COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Cyprus, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

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

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Cyprus, submitted on 6 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the new convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

Cyprus is a small open economy, thus highly exposed to external shocks. It is experiencing a successful process of nominal and real convergence with the EU. Averaging 3.5% p.a. over

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

the last ten years, GDP growth is robust, while inflation is low. HICP inflation hovered at levels below 3% for most of the decade. The Cypriot economy has enjoyed almost full employment conditions. Long-term unemployment is at very low levels, while productivity growth is high by international standards. However, nominal wage growth and unit labour costs (ULC) tended to increase relatively faster than in its trade partners. Nonetheless, export-oriented services sectors, which account for the bulk of total exports, are performing well, although large surpluses of the trade in services have not fully offset the deficit in trade of goods. Thus, Cyprus's current account balance has been negative over the last ten years. Nonetheless, its financing has remained unproblematic via portfolio and direct investment inflows and non-resident deposits with resident financial institutions. The fiscal consolidation programme currently implemented has reduced the deficit to 2% of GDP in 2006 and the government debt is on a declining path.

2.2. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2009. The Council welcomed "the structural adjustment planned over the programme period after bringing the deficit below 3% of GDP in 2005". The Council invited Cyprus to "ensure through measures of a permanent nature that budgetary consolidation towards the programme's medium-term objective is sustained after the excessive deficit has been corrected". The Council also invited Cyprus to "control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances".

2.3. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of Cyprus, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 17 October 2006. The Cypriot National Reform Programme identifies as key challenges/priorities: fiscal sustainability; quality of public finances; R&D, innovation and ICT; increasing the diversification of the economy; competition and business environment; environmental sustainability; infrastructure; human capital; and social cohesion.

The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Cyprus is making good progress in the implementation of its National Reform Programme. Overall, the implementation of the majority of measures seems to be proceeding as planned.

Against the background of strengths and weaknesses identified, Cyprus was recommended to take action in the areas of reforms of the pension and healthcare systems; and employment and training opportunities for young persons.

2 Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Box: Main points of covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

On the updated convergence programme of Cyprus, 2006-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated convergence programme of Cyprus, which covers the period 2006 to 2010.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 3.7% in 2006 to 4.1% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic.

(3) For 2006, the general government deficit is estimated at just below 2% of GDP in the Commission services' autumn 2006 forecast, as targeted in the previous update of the convergence programme. With real GDP growth lower than projected in the previous update (3.7% instead of 4.2%), total expenditure is estimated to be higher than planned but this is estimated to be offset by higher total revenues.

(4) After the correction of the excessive deficit in 2005, the programme aims at further consolidating public finances. The general government balance is projected to improve from a deficit of 1.9% of GDP in 2006 to a balanced position in 2010 entirely through

5 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

expenditure retrenchment as the revenue ratio remains constant over the programme period. While total expenditure is projected to fall by 1¾ percentage point of GDP over the programme period, of which 1 percentage point of GDP corresponds to declining interest payments, social transfers are planned to increase by 1¼ percentage point. The primary surplus is planned to rise from 1½% of GDP in 2006-07 to just above 2% of GDP in 2008 and to remain constant thereafter. The planned consolidation is slightly faster than in the previous update of the convergence programme, against a broadly similar macroeconomic scenario.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of around 1½% of GDP in 2006 to a surplus of some ¼% of GDP at the end of the programme period. As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.5% of GDP, which the programme aims to achieve by 2008, one year earlier than in the previous update. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¾% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) The risks to the budgetary projections in the programme appear broadly balanced. The target for 2007 seems plausible when compared with the Commission services' autumn 2006 forecast and, for the year 2008, when the primary surplus is planned to improve, there is relatively detailed information in the programme about the measures that support the adjustment. However, there is a risk of spending slippages given the high degree of expenditure restraint envisaged and the lack of information on the spending ceilings and their enforcement. On the other hand, the overall track record with respect to the achievement of the budgetary targets is good.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to ensure that the MTO is achieved by 2008, as envisaged in the programme. In addition, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. The pace of adjustment towards the MTO implied by the programme is in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. After the achievement of the MTO, the fiscal policy stance implied by the programme is also in line with the Pact.

(8) Government gross debt is estimated to have reached 64¾% in 2006, above the 60% of GDP Treaty reference value. The programme projects that the debt ratio would fall below the 60% of GDP reference value in 2008 and would attain just above 46% of GDP by the end of the programme period. The risks to the projected evolution of the debt ratio appear to be broadly balanced. In view of the risk assessment, the debt ratio is sufficiently diminishing towards the reference value in the early part of the programme period and is planned to approach it by 2007.

