the medium term budgetary framework of 2007-2009.	2007-2010	-	-	-
5. Redirection of expenditure in line with Lisbon priorities	Some progress was achieved in particular in the areas of research, innovation, energy, education e.t.c The measure is being incorporated in the medium term budgetary	2007-2010	-	-	-

Measures	***Progress***	***Timetable***	***Budgetary impact in percent of GDP***[12]		
			2007	***2008***	***2009***
	framework of 2007-2009.				
6. Increase of the retirement age of general government employees from 60 to 63 years of age. Extension of the measure to cover the broader public sector.[13]	A gradual extension of the retirement age to 63 years of age for civil servants and employees of local government, excluding educational service employees, has been implemented. The above measure has also been implemented for 9 semi-governmental organisations. Relevant bills for an additional 13 semi-governmental organisations are currently in the stage of legal vetting by the Law Office of the Republic.	2007	(0.2)	(-0.1)	(0.2)
7. Reduction of net interest payments brought by the reduction of stock of debt due to the running down of sinking fund deposits and the reduction of interest rates.	The measure is currently being implemented through the abolition of the compulsory accumulation of sinking fund deposits for debt redemption, leading to the gradual running down of accumulated sinking fund deposits.		-0.3	-0.5	-0,8
8. Introduction of income criteria for new social schemes or for the extension of existing social schemes, favouring the vulnerable social groups, including low income earners, old aged, households living in rural areas etc.	The social package introduced in 2006 amounting to 0.2 percent of GDP was based on income criteria.	2007	-	-	-
Impact of Expenditure Measures			**-0.1**	**-0.9**	**-1.1**

[13] The fiscal impact of this measure has been estimated and incorporated in the total fiscal impact of expenditure measure 3 above.

Measures	***Progress***	***Timetable***	***Budgetary impact in percent of GDP[14]***		
			2007	***2008***	***2009***
Revenues					
1. Increase of land and survey fees to meet the administrative costs of issuing title deeds, mortgaging, acquiring and inspecting immovable property.	A Bill has been prepared by the Ministry of Interior and will be submitted to the House of Representatives by the end of 2006. No consensus has been reached yet for its implementation.	This measure is expected to be implemented during the first quarter of 2007.	-	-	-
2. Amendment of the legislation concerning the issuance of title deeds for buildings erected with minor irregularities	Legislations was enacted in July 2004 and March 2005 by the House of Representatives covering the buildings erected prior to and post 1990 respectively. The measure is being implemented. However, fiscal impact is much lower than originally anticipated.	Amendment of the legislation during the first half of 2007.	-	-	-
3. Regularisation of dividend income policy for semi-governmental organizations	Dividend income policy of semi-governmental organisations has been regularised through legislative amendment.	A law was enacted on the 13th July 2006 providing for the regularisation of dividend income policy of semi-governmental organisations, which came into force in the form of law.	-	-0.1	-0.1
4. Improving the efficiency of the Land and Surveys Department	Introduction of administrative changes, reorganisation of the Department and simplification of procedures.	2006	0.5	0.4	0.4
5. Introduction of reduced and minimum VAT rates on specific goods and services.	Cyprus upon accession to the EU obtained a transitional period from the application of the minimum VAT rate (15%) on hotel and restaurant services and sale of property and a reduced rate (5%) on the sale of foodstuffs and pharmaceuticals. This	2008	-	0.8	0.8

[14] The budgetary impact is estimated in percent of GDP vis-à-vis the base year of 2005.

Measures	***Progress***	***Timetable***	***Budgetary impact in percent of GDP[14]***		
			2007	***2008***	***2009***
	expires on the 31.12.2007. Cyprus is obliged to raise the VAT rate applied on hotel and restaurant services from 8% to 15%, on the sale of property from 0% to 15%, and on the sale of foodstuffs and pharmaceuticals from 0% to 5%.				
6. Reform of the taxation of motor vehicles[15]	Following, a recent decision by the National High Court, which was based on a relevant decision of the European Court of Justice, but also taking into account the very high and distortive tax rates on motor vehicles, the government considered necessary to introduce a radical reform on the taxation of motor vehicles including imported used cars.. The new tax provides for lower excise duties, registration taxes and circulation fees for motor vehicles and, at the same time, reductions of excise duties depending on carbon dioxide emissions, and age of vehicles.	2006	-	-0.4	-0.4
7. Termination of the provision of compensating grants during the period 2004-2006 through the EU budget		2007	-0.4	-0.4	-0.4
8. Intensification of the dialogue on the required reforms with respect to the viability of the Social Security Scheme[16]	Studies were undertaken by the International Labour Office's actuarial experts, the European Commission and the IMF indicating that reforms are required to safeguard the financial viability of the Social Security Fund in the long-term.	The social dialogue is anticipated to be completed by the end of 2006. The government intends to submit a concrete set of	-	-	-

[15] No fiscal impact was forecast for 2007 as it is anticipated that increased motor vehicle sales, that have been subdued recently, will compensate for lower excise duty taxes. A negative fiscal impact is anticipated in 2008.
[16] The fiscal impact of the introduction of any parametric reforms was not incorporated in the current update of the Convergence Programme, due to the uncertain outcome of the negotiations.

Measures	***Progress***	***Timetable***	***Budgetary impact in percent of GDP[14]***		
			2007	***2008***	***2009***
	Consultations are under way between the social partners for the adoption of parametric reforms.	proposals, providing for the gradual introduction of a set of parametric reforms.			
9. Adjustment of the contribution levels to the Social Security Funds of specific occupations (self employed) and aligning them to their actual level of earnings.	A bill to this effect has been approved by the Council of Ministers and submitted to the House of Representatives.	2007	-	-	-
Impact of Revenue Measures			**0.1**	**0.3**	**0.3**
Total Adjustment from Revenue and Expenditure Measures			**0.2**	**1.2**	**1.4**

APPENDIX III: Tables

Table 1a: Macroeconomic Prospects

	ESA Code	Year 2005 level	Year 2005 rate of change	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. Real GDP	B1*g	5953.3	3.9	3.7	3.9	4.1	4.1	4.1
2. Nominal GDP	B1*g	7861.6	6.4	6.5	6.7	6.7	6.3	6.3
Components of real GDP								
3. Private consumption expenditure	P.3	3993.0	4.8	4.6	3.3	3.6	3.6	3.7
4. Government consumption expenditure	P.3	945.7	3.4	4.6	3.3	2.7	2.9	2.9
5. Gross fixed capital formation	P.51	1124.8	2.6	5.7	4.1	4.2	4.3	4.3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	30.6	0.5	0.2	-0.1	0.0	-0.3	-0.6
7. Exports of goods and services	P.6	3022.3	4.7	3.7	4.0	3.9	4.3	4.5
8. Imports of goods and services	P.7	3163.2	3.1	5.3	2.6	3.1	3.0	3.2
Contributions to real GDP growth								
9. Final domestic demand		6094.1	3.1	4.4	3.2	3.6	3.3	3.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	30.6	0.5	0.2	-0.1	0.0	-0.3	-0.6
11. External balance of goods and services	B.11	-140.9	0.7	-0.9	0.6	0.3	0.6	0.6

Table 1b: Price Developments

	ESA Code	Year 2005	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		132.1	2.4	2.7	2.7	2.5	2.1	2.1
2. Private consumption deflator		128.1	2.6	2.3	2.4	2.3	2.0	2.0
3. HICP			2.0	2.4	2.5	2.4	2.0	2.0
4. Public consumption deflator		150.2	4.1	2.4	2.5	2.4	2.0	2.0
5. Investment deflator		132.1	4.8	4.8	3.9	3.8	3.5	3.6
6. Export price deflator (goods and services)		126.0	2.8	2.4	2.2	2.0	2.0	2.0
7. Import price deflator (goods and services)		126.7	4.5	2.6	2.2	2.2	2.2	2.2

Table 1c: Labour market developments

	ESA Code	Year 2005 Level	Year 2005 rate of change	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. Employment, occupied population, domestic concept national accounts definition		351.5	2.6	1.4	1.2	1.2	1.3	1.3
2. Employment, hours worked		654.641	1.8	1.3	1.1	1.1	1.2	1.2
3. Unemployment rate (%) - harmonised definition-Labour Force Survey			5.3	4.8	4.8	4.7	4.6	4.4
4. Labour productivity persons fulltime equivalent			1.3	2.2	2.6	2.8	2.7	2.7
5. Labour productivity hours worked			2.0	2.3	2.7	2.9	2.8	2.9
6. Compensation of employees	D1		5.4	4.6	5.1	5.2	4.7	4.7

Table 1d: Sectoral Balances

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.6	-6.4	-5.8	-5.4	-4.8	-4.2
of which: - Balance of goods and services		-2.7	-3.5	-3.0	-2.6	-2.1	-1.5
- Balance of primary incomes and transfers		-2.9	-2.9	-2.8	-2.7	-2.7	-2.7
- Capital account		0.5	0.0	0.0	0.0	0.0	0.0
2. Net lending/borrowing of the private sector	B.9/EDP B.9	-3.3	-4.5	-4.2	-4.6	-4.4	-4.0
3. Net lending/borrowing of general government	B.9	-2.3	-1.9	-1.6	-0.7	-0.4	-0.1
4. Statistical discrepancy		optional	optional	optional	optional	optional	optional

Table 2: General government budgetary prospects

	ESA code	Year 2005 level	Year 2005 % GDP	Year 2006 % GDP	Year 2007 % GDP	Year 2008 % GDP	Year 2009 % GDP	Year 2010 % GDP
Net lending (B9) by sub-sector								
1. General government	S.13	-183.6	-2.3	-1.9	-1.6	-0.7	-0.4	**-0.1**
2. Central government	S.1311	-409.7	-5.2	-4.8	-4.4	-3.3	-2.8	**-2.4**
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313	-7.4	-0.1	-0.1	-0.1	-0.1	-0.1	**-0.1**
5. Social security funds	S.1314	233.5	3.0	3.0	2.8	2.6	2.5	**2.3**
General government (S13)								
6. Total revenue	TR	3242.8	41.2	42.1	42.2	42.3	42.3	42.1
7. Total expenditure	TE	3426.4	43.6	44.0	43.8	43.0	42.7	42.2
8. Net lending/borrowing	EDP B.9	-183.6	-2.3	-1.9	-1.6	-0.7	-0.4	-0.1
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	270.0	3.4	3.3	3.0	2.8	2.5	2.3
pm. 9a FISIM		2.9	0.0	0.0	0.0	0.0	0.0	0.0
10. Primary balance		86.4	1.1	1.4	1.4	2.1	2.1	2.2
11. Total Taxes (11=11a+11b+11c)		2136.2	27.2	27.3	27.5	28.0	28.2	28.0
11a. Taxes on production and imports	D.2	1328.3	16.9	17.5	17.6	17.9	18.1	17.9
11b. Current taxes on income, wealth etc	D.5	729.1	9.3	9.7	9.9	9.9	10.0	10.0
11c. Capital taxes	D.91	78.8	1.0	0.1	0.1	0.1	0.1	0.1
12. Social contributions	D.61	650.1	8.3	8.4	8.5	8.5	8.5	8.5
13. Property income	D.4	77.9	1.0	1.0	0.9	0.9	0.9	0.9
14. Other (14=15-(11+12+13))		378.6	4.8	5.4	5.2	4.9	4.8	4.7
15=6. Total revenue	TR	3242.8	41.2	42.1	42.2	42.3	42.3	42.1
p.m.:Tax burden (D.2+D.5+D.61+D.91-D.995)		2782.3	35.4	35.6	36.0	36.4	36.6	36.5
Selected components of expenditure								
16. Collective consumption	P.32	786.2	10.0	9.7	9.3	8.9	8.8	8.7
17. Total social tranfers	D62+D63	1632.3	20.8	21.6	22.1	22.5	22.7	22.9
17a. Social transfers in kind	P.31=D.63	634.3	8.1	8.5	8.8	8.9	8.8	8.7
17b. Social transfers other than in kind	D.62	998.0	12.7	13.1	13.4	13.6	13.9	14.3
18=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	270.0	3.4	3.3	3.0	2.8	2.5	2.3
19. Subsidies	D.3	55.3	0.7	0.6	0.6	0.5	0.5	0.5
20. Gross fixed capital formation	P.51	246.4	3.1	3.1	3.1	3.1	3.1	3.1
21. Other (21=22-(16+17+18+19+20))		436.2	5.5	5.7	5.7	5.2	5.2	4.8
22=7. Total expenditure	TE	3426.4	43.6	44.0	43.8	43.0	42.7	42.2
pm: compensation of employees		1127.3	14.3	14.5	14.4	14.2	14.1	13.9

Table 3: General government expenditure by function

% of GDP	COFOG Code	Year 2003	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. General public services	1	9.1	9.0	9.1	9.0	8.9	8.7	8.6	8.5	8.3
2. Defence	2	3.2	3.1	2.1	2.1	2.1	2.0	1.8	1.7	1.6
3. Public order and safety	3	2.0	1.9	2.4	2.0	2.0	2.0	1.9	1.9	1.8
4. Economic affairs	4	6.2	6.2	4.6	6.1	4.6	4.6	4.3	4.2	4.0
5. Environmental protection	5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Housing and community amenities	6	4.1	4.0	3.4	4.0	3.7	3.7	3.6	3.6	3.8
7. Health	7	3.2	3.1	2.9	3.0	3.0	3.1	3.2	3.2	3.3
8. Recreation, culture and religion	8	0.5	0.8	0.7	0.6	0.7	0.7	0.7	0.7	0.7
9. Education	9	5.7	5.6	6.3	6.8	6.9	6.9	6.8	6.8	6.8
10. Social protection	10	11.3	11.5	11.4	10.0	12.1	12.1	12.1	12.1	12.1
11. Total expenditure (= item 7=26 in Table 2)	**TE**	**45.3**	**45.3**	**43.0**	**43.6**	**44.0**	**43.8**	**43.0**	**42.7**	**42.2**

Table 4: General government debt developments

% of GDP	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. Gross debt	**70.4**	**69.2**	**64.7**	**60.5**	**52.5**	**49.0**	**46.1**
2. Change in gross debt ratio	**1.3**	**-1.2**	**-4.5**	**-4.2**	**-8.0**	**-3.5**	**-2.9**
Contributions to change in gross debt ratio							
3. Primary balance	**-0.8**	**1.1**	**1.4**	**1.4**	**2.1**	**2.1**	**2.2**
4. Interest expenditure (incl. FISIM)	**3.3**	**3.4**	**3.3**	**3.0**	**2.8**	**2.5**	**2.3**
5. Stock-flow adjustment	**2.2**	**0.9**	**-2.0**	**-1.6**	**-4.8**	**-0.6**	**0.0**
of which:							
- Differences between cash and accruals	0.4	0.2	0.1	0	0	0	0
- Net accumulation of financial assets	1.7	0.4	-2.1	-1.6	-4.8	-0.6	0.0
- of which: privatisation proceeds	0	0	0	0	0	0	0
- Valuation effects and other	0.1	0.1	0	0	0	0	0
p.m. implict interest rate on debt	**4.97**	**4.88**	**4.71**	**4.70**	**4.69**	**4.71**	**4.71**
Other relevant variables							
6. Liquid financial assets	9.9	9.8	7.8	6.2	1.4	0.8	0.8
of which:Sinking Fund Deposits	7.6	7.0	6.6	5.5	1.0	0.5	0.3
7. Net finacial debt (7=1-6)	60.5	59.4	56.9	54.3	51.1	48.2	45.3

Table 5: Cyclical developments

% of GDP	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. Real GDP growth (%)		**3.9**	**3.7**	**3.9**	**4.1**	**4.1**	**4.1**
2. Net lending of general government	EDP B.9	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41+ FISIM	**3.4**	**3.3**	**3.0**	**2.8**	**2.5**	**2.3**
4. Potential GDP growth (%)		3.7	3.7	3.7	3.7	3.7	3.7
contributions:							
- labour		n.a	n.a	n.a	n.a	n.a	n.a
- capital		n.a	n.a	n.a	n.a	n.a	n.a
- total factor productivity		n.a	n.a	n.a	n.a	n.a	n.a
5. Output gap		-1.7	-1.6	-1.4	-1.0	-0.6	-0.2
6. Cyclical budgetary component		-0.8	-0.7	-0.6	-0.5	-0.3	0.0
7. Cyclically-adjusted balance (2-6)		-1.6	-1.2	-1.0	-0.3	-0.1	-0.1
8. Cyclically-adjusted primary balance (7-3)		1.9	2.1	2.0	2.6	2.4	2.2

Table 6: Divergence from previous update

	ESA Code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
Real GDP growth (%)							
Previous update		4.1	4.2	4.2	4.2	4.3	n/a
Current update		3.9	3.7	3.9	4.1	4.1	4.1
Difference		0.2	0.5	0.3	0.1	0.2	
General government net lending (% of GDP)	EDP B.9						
Previous update		-2.5	-1.9	-1.8	-1.2	-0.6	n/a
Current update		-2.4	-1.8	-1.7	-0.9	-0.5	-0.3
Difference		0.1	0.1	0.1	0.3	0.1	
General government gross debt (% of GDP)							
Previous update		70.5	67.0	64.0	56.9	53.5	n/a
Current update		69.2	64.7	60.5	52.5	49.0	46.1
Difference		1.3	2.3	3.5	4.4	4.5	

Table 7: Long-term sustainability of public finances
(baseline scenario)

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	**37.0**	**43.6**	**42.2**	**45.5**	**51.0**	**65.0**
Of which: age-related expenditures	14.3	16.7	17.7	19.4	22.7	28.0
Pension expenditure	6.2	6.9	7.3	9.1	11.9	17.0
Social security pension	4.3	4.8	5.1	6.8	9.2	13.4
Old-age and early pensions	3.8	4.4	4.5	6.0	8.2	11.8
Other pensions (disability, survivors)	0.5	0.4	0.6	0.8	1.0	1.6
Occupational pensions (if in general government)	1.9	2.1	2.2	2.3	2.7	3.6
Health care Long-term care	2.4	3.0	3.4	3.5	3.9	4.0
Education expenditure	5.2	5.8	6.0	5.8	5.7	5.5
Other age-related expenditures	0.5	1.0	1.0	1.0	1.2	1.5
Interest expenditure	3.3	3.4	2.7	3.0	5.0	14.5
Total revenue	**34.7**	**41.2**	**42.1**	**42.0**	**41.8**	**40.0**
Of which: property income	0.9	0.7	1.0	1.0	1.0	1.0
of which: from pensions contributions (or social contributions if appropriate)	6.5	8.3	8.5	8.4	8.2	7.8
Pension reserve fund assets	35.5	39.4	40.4	27.0	0.0	-95.0
Of which: consolidated public pension fund assets (assets other than government liabilities)	0.9	0.7	1.0	1.0	1.0	1.0
Assumptions						
Labour productivity growth	2.9	1.3	2.7	3.0	3.0	3.0
Real GDP growth	5.2	3.9	4.1	3.2	3.0	3.0
Participation rate males (aged 15-64)	78.9	81.0	81.5	81.1	81.5	85.1
Participation rates females (aged 15-64)	52.5	56.0	56.4	56.0	57.7	67.5
Total participation rates (aged 15-64)	65.5	69.0	69.4	69.0	69.7	76.6
Unemployment rate	3.3	3.3	4.4	3.5	3.5	3.5
Population aged 65+ over total population	11.3	12.2	13.2	16.5	20.8	28.1

Table 8: Basic assumptions

	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
Short-term interest rate (euro area; 3 month money market)	2.2	3.1	3.7	3.6	3.5	3.5
Long-term interest rate (10-year German bonds)	3.4	3.8	4.1	4.2	4.0	4.0
USD/€ exchange rate	1.25	1.27	1.28	1.28	1.28	1.28
Nominal effective change rate of the Cyprus pound (% change)	1.5	1.2	1.0	0.0	0.0	0.0
EU export markets, extra-EU volumes	8.0	9.9	8.6	7.9	7.5	7.5
EU GDP growth	1.8	2.8	2.4	2.4	2.5	2.5
Growth of relevant foreign markets	5.7	7.7	6.5	6.2	6.2	6.2
World import volumes, excluding EU	7.5	9.1	8.2	7.9	7.8	7.8
World import prices (in USD)	6.5	5.6	3.6	1.7	1.5	1.5
Oil prices, (Brent, USD/barrel)	58.0	66.0	68.0	69.0	69.0	70.0
Non-oil commodity prices (in USD)	10.3	23.7	4.3	-1.4	0.0	2.0