(9) The long-term budgetary impact of ageing in Cyprus is among the highest in the EU, influenced notably by a very large increase in pension expenditure as a share of GDP. The initial budgetary position contributes to easing part of the projected considerable long-term budgetary impact of an ageing population, but it is not sufficient to cover it. Moreover, the current level of gross debt is above the Treaty reference value. Continuing the consolidation of the public finances simultaneously with adopting pension reform measures aimed at containing the significant increase in age-related expenditures would contribute, as recognised by the authorities, to reducing risks to the sustainability of public finances. Overall, Cyprus appears to be at high risk with regard to the sustainability of public finances.

(10) The convergence programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the gradual implementation of pension and healthcare reforms in order to address the impact of ageing populations, but there is limited clarity as to the content and the timeframes for the finalisation and full implementation of a comprehensive life-long strategy.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[6].

The overall conclusion is that, after the correction of the excessive deficit in 2005, the programme is making good progress towards the MTO over the programme period, owing to expenditure restraint and in a context of strong growth prospects. The general government gross debt is foreseen to approach the 60% of GDP reference value by 2007 and to continue declining in the subsequent years.

In view of the above assessment, in particular the level of debt and the projected increase in age-related spending, Cyprus is invited to control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances.

6 In particular, the data on "Cyclical Developments" (Table 5), the contributions to Potential GDP Growth (item 4) are not provided.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**CP December 2006**	**3.9**	**3.7**	**3.9**	**4.1**	**4.1**	**4.1**
	COM Nov 2006	3.8	3.8	3.8	3.9	n.a.	n.a.
	CP December 2005	*4.1*	*4.2*	*4.2*	*4.2*	*4.3*	*n.a.*
HICP inflation (%)	**CP December 2006**	**2.0**	**2.4**	**2.5**	**2.4**	**2.0**	**2.0**
	COM Nov 2006	2.0	2.4	2.0	2.4	n.a.	n.a.
	CP December 2005	*2.1*	*2.0*	*2.0*	*2.0*	*2.0*	*n.a.*
Output gap (% of potential GDP)	**CP December 2006**[1]	**-0.9**	**-1.0**	**-1.1**	**-1.1**	**-1.1**	**-1.1**
	COM Nov 2006[5]	-1.3	-1.3	-1.3	-1.3	n.a.	n.a.
	CP December 2005[1]	*-0.8*	*-0.3*	*0.1*	*0.0*	*0.1*	*n.a.*
General government balance (% of GDP)	**CP December 2006**	**-2.3**	**-1.9**	**-1.6**	**-0.7**	**-0.4**	**-0.1**
	COM Nov 2006	-2.3	-1.9	-1.7	-1.7	n.a.	n.a.
	CP December 2005	*-2.5*	*-1.9*	*-1.8*	*-1.2*	*-0.6*	*n.a.*
Primary balance (% of GDP)	**CP December 2006**	**1.1**	**1.4**	**1.4**	**2.1**	**2.1**	**2.2**
	COM Nov 2006	1.1	1.4	1.4	1.4	n.a.	n.a.
	CP December 2005	*0.7*	*1.2*	*1.2*	*1.4*	*1.7*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP December 2006**[1]	-2.0	-1.5	-1.2	-0.3	0.0	0.3
	COM Nov 2006	-1.8	-1.4	-1.2	-1.2	n.a.	n.a.
	CP December 2005[1]	*-2.2*	*-1.8*	*-1.8*	*-1.2*	*-0.6*	*n.a.*
Structural balance[2] (% of GDP)	**CP December 2006**[3]	**-3.3**	**-1.9**	**-1.0**	**-0.3**	**-0.1**	**-0.1**
	COM Nov 2006[4]	-2.7	-1.4	-1.2	-1.2	n.a.	n.a.
	CP December 2005	*-3.1*	*-2.1*	*-2.1*	*-1.5*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**CP December 2006**	**69.2**	**64.7**	**60.5**	**52.5**	**49.0**	**46.1**
	COM Nov 2006	69.2	64.8	62.2	59.6	n.a.	n.a.
	CP December 2005	*70.5*	*67.0*	*64.0*	*56.9*	*53.5*	*n.a.*

Notes:

[1] Commission services calculations on the basis of the information in the programme.

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[3] One-off and other temporary measures taken from the programme (1.3% of GDP in 2005 and 0.4% in 2006, deficit-reducing,). They include 0.4% of GDP in 2005 and 2006 accounting for the EU funds-related transactions.

[4] One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.9% of GDP in 2005; deficit-reducing) as compared to the programme (see note 3) the Commission services did not treat any EU fund-related transactions as one-off.

[5] Based on estimated potential growth of 3.9%, 3.7%, 3.9% and 4.0% respectively in the period 2005-2008.

Source:

Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations