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CYPRUS: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2007 STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The Cyprus’s stability programme was submitted on 7 December 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 27 February 2008. Comments should be sent to P. Eliofotou, G. Moschovis or M. Capó Servera (Polyvios.Eliofotou@ec.europa.eu, George.Moschovis@ec.europa.eu, Mateo.Capo@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services’ autumn 2007 forecast, (ii) the code of conduct (“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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Cyprus, has to submit a stability programme and annual updates thereof. Cyprus submitted its first stability programme, covering the period 2007-2011, on 7 December 2007.

Over the last ten years, Cyprus has been characterised by high and volatile economic growth, reflecting high exposure to external shocks. Fiscal policy has not always taken advantage of favourable cyclical conditions to achieve budgetary targets close-to-balance or in surplus, which would provide a safety margin to normal fluctuations, and allow automatic stabilizers to operate fully in economic downturns. This highlights the need for avoidance of pro-cyclical stance in good times. The last four years the Cypriot authorities embarked on a successful mainly revenue-based fiscal consolidation, which brought general government deficit from 6.5% of GDP in 2003 to 1.2% in 2006. On the back of exceptionally high revenues, the budget balance attained a surplus of 1.5% of GDP in 2007. Furthermore, debt declined from a 69% of GDP in 2003 down to about 60% in 2007. The lack of primary current expenditure restraint and the temporary composition effects of the recent increase in tax revenues, associated with revenues from the strong profitability of the financial sector and the buoyant investment in real estate, highlight the need for better expenditure control. This would help to stabilise the economy in the new context of euro area membership. The reform of the pension system and a timely implementation of the adopted reforms in health care would also contribute to the control of primary spending, while underpinning the sustainability of public finances in the long run.

The macroeconomic scenario underlying the programme envisages that real GDP growth will moderate slightly from 4.2% in 2007 to some 4% on average over the rest of the programme period. The programme foresees domestic demand to be the main driver of growth in the medium term, underpinned by buoyant investment activity and strong private consumption. Nonetheless, both components are foreseen to moderate somewhat over the programme horizon from the particularly high levels of the recent past to historical levels. Although the moderation is projected to be more pronounced for investment, it should remain strong. Private consumption is supported by wage and employment gains as well as increased consumer credit on the back of low interest rates. In contrast, public consumption would remain moderate, due to the implementation of the 3-year Medium Term Budgetary Framework (MBTF). On the external side, exports are projected to rise throughout the programme period as a result of the continuation of the buoyant performance of export-oriented financial and business services as well as of an improved performance of the tourism sector. As imports are forecast to grow moderately, the contribution to growth of the external sector is projected to become gradually neutral by the end of the programme period. Assessed against currently available information[1], this scenario appears to be based on plausible growth assumptions until 2009, while they appear to be slightly on the high side thereafter. The programme's projections for inflation appear realistic but on the backdrop of the latest developments in oil and food prices at international level, the balance of risks is

[1] The assessment takes notably into account the Commission services' autumn 2007 forecast and the Commission assessment of the October implementation report of the national reform programme.

somewhat tilted on the upside. The cyclical conditions in Cyprus over the programme period can be qualified as economic ‘good times’ as defined in the revised Stability and Growth Pact (SGP). This is supported by the analysis of tax elasticities, so that Cyprus can be assessed to be in ‘good times taking into account tax elasticities'.

For 2007, the stability programme estimates the general government surplus at 1.5% of GDP, more than 3 percentage points of GDP better than the target of a deficit of 1.6% of GDP set in the last update of the convergence programme. The marked turnaround in 2007 is attributed to an unexpected rise in total revenues by 3.3 percentage points of GDP that more than offset the rise in total expenditures. This rise seems largely explained by composition effects associated with an asset and property boom, which mainly affect indirect taxes. Consequently, although these revenues might be of a transitory nature, they cannot be considered as a pure one-off as laid down in the definition set in the Code of Conduct. Compared to 2006, revenues from indirect taxes are estimated to increase by 1.8 percentage points of GDP in 2007, while revenues from direct taxes would increase by 2.6 percentage points of GDP. In contrast, property taxes are estimated to decline by 0.7 percentage points. . The 2007 estimated outturn respects the invitation in the Council opinion of 27 February 2007 on the last update of the convergence programme2 to “implement the fiscal consolidation path as foreseen in the programme”. Total expenditure for 2007 is estimated at 44.4% of GDP, broadly in line with the Commission services' autumn forecast but considerably higher than budgeted in the December 2006 update of the Convergence Programme (43.8% of GDP). This is mainly due to higher-than-expected social transfers other than in kind by 0.6 percentage points of GDP, which are not sufficiently explained in the programme.

In view of the better-than-expected 2007 outturn, the budgetary targets presented in the stability programme are much improved compared to those in the last update of the convergence programme against a broadly unchanged macroeconomic background. The stability programme puts forward a more ambitious medium-term objective (MTO) of a balanced position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), compared to a structural deficit of 0.5% of GDP previously. The budgetary strategy in the stability programme aims at maintaining this new MTO, which has already been over-achieved in 2007, over the programme period. The general government surplus is planned to decline to 0.7% of GDP by 2011, from 1.5% in 2007; in primary terms, the drop is more pronounced, to 2.8% of GDP in 2011 from 4.7%. The narrowing of the surplus mainly reflects a fall in the share of total revenues in GDP by 1¼ percentage points as total expenditure is planned to decline by just ¼ of a percentage point of GDP. The latter mainly reflects important savings on interest expenditure as primary expenditure is set to increase by ¼ of a percentage point, as a containment of expenditure on compensation of employees, subsidies and public investment is more than offset by increases in social payments and other expenditure. The fall in total revenues is concentrated in 2008 (1½ percentage points of GDP), as half of the extraordinary increase of revenues in 2007, amounting to 1.5% of GDP, is not expected to continue in 2008. Government gross debt, estimated at 60% of GDP in 2007, is projected to decline by 11½ percentage points of GDP in 2008 to 48½% of GDP. This is mainly due to a high primary surplus and a large debt-decreasing stock-flow adjustment, resulting from a large decumulation of financial assets associated with the sinking funds. Thereafter, debt-to-

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2 OJ C 71, 28.3.2007, p. 16.

GDP ratio is projected to decline further by 8 percentage points of GDP over the programme period.

The budgetary outcomes in 2008 and 2009 could be better than projected in the programme but worse thereafter. The programme assumes that only part of the better-than-expected revenues in 2007 is carried over to subsequent years. Although uncertain in the absence of more detailed data, there seems to be scope for a higher degree of carryover, especially in 2008 and 2009. A negative risk to revenues stems from the fact that the macroeconomic scenario embodies favourable projections for private consumption growth in the outer programme years. Moreover, given the exposure of the Cypriot economy to external shocks, due to its small size and openness, and its strong specialisation in tourism, unforeseen geopolitical tensions in the region could also adversely affect growth prospects. The reliance on the respect of expenditure ceilings, which were introduced as recently as 2006, constitutes a further risk as their nature and in particular enforcement mechanism is not fully specified.

In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the new MTO throughout the programme period, as envisaged in the programme. The 1.5% of GDP in revenues considered by the programme as temporary, although likely transitory in nature, does not qualify as a one-off and it is not considered as such by the Commission services. Given the good times, the structural surplus reduction by more than 1 percentage points of GDP in 2008, from 1¾% of GDP the previous year, may imply a pro-cyclical fiscal stance, which would not be in line with the Stability and Growth Pact. However, the consideration by the Government that the rise in revenues in 2007 may be only partially permanent reflects a prudent budgetary approach, according to which revenues from a particularly tax-intensive composition of growth should not trigger additional permanent expenditure. Although the planned deterioration of the budgetary position compared to 2007 reflects to a large extent an expected normalisation of tax revenues, there is a risk that the stance in 2008 may turn out to be procyclical, given the risks associated to the enforcement of the expenditure ceilings.

Cyprus appears to be at high risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is among the highest in the EU, influenced notably by a very large increase in pension expenditure as a share of GDP. The budgetary position in 2007 as estimated in the programme contributes to offsetting part of the projected considerable long-term budgetary impact of an ageing population but it is not sufficient to cover it. Maintaining high primary surpluses and adopting pension reform measures aimed at containing the significant increase in age-related expenditures, as currently envisaged, would contribute to reducing risks to the sustainability of public finances.

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Cyprus' national reform programme[3] and is summarised as follows. Cyprus' 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

[3] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)" - COM(2007) 803, 11.12.2007.

sustainability; infrastructure; human capital; and social cohesion. The Commission's assessment was that Cyprus had made good progress in the implementation of its national reform programme over the 2005-2007 period. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Cyprus is recommended to give highest priority to the challenges in the areas of pension and health care systems reforms, enhancing life long learning and employment and training opportunities for young people. In addition, Cyprus should also focus on the areas of: improving competition in professional services; further stimulate private sector R&D; and address the very high gender pay gap.

The overall conclusion is that the budgetary strategy in the programme should be sufficient to maintain a sound budgetary position and macroeconomic stability throughout the period. The programme puts forward a more ambitious MTO of a balanced position in structural terms (compared to a deficit of 0.5% of GDP previously), which has already been over-achieved in 2007. This is the result of an unexpected increase in total revenues by over 3 percentage points of GDP, largely explained by composition effects associated to the strong profitability of the financial sector and the buoyant investment in real estate, which are projected by the programme to return to historical trends in the coming years. The budgetary targets, which are significantly better than in the previous programme, could be overachieved in 2008 and 2009 given the better 2007 basis. Thereafter, they could be worse given the favourable growth assumptions. Although the planned reduction of the budgetary surplus compared to 2007 reflects to a large extent an expected normalisation of tax revenues, there is a risk that the stance in 2008 may turn out to be procyclical. The level of debt is projected to decline significantly, especially in 2008. Given the projected increase in age-related spending, the reform of the pension system and a timely implementation of adopted reforms in health care, would have a positive effect on the long-term sustainability of public finances, which appears to be at high risk.

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Nov 2007**	**3.8**	**4.2**	**4.1**	**4.0**	**4.0**	**4.0**
	COM Nov 2007	3.8	3.8	3.9	3.9	n.a.	n.a.
	CP Dec 2006	*3.7*	*3.9*	*4.1*	*4.1*	*4.1*	*n.a.*
HICP inflation (%)	**SP Nov 2007**	**2.2**	**2.2**	**2.5**	**2.0**	**2.0**	**2.0**
	COM Nov 2007	2.2	2.0	2.3	2.1	n.a.	n.a.
	CP Dec 2006	*2.4*	*2.5*	*2.4*	*2.0*	*2*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-1.0**	**-0.7**	**-0.6**	**-0.6**	**-0.4**	**0.0**
	COM Nov 2007[2]	-1.4	-1.1	-0.8	-0.6	n.a.	n.a.
	CP Dec 2006	*-1.0*	*-1.1*	*-1.1*	*-1.1*	*-1.1*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-5.9**	**-6.6**	**-6.5**	**-6.3**	**-5.9**	**-5.6**
	COM Nov 2007	-5.7	-5.8	-5.7	-5.5	n.a.	n.a.
	CP Dec 2006	*-6.4*	*-5.8*	*-5.4*	*-4.8*	*-4.2*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**
	COM Nov 2007	-1.2	-1.0	-0.8	-0.6	n.a.	n.a.
	CP Dec 2006	*-1.9*	*-1.6*	*-0.7*	*-0.4*	*-0.1*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**2.1**	**4.7**	**3.4**	**2.9**	**2.9**	**2.8**
	COM Nov 2007	2.1	2.2	2.2	2.2	n.a.	n.a.
	CP Dec 2006	*1.4*	*1.4*	*2.1*	*2.1*	*2.2*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**-0.8**	**1.8**	**0.7**	**0.7**	**0.8**	**0.7**
	COM Nov 2007	-0.7	-0.6	-0.5	-0.4	n.a.	n.a.
	CP Dec 2006	*-1.5*	*-1.2*	*-0.3*	*0.0*	*0.3*	*n.a.*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**-0.8**	**0.3**	**0.7**	**0.7**	**0.8**	**0.7**
	COM Nov 2007	-0.7	-0.6	-0.5	-0.4	n.a.	n.a.
	CP Dec 2006	*-1.9*	*-1.2*	*-0.3*	*0*	*0.3*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**65.2**	**60**	**48.5**	**45.3**	**43.8**	**40.5**
	COM Nov 2007	65.2	60.5	53.3	49.6	n.a.	n.a.
	CP Dec 2006	*64.7*	*60.5*	*52.5*	*49.0*	*46.1*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 3.5%, 3.5%, 3.6% and 3.7% respectively in the period 2006-2009 according to

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and termporary measures according to the Commission services' autumn forecast. The programme considers revenues in 2007 amounting to 1.5% of GDP as one-offs. Although transitory in nature, this amount of revenues does not qualify as a one-off. Therefore, it is not considered as such by the Commission services. No other one-off or temporary measures are presented.

Source:

Convergence programme (CP); Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Cyprus submitted its first stability programme in December 2007 covering the period 2007 to 2011 on 7 December 2007. The programme, which was adopted by the government on 5 December 2007, is consistent with the 2008 budget, approved by the Council of Ministers on 6 September 2007. The stability programme will be submitted to the House of Representatives for discussion.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Cyprus, with a particular focus on Cyprus in EMU and the role for fiscal policy. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 0 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 12).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON CYPRUS IN EMU: A NEW ROLE FOR FISCAL POLICY?

2.1. Introduction

Cyprus has adopted the euro as from 1 January 2008[4]. This historical decision implies a loosening of constraints in inward and outward capital flows. Within the institutional framework of EMU, the adherence of Member States to prudent fiscal policies and their commitment to self-restraining fiscal rules contributes to maintaining an economic environment in which monetary policy can effectively pursue price stability. For a small open economy such as Cyprus, the respect of the Stability and Growth Pact's provisions and the adoption of budgetary targets close-to-balance or in surplus over the medium-term contributes to building a safety margin to normal fluctuations and to avoid large structural deficits, which are at the origin of debt accumulation. Moreover, it allows automatic fiscal stabilizers to operate fully during normal economic downturns. In this way, a national shock-absorption setting could be established, which should help Cyprus in responding to external shocks, while allowing for the implementation of an optimal budgetary stance at EMU level.

In this context, it is relevant to analyse the role played by fiscal policy in Cyprus in the past in order to identify the challenges it will face within EMU. In its economic assessment of December 2006 update of the Convergence Programme of Cyprus, the Commission identified a number of challenges for the Cypriot economy on three main fronts. On the stabilisation front, the countercyclical response of fiscal policy during slowdowns/recessions has created large public deficits and increased government debt, which have not been fully corrected during the upside of the cycle. The lack of primary current expenditure restrain in recent years highlights the need to control expenditure, which is key to enhance fiscal discipline along with the avoidance of pro-cyclical stances. Moreover, fiscal consolidation until now has been mainly revenue driven and has often relied on one-off measures. On the sustainability front, the projected increases in ageing-related expenditure would put Cyprus at high risk in the absence of reforms in the areas of social security and health care. On the efficiency front, the quality and composition of government expenditure remains a challenge, despite the national authorities' efforts during the last couple of years to address it. Savings in primary current expenditure might free resources to strengthen the economy's productive potential through investment in human and physical capital and knowledge. The Stability Programme of Cyprus provides relevant indication of the future role that Cyprus will give to fiscal policy through the description of budgetary and other economic policy measures to be taken the following four years.

Section 2.2 gives a brief outlook of the economic performance of Cyprus since the late 1990s. Section 2.3 examines past public finances developments and analyses cyclical conditions in order to assess the fiscal stance over the economic cycle. Section 2.4 analyses the composition of the ongoing fiscal consolidation. Finally, section 2.5 discusses the role of fiscal policy within the EMU as well as the efficiency and effectiveness of the individual spending areas.

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4 On a proposal by the Commission, the Council also fixed at 0.585274 the rate at which the Cypriot pound will be converted into euro

2.2. Economic 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. Over the last ten years, economic activity has been growing at an annual average rate of about 3½% in real terms, which compares with 2¼% in the euro area (Figure 1). However, such ten-year averages actually conceal significant differences over time. Three sub-periods can be identified: 1997-2001, 2002-2003 and 2004 to date.

Figure 1: Contribution of components to Cyprus' GDP growth

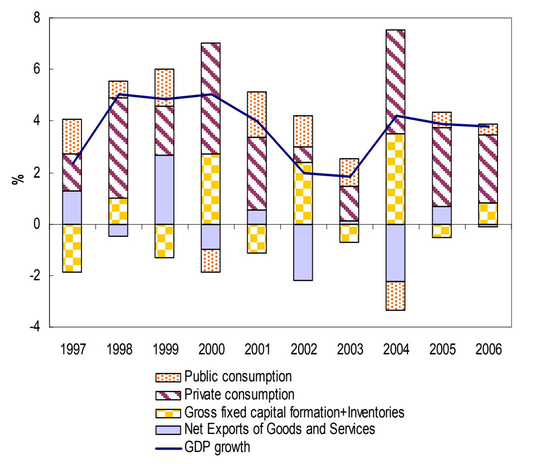
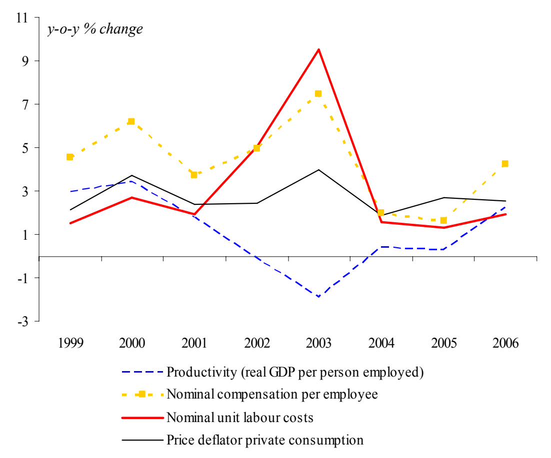


Figure 2: Inflation, productivity and wage trends



Source: Commission services

The period 1997-2001 is characterised by a strong economic expansion. GDP growth averaged about 4¼% per year. In this period, growth was mainly driven by domestic demand, on the back of strong private consumption and investment. Public consumption accounted for almost one percentage point of real GDP growth. Net exports added around ½ of a percentage point to GDP growth on average each year, due to a buoyant performance of exports of services. In contrast, in 2002-2003 the Cypriot economy's growth decelerated to an average of almost 2% per year. Like the rest of Europe, Cyprus suffered from the global slowdown in the post-11 September 2001 period. A negative confidence shock and disruptions in economic activity, induced by uncertainty in the global economy and by an unfavourable external environment, were the main reasons for this slowdown. During these two years economic growth continued to be driven by domestic demand, especially public consumption, as fiscal policy turned expansionary to counter the adverse effects of the slowdown. The rest of the contribution to domestic demand growth was accounted for by private construction investment and consumption. The external sector posed a drag on growth, as exports of both goods and services plummeted by much more than the reduction recorded in imports. From 2004 onwards, economic activity regained momentum with GDP growth rates over 3%. Domestic demand remained the mainstay of the recovery, mainly driven by private consumption. A pick-up in private investment, reflecting improved profitability of the corporate sector (primarily of financial corporations), and a surge in construction and real estate activity (asset boom) boosted the economic expansion further. The public sector's contribution to growth during this period was neutral due to the fiscal consolidation programme followed by the authorities, in order to correct the excessive deficit as required by the Council[5]. However, the external sector continued to be a drag on growth, as imports of goods surged in response to increased private consumption and investment activity.

For most of the last decade, the consumer price index hovered on average at levels below 3%, although a strong pick-up in wage growth and weak labour productivity led unit labour costs to surge in 2002-2003, thus putting upward pressure on consumer prices (Figure 2). Although productivity growth is overall high by international standards, nominal wage growth and unit labour costs (ULC) tended to increase relatively faster than in its trade partners[6]. The labour market has been operating at almost full employment conditions, with an unemployment rate at around 4½% since the mid-1990s, while the employment rate has been situated at around 69%. Moreover, the increasing share of foreign workers in the labour force has been paramount in restraining wage pressures. Working permits, particularly from 2004 onwards, have been issued to foreigners leading to large-scale inflows with a view to lowering the pressure on the labour market. Long-term unemployment is at very low levels.

The share of compensation of employees of the public sector in the total economy has been traditionally large in Cyprus (around 30% compared to 20% in the EU27) and indicates the relatively important size of the public sector in the economy. Public sector wages showed a notable pick up during 2002 and 2003 outpacing wage increases in the private sector. Afterwards, wage setting in the public sector has acted as a guide for private sector wage negotiations. In 2004 and 2005, the government agreed with public sector unions not to increase contractual salaries, as an important element of the fiscal consolidation strategy. The example of the government was followed by the banking sector, which had a moderating impact on wage settlements in the private sector at large. As a result, wage moderation contributed to a sharp deceleration in unit labour costs from 9½% in 2003 to about 1½% nowadays.

2.3. Fiscal policy over the cycle

This section examines the fiscal policy stance over the different phases of the Cypriot economic cycle between 1998[7] and 2006. The general government balance has been in the red during the whole period (Figure 3), albeit following an overall improving path. In parallel, government debt increased from 58½% of GDP in 1998 to 65¼ % by 2006. However, overall in line with economic activity, such global figures actually conceal three sub-periods over which the fiscal policy stance recorded important swings: 1998-2000, 2001-2003 and 2004 to date.

Firstly, between 1998 and 2000, a period of good times and buoyant economic growth, the government deficit improved, from around 4% of GDP to 2¼% of GDP. Moreover, debt-increasing stock-flow adjustments (SFA) kept debt-to-GDP ratio up, at close to 60%

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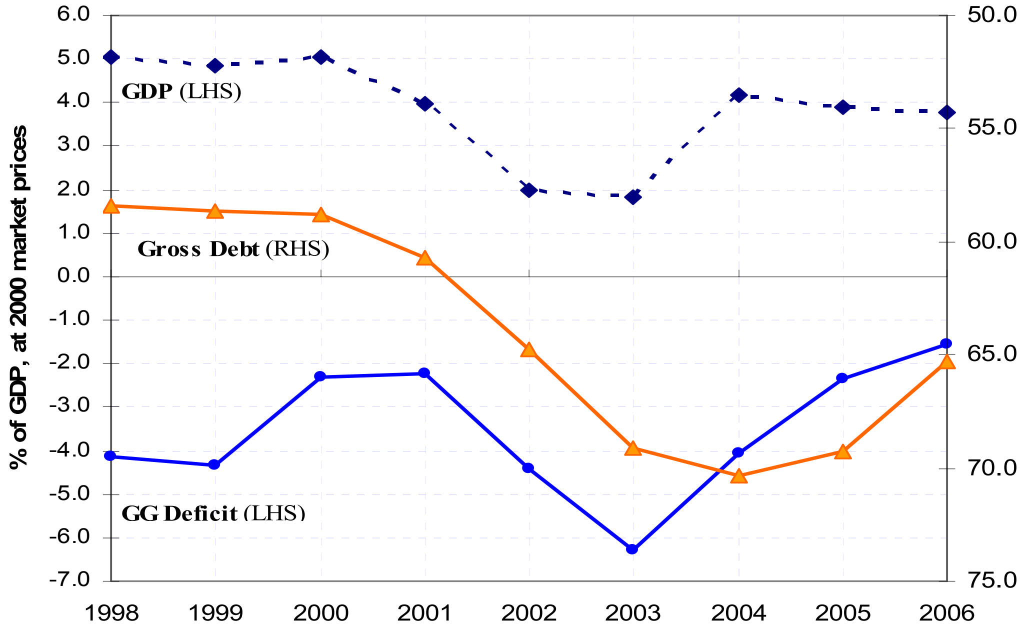
[5] Council Decision 2005/184/EC published on 9.3.2005 in the Official Journal: OJ L062, p.19

[6] However, developments in ULC, as well as goods trade may not provide an accurate indication of the competitive position of the Cypriot economy as a whole. While the manufacturing sector only represents 10% of the economy, exports of goods mainly consist of re-exports. Moreover, the services sector (such as banking and other financial services, international business services, and shipping) seems to be doing well.

[7] This is the first year when budgetary data exist in AMECO in accordance with ESA95 rules.

of GDP. The improvement in the government accounts was only partially of a structural nature. The cyclically-adjusted primary balance improved from a deficit of ¾% of GDP in 1998 to a surplus of about ½% of GDP. However, the adjustment was revenue-led, with a 2½% of GDP increase in direct and indirect taxes being partially offset by rising current expenditures. This pro-cyclical expenditure pattern in such a period of economic upturn amplified further the economic cycle, while hampering the improvement of the structural primary balance.

Figure 3: GDP, General Government Deficit and Debt



Source: Commission services, AMECO

Overall, Cyprus did not take advantage of the favourable cyclical conditions. As a result, it failed to put public finances in a sound position, which would have allowed automatic stabilizers to fully operate in the subsequent economic downturn while keeping public deficits under control. Between 2001 and 2003, following the 11 September event in the US, domestic fiscal policy became expansionary. The deficit peaked at 6¼% of GDP in 2003, while the debt-to-GDP ratio went up to 70¼% of GDP. As witnessed by the cyclically-adjusted primary balance, which deteriorated by 2¾ percentage points, the worsening of the fiscal position went beyond the pure effect of the cycle. Moreover, it was mainly due to spending increases. Although total revenues rose by nearly 3 percentage points of GDP, mainly due to buoyant proceeds of indirect taxes, significant increases in social benefits, compensation of employees and other current expenditure, clearly outpaced higher government receipts.

As a result, in 2004 the Council addressed a recommendation to the Cypriot authorities to correct the excessive deficit by 2005 at the latest to which Cyprus responded by embarking on a strong fiscal adjustment. On the back of an economic recovery and a tax-rich economic activity, the government deficit was cut by some 4% of GDP to around 2¼% of GDP by 2005. The cyclically-adjusted primary balance improved by 4¼ percentage points and recorded a surplus of 1½% of GDP in 2005. Unlike the 1998-2000 consolidation process, the fiscal adjustment was driven by both, revenues and expenditures, although, as discussed later, the former accounted for about ¾ of the total, and partially relied on one-off measures[8]. In 2006, under unchanged cyclical conditions, fiscal consolidation progressed further, reducing the government deficit and the debt ratio to 1½% and 65.3% of GDP, respectively. The composition of this process of fiscal consolidation is discussed in the next section. Although a counter-cyclical behaviour of expenditure in this period contributed to the fiscal adjustment, the reliance on temporary measures on the revenue side undermined the sustainability of the adjustment.

2.4. The composition of fiscal consolidation

Between 2003 and 2006, Cyprus' general government deficit recorded a reduction of some 4¾ percentage points, from 6¼% of GDP to 1½% of GDP. Over the whole period, fiscal consolidation was based on a mixture of both expenditure and revenue measures. Total expenditure declined by some 1¼ percentage points to about 44% of GDP in 2006, on the back of expenditure restraint across many of the expenditure categories. However, this retrenchment was partially offset by increasing social transfers and benefits. In particular, while interest payments remained stable as a percentage of GDP, with the effect of rising interest rates being offset by a falling stock of debt, spending was restrained mainly through the adoption of structural measures. The imposition of ceilings[9] on current and capital expenditure items across the government budget, aiming at keeping expenditures growing below nominal GDP, was the most important and efficient measure undertaken. Furthermore, public consumption growth was also contained through an agreement with public sector' unions to freeze wages and employment positions in the public sector for 2004 and 2005. In addition, a substantial reduction in defence outlays, together with the reduction of capital expenditures from the unusually high level of 2003 and 2004 have all contributed to spending retrenchment. Contractual wage increases in 2006 were also restricted to just 2% while employment growth in the public sector was limited to 1%. However, no significant measures to control social transfers and benefits were taken over this period and, as a result, its share of GDP rose from 11¼% in 2003 to 12¼% in 2006, thus unveiling the lack of control of those expenditures most difficult to reverse in bad times. According to the Commission services autumn forecasts, social benefits are projected to increase further in 2007.

The bulk of the fiscal adjustment thus came from the revenue side, with total revenues increasing by 3½% of GDP. Net of one-offs, government receipts actually grew by almost 5½% of GDP, while temporary revenues were sizeable in the period 2003-2005 (between 1.8% and 0.9% of GDP). These revenue measures were of a temporary nature, mainly related to taxes on past profits of semi-governmental organisations, and a tax-amnesty. Nonetheless, these temporary revenues have been gradually substituted by revenues coming from a tax-rich growth, as well as from structural measures, including the adoption of legislation in 2005 to strengthen the authorities' tax-collection capacity and fight tax-evasion. These measures also included the regularisation through legislation of the practise of dividend income policy for semi-governmental organisations.

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8 In 2004-2005, one-off and temporary measures amounted at 2 percentage points of GDP.

9 For the 2005 budget, the ceilings stood at 3% and 4% respectively, compared with the 2004 Budget, while for the 2006 budget the ceilings were at 2% and 6%, respectively.

Figure 4: General Government

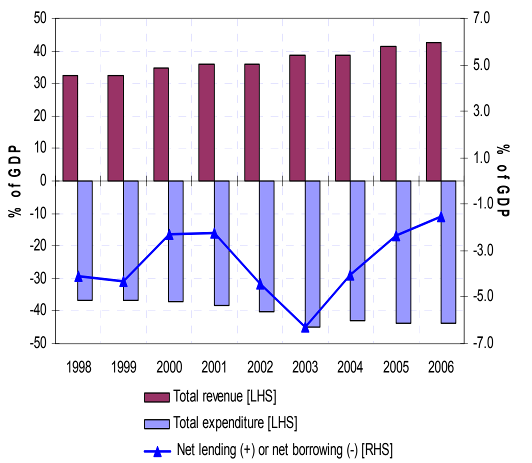
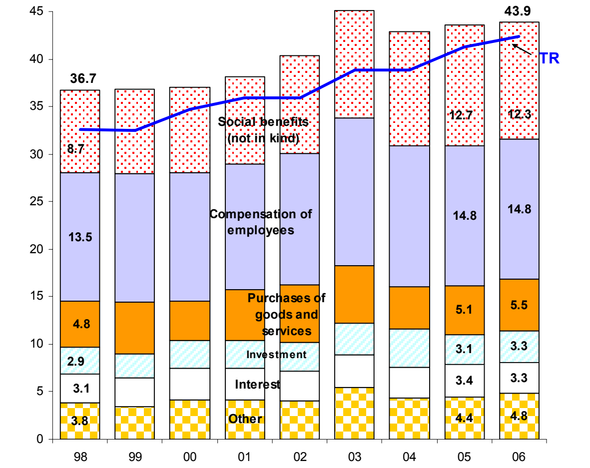


Figure 5: The evolution of government expenditure (economic classification, % of GDP) and Total Revenue



Note: In Figure 5, "Other" includes subsidies and other current and capital transfers.

Source: Commission services, AMECO database

Moreover, legislative and administrative measures related to the operation of the Land and Survey Department coupled with the booming construction activity have contributed to a buoyant performance of the associated revenues from taxes, charges and fees. As a result, in 2006, the adjustment was further strengthened without resorting to initially-budgeted one-off measures revenues. The 2006 improvement in the government deficit was mainly due to higher tax revenues associated with the buoyant performance of the real estate sector, the improved corporate profitability as well as improved tax administration and collection. However, part of the apparently high structural increase in tax revenues seemed to actually reflect temporary composition effects.

Beyond the latest consolidation effort, the composition of public finances in 2006 vis-à-vis 1998 reveals that reining in current expenditures remains a key challenge for fiscal policy in Cyprus. Moreover, part of the revenue increase seems associated with growth composition effects, which might fade away with the end of the asset boom. As a percentage of GDP, total expenditure has increased by 7¼%. Only about ½ a percentage point of GDP of it was accounted for by interest expenditure, which has recorded only a marginal increase despite the increase in the stock of debt, and investment spending. So most of the increase in total expenditure was due to increases in primary current expenditure; specifically, increases of social benefits, compensation of employees and other current transfers.

Figure 6: The tax burden by tax category, 1998-2006

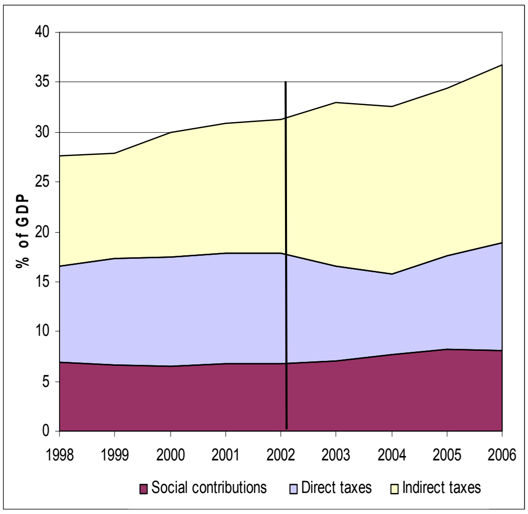
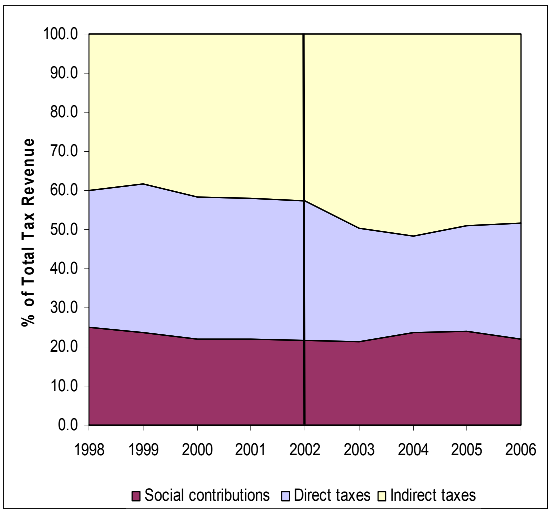


Figure 7: The tax burden by tax category (as % of Total Tax Revenue), 1998-2006



Note: In 2002 a tax reform was initiated that was completed by 2004, during which the weight shifted from direct to indirect taxes.

Source: Commission services, AMECO database

On the revenue side, the increase recorded since 1998 amounts to 10 percentage points of GDP. The bulk of this increase accounts for revenues from indirect taxes, while the rest comes mainly from an increase in direct taxes and social contributions revenues. Furthermore, other current transfers received have increased since 2004 due to the EU compensating expenditure measures related to the country's EU accession. The shift from direct to indirect taxation results from the tax reform enacted in 2002 and completed in 2004 in order to comply with the EU acquis and adapt the VAT rates. This is a positive development, as the tax system seems to have become less distortive. Furthermore, revenues seem to have benefited largely from the tax-amnesty not only temporarily but also on a more permanent basis. The tax amnesty, with the repatriation of significant amounts of funds and the accompanying adopted legislation strengthening the tax-collection capacity of the authorities, seem not only to have broadened the tax base but also to have contributed to better tax-compliance.

Table 1: Cyprus Tax Elasticities

	1999	2000	2001	2002	2003	2004	2005	2006
Indirect Taxes	0.47	3.00	1.62	1.97	4.49	1.40	1.04	1.91
Direct Taxes	2.41	1.34	1.25	1.07	-1.14	-1.29	3.58	3.90
Social Contributions	0.47	0.85	1.51	0.69	1.65	2.41	2.23	0.25
TOTAL Tax Revenue	**1.15**	**1.85**	**1.46**	**1.36**	**1.87**	**0.83**	**1.95**	**2.05**

Source: Commission services

However, government revenues have benefited much from the particular growth model prevailing in the last few years in Cyprus, which is mainly driven by private consumption and investment, particularly construction. While exports, which have a low tax content, have not been growing as fast as the whole economy in the last few years, private consumption and buoyant activity in the construction sector have been driving indirect taxes up. Moreover, while the economic boom is boosting corporate profitability, especially in the financial and business services, and thus corporate taxes, the high job-content of growth is not only supporting social security revenues, but also sustaining household incomes in spite of the moderate wage growth. Within this context, the standard way to measure structural revenues and balances may lead to the conclusion that the increase in revenues is of a permanent nature, while it would actually fade out once the growth composition changes, even if cyclical conditions would remain favourable.[10]

2.5. Challenges for fiscal policy in EMU

Within the EMU fiscal framework, Member States should adopt a prudent fiscal policy and aim to achieve medium-term targets of a 'close to balance or in surplus' budgetary positions. Then, automatic fiscal stabilizers should be allowed to operate symmetrically over the cycle. Therefore, fiscal policy would be counter-cyclical and hence, provide positive contributions to macroeconomic stability. That for, a fiscal policy needs to develop a strategy leading to meet a series of challenges.

Fiscal policy in Cyprus has a crucial role to play in the stabilisation of the economy, in particular, the symmetric behaviour over the cycle. Taking into account the high exposure of the Cypriot economy to external shocks, a symmetric countercyclical response of fiscal policy would help offset the effects of downside and upside years of the cycle. Moreover, the transitory nature of a large part of the revenue increases in recent years would suggest that the composition of the consolidation process might not have been of a permanent nature, while primary current expenditure restrain has only been short lived, with most of expenditure items remaining on a rising trend.

Therefore, this would entail further pursuing the fiscal consolidation process, even beyond the requirement of the Stability and Growth Pact, by restraining current primary expenditure.

On the long-term sustainability front, Cyprus would be at high risk if it did not take sufficient measures to address the projected increases of government expenditure in the face of an ageing population. These costs are mainly driven by the rise in the public pensions and public health care costs, which partially explain the steady increase in current primary expenditures. The improved structural budgetary position as of 2006 contributes to a reduction in the sustainability gap. Nevertheless, a significant sustainability gap remains, while, as discussed above, part of such a structural improvement might be linked to growth composition effects rather than to more permanent factors. Within this context, going beyond the achievement of the national MTO would be a positive step in reducing the gap further. The challenge of a timely implementation of reforms in the areas of social security and health, and pension reform in particular, would contribute to the necessary control of primary spending, while underpinning the sustainability of public finances in the long run. Moreover, in the absence of debt-increasing below the line operations, the control of ageing-related expenditures would ensure that the debt-to-GDP ratio be sufficiently diminishing.

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[10] C. Martinez Mongay, L. A. Maza Lasierra and J Yaniz Igal "Asset Booms and Tax Receipts: The case of Spain, 1995-2006", European Economy, Economic Papers, No. 293 of November 2007

Finally, improving the quality and composition of government expenditure would have a positive impact on economic efficiency. A stricter control of non-productive expenditure would free resources to strengthen the economy's productive potential through investment in human and physical capital and knowledge. The introduction of a 3-year medium-term budgetary framework (MTBF) is a positive step in this respect to address the efficiency, transparency and accountability of budgetary management. Yet, its fully-fledged implementation, where budgetary provisions will be closely related to the accomplishment of particular targets and objectives, is some way afar.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

Although the programme includes a sensitivity analysis comparing the budgetary implications of alternative growth and interest rate scenarios, only the so-called “central" is a fully-developed macroeconomic scenario and provides the necessary information to be assessed by the Commission services. It is considered as the “reference scenario” in this assessment.

3.1. Economic activity

Following an estimated real GDP growth of 4.2% for 2007, consistent with the latest quarterly data releases, the programme projects a marginal deceleration in 2008 to 4.1%. Thereafter, real GDP would grow at 4% per year, above potential (as estimated by the Commission Services for the autumn 2007 forecasts) until the end of the programme period. As regards external macroeconomic developments, the programme uses the “common external assumptions” on the main extra-EU variables, as provided by the Commission.

The programme foresees domestic demand to be the main driver of growth in the medium term, underpinned by buoyant investment activity and strong private consumption. Nonetheless, both components are foreseen to moderate somewhat over the programme horizon from the particularly high levels of the recent past to historical levels. The moderation is projected to be more pronounced for investment, which attained very high growth rates in the past couple of years due to a construction boom largely driven by buoyant foreign demand for housing. However, investment should remain strong, supported by a stable macroeconomic environment, further interest rate convergence with the euro area, the implementation of structural reforms (e.g. liberalisation in energy and communication sectors) and infrastructure investment. Private consumption is supported by wage and employment gains as well as increased consumer credit on the back of low interest rates. In contrast, public consumption would remain moderate, due to the implementation of the 3-year Medium Term Budgetary Framework (MBTF), which is expected to allow better fiscal management and stricter controls on current primary expenditure. On the external side, after a sharp deceleration in 2007 of exports and imports, partly due to lower re-export activity, exports are projected to rise throughout the programme period as a result of the continuation of the buoyant performance of export-oriented financial and business services as well as of an improved performance of the tourism sector. As imports are forecast to grow moderately, the contribution to growth of the external sector is projected to become gradually neutral by the end of the programme period.

The programme's macroeconomic assumptions are plausible until 2009, while they appear to be slightly on the high side thereafter. The economic outlook described in the programme's central scenario is slightly more favourable than the Commission services' autumn 2007 forecast, but seems consistent with the latest quarterly data releases, which were not available at the cut-off date of the forecasts. In 2008 and 2009, growth is broadly in line with the Commission forecast. Thereafter, GDP is projected to grow above potential, as calculated according to the commonly agreed methodology and based on the figures of the programme, until the end of the programme period. Regarding the GDP components, private consumption growth appears favourable, on the back of somewhat optimistic employment growth. The programme's projection of the external sector's contribution to GDP growth is less favourable due to lower exports of goods and services, partly due to lower re-export activity. Hence, net exports are assumed by the programme to continue posing a moderate drag on growth until 2009, compared to the broadly neutral contribution projected in the Commission forecast.

Table 2: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	3.8	4.2	3.9	4.1	3.9	4.0	4.0	4.0
Private consumption (% change)	4.9	4.9	3.4	4.2	3.5	4.0	4.0	4.0
Gross fixed capital formation (% change)	4.8	8.0	4.7	4.5	4.8	4.2	3.6	3.3
Exports of goods and services (% change)	3.8	1.6	4.0	2.7	4.0	3.3	3.7	3.9
Imports of goods and services (% change)	4.0	3.3	3.8	3.1	3.9	3.5	3.5	3.6
Contributions to real GDP growth:								
- Final domestic demand	4.1	5.2	3.9	4.4	3.9	4.2	4.0	4.0
- Change in inventories	-0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.2	-1.0	0.0	-0.3	0.0	-0.2	-0.1	0.0
Output gap[1]	-1.1	-0.7	-0.8	-0.6	-0.6	-0.6	-0.4	0.0
Employment (% change)	1.5	1.9	1.5	1.8	1.5	1.8	1.8	1.7
Unemployment rate (%)	4.3	4.2	4.1	4.0	3.9	3.9	3.7	3.6
Labour productivity (% change)	2.4	2.3	2.5	2.2	2.4	2.2	2.2	2.2
HICP inflation (%)	2.0	2.2	2.3	2.5	2.1	2.0	2.0	2.0
GDP deflator (% change)	2.5	2.7	3.0	2.9	2.6	2.3	2.3	2.2
Comp. of employees (per head, % change)	3.5	4.8	3.5	5.0	3.5	4.5	4.5	4.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-5.8	-6.6	-5.7	-6.5	-5.5	-6.3	-5.9	-5.6

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

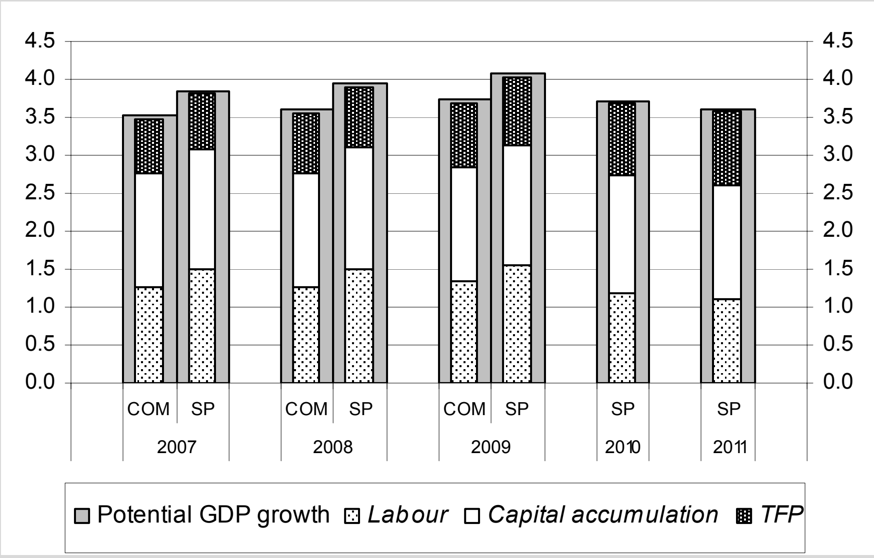
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

In 2008 and 2009, cyclical conditions, as measured by the output gap calculated with the commonly agreed method on the basis of the programme figures, are negative yet somewhat more favourable, until 2008, than in the Commission services' forecasts. This would be explained by slightly different projections in the programme for both headline and potential GDP growth. According to the programme, the output gap would remain negative but declining over the forecast horizon, in line with the Commission services' projections. In this regard, the successive Commission services' forecast exercises and stability programmes show a significant degree of volatility of real-time estimates of the potential growth, while the revisions of headline growth rates have been relatively modest.

Box 1: Potential growth and its determinants

The estimate of potential output growth, as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology, is lower than the average real GDP growth in the past ten years (Annex 2). However, it is favourable compared with the Commission service's autumn 2007 forecast. This seems to be explained by a higher contribution of labour to potential output on the back of somewhat optimistic employment growth projections in the programme.

Potential growth and its determinants



However, the main factors driving GDP growth in the long term are changing over the programme horizon. While capital accumulation shows a stable contribution to potential output growth and remains one of the largest contributors, the contribution of TFP increases over the programme period at the expense of that of labour. This pattern seems to be explained by the good progress made by Cyprus in the implementation of structural reforms that contribute to significantly raising TFP growth. Specifically, reforms to promote research and development and reforms in the labour market aiming at enhancing human capital, should accelerate technological change and deliver productivity gains.

3.2. Labour market and cost and price developments

According to the programme, employment growth is projected to decrease over the programme period from about 2% to 1¾%, broadly in line with historical trends but somewhat more optimistic than the Commission services' forecast. This is due to the assumption of a continuation of foreign and Turkish-Cypriot workers' inflows, whose share has already attained around 18% of the total labour force in 2006. These workers' inflows helped easing tight labour market conditions, particularly in sectors requiring low skills. In addition, the programme projects a gradual long-term increase in the participation rate of female and older workers, on the back of active measures to strengthen female participation and a gradual rise in the retirement age. Concurrently, the unemployment rate should fall from an estimated 4¼% in 2007 to just below 3¾% by 2011, consistent with strong employment and economic growth slightly above potential. The programme foresees that the contribution of labour to GDP growth will remain stable over the forecast horizon, which is broadly in line with the Commission services' autumn 2007 forecast.

According to the programme, the recent oil price increases and its expected evolution as well as soaring food prices in the world markets will have a significant impact on the import-dependent economy of Cyprus. As a result, HICP inflation is expected to rise at 2.2% in 2007. The impact of rising oil prices would be further carried over in the beginning of 2008, before ebbing to around 2.2% in the 3rd quarter of the year. HICP is forecast to average around 2.5% in 2008 as a whole. In both years, 2007 and 2008, HICP projections are ¼ percentage point higher than the Commission forecast. In 2009, inflation is projected to decrease further to 2%, in line with the Commission services' autumn 2007 forecast, and to remain around that level until the end of the programme horizon. However, on the basis of latest data releases on inflation as well as on money and credit growth, the programme's projections may be on the low side.

Real unit labour costs are projected to increase by some 2¼% per year over the programme period as a result of the continuation of the restrictive wage policy followed in recent years. Specifically, collective agreements covering the years up to 2007 are expected to continue over the period 2009-11. Moreover, foreign workers inflows, which are mainly employed in sectors where the labour market is particularly tight, put downward pressure on wages. As a result, real earnings are foreseen to rise in line with productivity gains by around 2¼% over the period following large investment projects undertaken in recent years, the utilisation of new technologies and the development of human capital. Compared with the Commission services autumn 2007 forecast, labour productivity seems in line but the same does not apply to compensation per employee, where the programme's projections are higher over the whole period. Although this could feed in the unit labour cost, this dynamic is not reflected in the inflation projection. Therefore, the evolution of labour costs may induce inflationary pressures.

3.3. Macroeconomic challenges

Over the last ten years, Cyprus has been characterized by high and volatile economic growth, reflecting high exposure to external shocks. The lack of primary current expenditure restraint and the temporary composition effects of the recent increase in tax revenues highlight the need for better expenditure. It also highlights the need for the avoidance of a pro-cyclical stance. This would help to stabilise the economy in the new context of euro area membership. The reform of the pension system and a timely implementation of the adopted reforms in health care would also contribute to the control of primary spending, while underpinning the sustainability of public finances in the long run.

Box 2: Good or bad economic times?

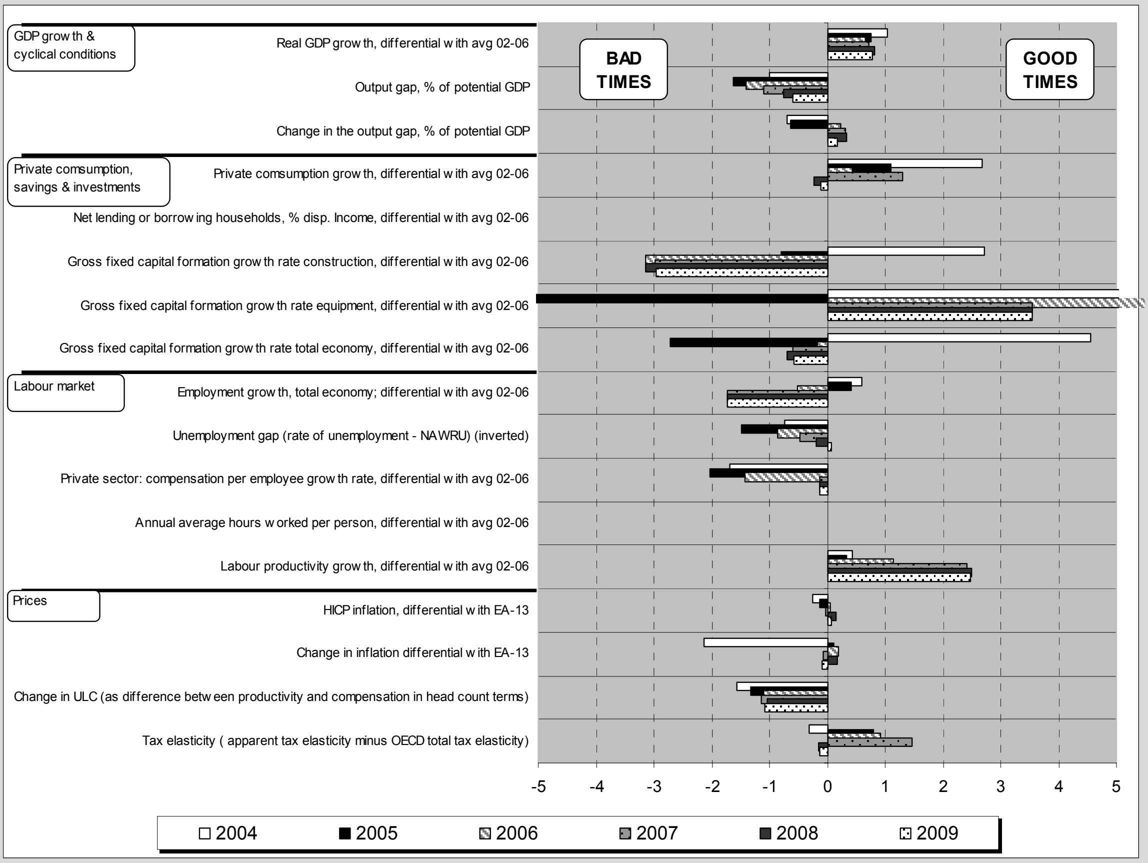
According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times, considering the economic outlook and taking into account tax elasticities in the period 2007-2009.

Although the output gap is negative it is gradually closing over the programme period, with medium-term GDP growth projected to be higher than in the recent past. Private consumption and investment is forecast to enjoy strong growth, although it is expected to decelerate to more historical levels over the forecast horizon from the particularly high levels of the recent past. Labour market conditions will remain tight, although large foreign workers inflows would help covering shortages in various sectors. Employment growth is projected to maintain a healthy pace while unemployment declines. Productivity is expected to accelerate, as a result of strong investment undertaken the last few years, while real earnings are foreseen to rise in line with productivity.

The bottom of the graph compares the apparent tax elasticity in the Commission services' 2007 autumn forecast with the OECD ex-ante elasticity. In Cyprus tax receipts are presently above the values implied by the OECD elasticities, indicating very favourable current tax developments, which under the no policy change assumption, are assumed to moderate in the next years.

All these factors point to the fact that Cyprus enjoys "good economic times".

Good versus bad times



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new programme. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 3 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the Convergence programme with the results of the new stability programme. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[11]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

For 2007, the programme foresees a government balance surplus of 1.5% f GDP, which represents a significant improvement of around 3.1 percentage points of GDP compared to the target deficit of 1.6% of GDP set in the last year's update (Table 2). In parallel, improved macroeconomic conditions compared with last year's update, a continued favourable external environment and confidence effects from euro adoption resulted in higher-than-projected growth of real GDP (4.2% instead of 3.9%), mainly driven by an increase in domestic consumption relative to external demand. In contrast, both the Commission forecast and the last year's update, projected a government deficit for 2007 of 1% and 1.6%, respectively. This large discrepancy is explained by the lack of precise information on the budgetary execution at the cut-off date of the Commission services' autumn 2007 forecast. On the basis of the latest budgetary information disclosed by the government, the revised budgetary target in the programme seems plausible.

Table 3: Budgetary implementation in 2007

[11] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

	2006		2007	
	Planned CP Dec 2006	**Outcome** SP Nov 2007	**Planned** CP Dec 2006	**Outcome** SP Nov 2007
Revenue (% of GDP)	42.1	42.6	42.2	45.9
Expenditure (% of GDP)	44.0	43.8	43.8	44.4
Government balance (% of GDP)	-1.9	-1.2	-1.6	1.5
Nominal GDP growth (%)			6.7	7.0
Nominal revenue growth (%)			7.0	15.3
Nominal expenditure growth (%)			6.2	8.5
Revenue surprise compared to target (% of GDP)			**3.7**	
Of which [1] : 1. Base effect			0.5	
2. GDP growth effect			-0.1	
3. Revenue growth effect			3.1	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*3.0*	
Expenditure surprise compared to target (% of GDP)			**0.6**	
Of which [1] : 1. Base effect			-0.2	
2. GDP growth effect			-0.1	
3. Expenditure growth effect			0.9	
Government balance surprise compared to target (% of GDP)			**3.1**	
Of which: 1. Base effect			0.7	
2. GDP growth effect			0.0	
3. Revenue / expenditure growth effect			2.2	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source :
Commission services

Total expenditure for 2007 is estimated at 44.4% of GDP, broadly in line with the Commission services' autumn forecast but considerably higher than budgeted in the December 2006 update of the Convergence Programme (43.8% of GDP). This is mainly due to higher-than-expected social transfers other than in kind by 0.6 percentage points of GDP, which are not sufficiently explained in the programme. However, higher than expected tax receipts in 2007 compared to 2006, both from direct and indirect taxes, are estimated to boost total revenues by 3.3 percentage points of GDP and more than offset the rise in total expenditures. Compared to 2006, revenues from indirect taxes are estimated to increase by 1.8 percentage points of GDP in 2007, while revenues from direct taxes would increase by 2.6 percentage points of GDP. In contrast, property taxes are estimated to decline by 0.7 percentage points. No one-offs or other temporary measures are included.

The cyclically adjusted balance is estimated to improve from a deficit of about ¾% of GDP in 2006 to a surplus of 1¾ % in 2007. Since there are no one-off measures in 2007, the structural (the cyclically-adjusted balance net of one-offs and other temporary measures) improvement is estimated at 2½% of GDP in 2007. This is in line with the Council opinion of 27 February 2007 on the previous update of the convergence programme, which invited Cyprus in particular "*to implement the fiscal consolidation path as foreseen in the programme*".

The programme considers half of the extraordinary increase of revenues in 2007 as a one-off that will not repeat in the following years. However, higher-than-expected revenues in 2007 seem largely explained by composition effects associated with an asset and property boom, which mainly affect indirect taxes. Consequently, although these revenues might be of a transitory nature, they cannot be considered as a pure one-off as laid down in the definition set in the Code of Conduct.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme's budgetary strategy

After declining sharply to a deficit of 1.2% of GDP in 2006, from 2.4% of GDP in 2005, the general government balance is estimated to show a surplus of 1.5% of GDP in 2007, which would decline to 0.5% of GDP thereafter, before rebounding slightly to 0.7% in 2010-2011. The total worsening of the government surplus between 2007 and 2011 is about 0.8 percentage point in nominal terms. The estimated structural government surplus of around 1.8% of GDP in 2007 has allowed Cyprus to go beyond its specific medium-term objective (MTO) of a structural deficit (i.e. a cyclically-adjusted deficit net of one-off and other temporary measures) of 0.5% of GDP, one year earlier than scheduled in the previous programme. On the back of the public finances' turnaround in 2007 and the improved macroeconomic prospects, the programme proposes a more ambitious MTO of a balanced budgetary position as a way to safeguarding the important fiscal consolidation achieved so far.

With interest expenditure falling by about 1 percentage points of GDP over the programme period, the primary balance is projected to worsen by 1.9 percentage points. Particularly, after attaining a surplus of 4.7% of GDP in 2007, from a surplus of 2.1% a year earlier, the primary balance is planned to decline sharply to 2.9% of GDP in 2008 and remain broadly constant thereafter. This pattern represents a reverse of the upward trend projected in the previous update of the programme against a broadly unchanged macroeconomic scenario, except for 2007, which is more favourable. According to the programme, the projected downward trend is affected by the gradual deterioration in the balance of the Social Security Fund due to the gradual negative impact of population ageing.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance mentioned in the programme for 2007 is just ¼% of GDP (which is the figure shown in Table 4). This is due to the fact that the programme considers 1½ percentage points of GDP of the revenues collected in 2007 as a one-off and so it is excluded from the structural balance. However, although transitory in nature, this amount of revenues does not qualify as a one-off. Therefore, it is not considered as such by the Commission services, so the structural balance in 2008 should be 1¾% of GDP. As a result, the structural balance is projected to worsen by some 1% of GDP over the programme period, from a surplus of 1¾% of GDP in 2007 to a surplus of ¾% of GDP in 2011. Most of the worsening is foreseen to concentrate in 2008. This is attributed to the projected deceleration in 2008 of the growth rate of revenues, which are assumed to return to historical levels after the extraordinary performance in 2007. The programme projects a further worsening of the structural balance of less than ¼ percentage points by 2011.

Table 4: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Nov 2007**	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**
	CP Dec 2006	*-1.9*	*-1.6*	*-0.7*	*-0.4*	*-0.1*	*n.a.*
	COM Nov 2007	-1.2	-1.0	-0.8	-0.6	n.a.	n.a.
General government expenditure (% of GDP)	**SP Nov 2007**	**43.8**	**44.4**	**43.8**	**44.0**	**44.0**	**44.1**
	CP Dec 2006	*44.0*	*43.8*	*43.0*	*42.7*	*42.2*	*n.a.*
	COM Nov 2007	43.8	45.9	45.5	45.4	n.a.	n.a.
General government revenue (% of GDP)	**SP Nov 2007**	**42.6**	**45.9**	**44.3**	**44.5**	**44.6**	**44.7**
	CP Dec 2006	*42.1*	*42.2*	*42.3*	*42.3*	*42.1*	*n.a.*
	COM Nov 2007	42.6	45.0	44.8	44.8	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Nov 2007**	**-0.8**	**0.3**	**0.7**	**0.7**	**0.8**	**0.7**
	CP Dec 2006	*-1.9*	*-1.2*	*-0.3*	*0.0*	*0.3*	*n.a.*
	COM Nov 2007	-0.7	-0.6	-0.5	-0.4	n.a.	n.a.
Real GDP (% change)	**SP Nov 2007**	**3.8**	**4.2**	**4.1**	**4.0**	**4.0**	**4.0**
	CP Dec 2006	*3.7*	*3.9*	*4.1*	*4.1*	*4.1*	*n.a.*
	COM Nov 2007	3.8	3.8	3.9	3.9	n.a.	n.a.

Note:

[1] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and termporary measures according to the Commission services' autumn forecast. The programme considers revenues in 2007 amounting to 1.5% of GDP as one-offs. Although transitory in nature, this amount of revenues does not qualify as a one-off. Therefore, it is not considered as such by the Commission services. No other one-off or temporary measures are presented.

Source:
Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)

4.2.2. The composition of the budgetary adjustment

The narrowing of the general government surplus by ¾ of a percentage point of GDP over the period mainly reflects a fall in the share of total revenues over GDP by 1¼ percentage points, while total expenditure is planned to decline by just ¼ percentage point of GDP on the back of structural measures to restrain expenditure. In contrast to the practice followed in the previous years, the programme does not incorporate any one-off measures. However, as discussed in section 4.1, it considers half of the extraordinary increase of revenues in 2007 as a one-off. The extraordinary turnaround in 2007 is projected to ease off over the programme period. The programme expects a deceleration in the rate of growth of revenues as a result of lower capital taxes and land and survey fees, an increase of tax-free income, and a full impact of the 2007's VAT reductions on specific goods and services. This base effect also explains the significant deviations of programme's targets in each year from those of the previous programme and from the projections of the Commission services' autumn 2007 forecast.

The fall in total revenues is concentrated in 2008 (1.6 percentage points of GDP), with indirect tax receipts accounting for half of the reduction, while property income and other revenues decline both by 0.3 percentage points. Thereafter, total revenues will gradually recover by 0.4 percentage points over the rest of the programme period in line with increases in direct tax revenues, which reflect employment and wage gains.

Regarding total expenditure, a decline of interest expenditure by 1 percentage point will be partially offset by an increase in primary expenditure of around ¾ of a percentage point. The latter includes an increase in social payments and "other" expenditures by ½ of a percentage point each, partially offset by a planned reduction in compensation of employees, subsidies and public investment accounting for ¼ of a percentage point.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007
Revenue	**42.6**	**45.9**	**44.3**	**44.5**	**44.6**	**44.7**	**-1.2**
of which:							
- Taxes on production and imports	17.8	19.6	18.9	18.9	18.9	18.9	**-0.7**
- Current taxes on income, wealth, etc.	10.9	13.5	13.2	13.4	13.5	13.7	**0.2**
- Social contributions	7.9	7.9	7.9	8.0	8.0	8.0	**0.1**
- Other (residual)	6.0	4.9	4.3	4.2	4.2	4.1	**-0.8**
Expenditure	**43.8**	**44.4**	**43.8**	**44.0**	**44.0**	**44.1**	**-0.3**
of which:							
- Primary expenditure	40.5	41.2	40.9	41.6	41.7	41.9	**0.7**
of which:							
Compensation of employees	14.9	14.6	14.5	14.5	14.4	14.4	**-0.2**
Intermediate consumption	5.6	5.5	5.5	5.5	5.5	5.5	**0.0**
Social payments	12.4	13.1	12.8	13.4	13.4	13.6	**0.5**
Subsidies	0.5	0.6	0.6	0.5	0.5	0.5	**-0.1**
Gross fixed capital formation	3.0	3.0	3.0	2.9	2.9	2.9	**-0.1**
Other (residual)	4.1	4.5	4.6	4.8	4.9	5.0	**0.5**
- Interest expenditure	3.3	3.2	2.9	2.4	2.3	2.2	**-1.0**
General government balance (GGB)	**-1.2**	**1.5**	**0.5**	**0.5**	**0.7**	**0.7**	**-0.8**
Primary balance	**2.1**	**4.7**	**3.4**	**2.9**	**2.9**	**2.8**	**-1.9**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**-1.2**	**1.5**	**0.0**	**0.5**	**0.7**	**0.7**	**-0.8**
Output gap[1]	-1.0	-0.7	-0.6	-0.6	-0.4	0.0	**0.7**
Cyclically-adjusted balance[1]	-0.8	1.8	0.7	0.7	0.8	0.7	**-1.1**
Structural balance[2]	**-0.8**	**1.8**	**0.7**	**0.7**	**0.8**	**0.7**	**-1.1**
Change in structural balance		*2.6*	*-1.1*	*0.0*	*0.1*	*-0.1*	
Structural primary balance[2]	2.5	5.0	3.6	3.1	3.1	2.9	**-2.1**
Change in structural primary balance		*2.5*	*-1.4*	*-0.5*	*0.0*	*-0.2*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. The programme considers revenues in 2007 amounting to 1.5% of GDP as one-offs. Although transitory in nature, this amount of revenues does not qualify as a one-off. Therefore, it is not considered as such by the Commission services. No other one-off or temporary measures are presented.

Source :
Stability programme; Commission services' calculations

A key element of the fiscal strategy presented in the programme is to keep public expenditure growth below that of nominal GDP. The programme underlines the importance of the medium-term budgetary framework (MTBF) for the 3-year period 2007-2009, which was fully introduced in 2007. According to the MTBF, annual budgetary processes are linked to the achievement of medium–term budgetary targets through the introduction of expenditure rules at ministry level. Through the MTBF, the programme envisages to limit the practice of supplementary budgets, to introduce gradually quantifiable programme targets and performance-based budgeting and rationalise the public expenditure. The projected reduction of primary expenditures (current and capital) is associated with the imposition of ceilings on their annual growth rate, although excluding public wages. These ceilings were introduced in 2006, but the successive updates of the Convergence Programme and the new Stability programme, fail to provide sufficient information and concrete data that would allow an assessment of their actual impact. In particular, the programme does not include a detailed explanation of such ceilings and their enforcement mechanism. In parallel, expenditure targets over the programme period are from ½ to 1¾ percentage points higher, depending on the year, than projected in the previous programme. For 2007, this is due to the accelerated expropriation of land for development projects in conjunction with the advanced implementation of the Agricultural Development Scheme 2004-06. For 2008 and the following years, the programme projects a gradual deterioration of the balance of the Social Security Funds due to the impact of population ageing.

Box 3: The budget for 2008

The 2008 budget was approved by the Parliament by mid-December 2007. The budget law targeted a nominal general government deficit of 0.5% of GDP, which, according to the programme, has been changed to a surplus of 1.5% of GDP. On the revenue side, the main measures are revenue-decreasing and consist of a reduction of the VAT rate in certain goods and services, increase of tax-free income and a reduction of consumption tax rate in certain categories of goods and services. On the expenditure side, there are no major measures. No quantitative impact is provided.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Reduction in the excise duty levied on heating oil (-0.05% of GDP)	o Application of expenditure ceilings on current and capital expenditures
o Application of the reduced VAT rate of 5% on specific goods and services such as products of bakeries and confectioneries, entrance fees to cultural and sport events (-0.05% of GDP)	o Gradual extension of the retirement age in the public sector to 63 years of age
o Increase of tax-free income for individuals and alignment of tax brackets (-0.05% of GDP)	o Reduction of net interest payments by running down stock of debt financed by sinking fund deposits

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services, 2008 budget law.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 6 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the stability programme.

The official government balance projection for 2007 is of a surplus of 1.5% of GDP, thus 2.5 percentage points higher than the Commission services' autumn forecast, as the 2007 estimated outcome was not known at the latter's cut off date, while for 2008 and 2009 the official figures are around 1¼ percentage points higher. These differences are explained by the extraordinary developments in the collection of tax revenues in 2007, which have a base effect on the following years. The programme considers half of the extraordinary increase of revenues in 2007 as a one-off, thus not expected to continue in 2008. Although these revenues might be of a transitory nature, according to the rules set in the Code of Conduct, they cannot be accounted as a pure one-off. Indeed, higher-than-expected revenues in 2007 can largely be explained by composition effects associated with an asset and property boom, which would imply some carry-over in 2008 and following years. On the basis of currently available information, it is difficult to disentangle the different drivers of the significant increase in tax revenues. Consequently, the degree of the carry-over in 2008 and in the following years remains highly uncertain.

Table 6: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**42.6**	**45.0**	**45.9**	**44.8**	**44.3**	**44.8**	**44.5**	**44.6**	**44.7**
of which:									
- Taxes on production and imports	17.8	19.0	19.6	19.0	18.9	19.0	18.9	18.9	18.9
- Current taxes on income, wealth, etc.	10.9	13.3	13.5	13.3	13.2	13.3	13.4	13.5	13.7
- Social contributions	7.9	7.6	7.9	7.6	7.9	7.6	8.0	8.0	8.0
- Other (residual)	6.1	5.1	4.9	4.9	4.3	4.9	4.2	4.2	4.1
Expenditure	**43.8**	**45.9**	**44.4**	**45.5**	**43.8**	**45.4**	**44.0**	**44.0**	**44.1**
of which:									
- Primary expenditure	40.5	42.8	41.2	42.5	40.9	42.5	41.6	41.7	41.9
of which:									
Compensation of employees	14.9	14.2	14.6	14.2	14.5	14.2	14.5	14.4	14.4
Intermediate consumption	5.6	5.2	5.5	5.2	5.5	5.2	5.5	5.5	5.5
Social payments	12.4	12.8	13.1	13.1	12.8	13.1	13.4	13.4	13.6
Subsidies	0.5	0.7	0.6	0.5	0.6	0.5	0.5	0.5	0.5
Gross fixed capital formation	3.0	3.0	3.0	3.0	3.0	3.0	2.9	2.9	2.9
Other (residual)	4.1	6.9	4.5	6.6	4.6	6.6	4.8	4.9	5.0
- Interest expenditure	3.3	3.1	3.2	3.0	2.9	2.8	2.4	2.3	2.2
General government balance (GGB)	**-1.2**	**-1.0**	**1.5**	**-0.8**	**0.5**	**-0.6**	**0.5**	**0.7**	**0.7**
Primary balance	**2.1**	**2.2**	**4.7**	**2.2**	**3.4**	**2.2**	**2.9**	**2.9**	**2.8**
One-off and other temporary measures	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-1.2**	**-1.0**	**0.0**	**-0.8**	**0.5**	**-0.6**	**0.5**	**0.7**	**0.7**
Output gap[2]	-1.4	-1.1	-0.7	-0.8	-0.6	-0.6	-0.6	-0.4	0.0
Cyclically-adjusted balance[2]	-0.7	-0.6	1.8	-0.5	0.7	-0.4	0.7	0.8	0.7
Structural balance[3]	**-0.7**	**-0.6**	**1.8**	**-0.5**	**0.7**	**-0.4**	**0.7**	**0.8**	**0.7**
Change in structural balance		*0.1*	*2.6*	*0.1*	*-1.1*	*0.1*	*0.0*	*0.1*	*-0.1*
Structural primary balance[3]	2.6	2.6	5.0	2.5	3.6	2.5	3.1	3.1	2.9
Change in structural primary balance		*0.0*	*2.5*	*-0.1*	*-1.4*	*-0.1*	*-0.5*	*0.0*	*-0.2*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. The programme considers revenues in 2007 amounting to 1.5% of GDP as one-offs. Although transitory in nature, this amount of revenues does not qualify as a one-off. Therefore, it is not considered as such by the Commission services. No other one-off or temporary measures are presented.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

From 2009, there are some downside macroeconomic risks in achieving the fiscal targets. These risks are mainly associated with favourable projections of GDP growth above potential, but also to favourable projections on private consumption growth. Moreover, given the exposure of the Cypriot economy to external shocks, due to its small size and openness, and its strong specialisation in tourism, unforeseen geopolitical tensions in the region could also adversely affect growth prospects. According to the sensitivity analysis undertaken in the programme, a lower growth rate of real GDP by 2 percentage points would lead to deterioration of the budget balance at the beginning of the programming period by some 0.8 percentage points of GDP, leading to a deficit of 0.3% of GDP in 2008, reaching 2.5% of GDP by the end of the programme period.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2007-2011 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2011, the cyclically-adjusted balance would be -0.5 percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.5 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

According to the programme, the envisaged path of reduction would be largely underpinned by the fading out of the transitory revenues observed in 2007 (1.5 percentage points of GDP), while planned revenue-decreasing measures and expenditure reduction will have a much less important impact (around ½ percentage point of GDP).

Table 7 : Assessment of tax projections

	2008			2009			2010	2011
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	-1.1	-0.1	0.7	0.3	0.0	0.7	0.1	0.2
Difference (SP – COM)	-1.0		/	0.3		/	/	/
of which [2] *:*								
- discretionary and elasticity component	*-1.3*		/	*-0.1*		/	/	/
- composition component	*0.7*		/	*0.5*		/	/	/
Difference (COM - OECD)	/	-0.8		/	-0.7		/	/
of which [2] *:*								
- discretionary and elasticity component	/	*-1.2*		/	*-1.2*		/	/
- composition component	/	*-0.2*		/	*0.0*		/	/
p.m.: Elasticity to GDP	0.6	1.0	1.1	1.1	1.0	1.1	1.0	1.1

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

Source :

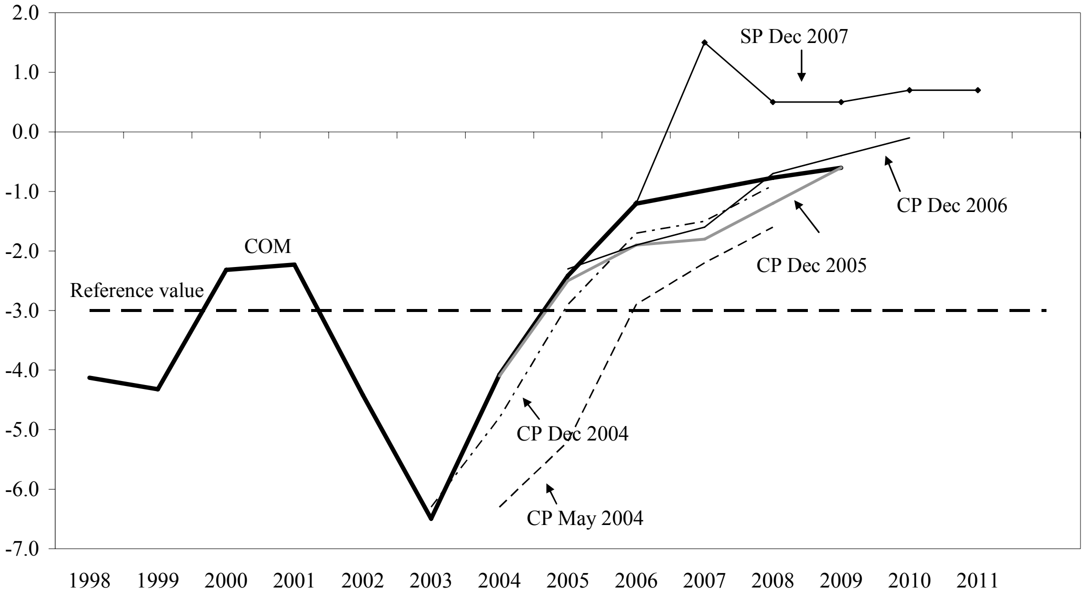
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Table 7 presents annual changes in the overall tax-to-GDP ratio and the tax elasticity relative to GDP. Based on this data, it appears that the programme is not fully consistent with the Commission services autumn 2007 forecast in its assumptions on the tax ratio for 2008 and 2009. The composition component is positive, denoting that national authorities are more optimistic than the Commission regarding developments in the tax base, especially in 2008. Nonetheless, the discretionary and elasticity component is negative, especially in 2009, indicating that the authorities simply reflect the assumption of tax revenues returning to normal levels after the extraordinary revenues in 2007.

In view of the extraordinary growth rates observed in recent years in the field of revenue collection and a potential carry-over effect of 2007, the estimates for 2008 and 2009 seem prudent. In this context, the programme lists a number of measures planned for 2008 aiming at reducing the tax burden. The heavy reliance of the consolidation strategy on the respect of expenditure ceilings may constitute an additional risk to the achievement of the budgetary targets, especially as the ceilings were introduced in 2006 but, as indicated above, the programme provides only limited information (on their nature and their enforcement mechanism) that would allow an assessment of their actual impact. The programme does not clarify either whether the ceilings, and the new medium-term budgetary framework more generally, will prevent the submission of supplementary expenditure laws during the year.

Summing up, the envisaged reduction of government surplus is due to a large extent to the return of tax elasticities back to historical levels, as exceptionally high revenues are not anticipated to continue in 2008. Taking into account the lack of detailed information and concrete data on the MTBF expenditure ceiling's impact so far, there are downside risks associated with expenditure slippages. Although the Cypriot government has so far over-achieved the budgetary targets set in previous updates, expenditure targets have been regularly overrun. However, given the prudent revenue projections, the overall assessment is that the budgetary outcome for 2008 and 2009 could be better than targeted in the programme, while thereafter there is a risk that the budgetary outcomes could be worse than targeted.

Figure 6: Government balance projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

The programme puts forward a more ambitious MTO of a balanced budget in structural terms, which, not only has already been over-achieved in 2007, but will be maintained over the programming period. Despite the risks to the budgetary targets, the budgetary strategy outlined in the programme seems sufficient to ensure that this new MTO will be maintained in each year of the programme period. The structural surplus, based on the Commission services' calculations on the basis of data from the programme, is estimated at 1¾% of GDP in 2007. However, thereafter is projected to worsen to ¾% of GDP in 2011. With the above-mentioned minimum benchmark estimated at a cyclically-adjusted deficit of about 1.8 % of GDP, a safety margin against breaching 3% of GDP deficit threshold seems already provided from 2007 onwards. Given the good times, the structural surplus reduction by more than 1 percentage points of GDP in 2008, from 1¾% of GDP the previous year, would imply a strongly pro-cyclical fiscal stance, which would not be in line with the Stability and Growth Pact. However, the consideration by the Government that the rise in revenues in 2007 may be only partially permanent reflects a prudent budgetary approach, according to which revenues from asset-related composition effects should not trigger additional permanent expenditure. Although the planned reduction of the budgetary surplus compared to 2007 reflects to a large extent an expected normalisation of tax revenues, there is a risk that the stance in 2008 may turn out to be procyclical, given the risks associated to the enforcement of the expenditure ceilings.

Table 8: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	Risk that may not be in line in 2008	Risk that may not be in line in 2008

Notes:

[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a structural deficit of 1¾% of GDP for Cyprus). These benchmarks represent estimates and as such need to be interpreted with caution.

[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".

[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

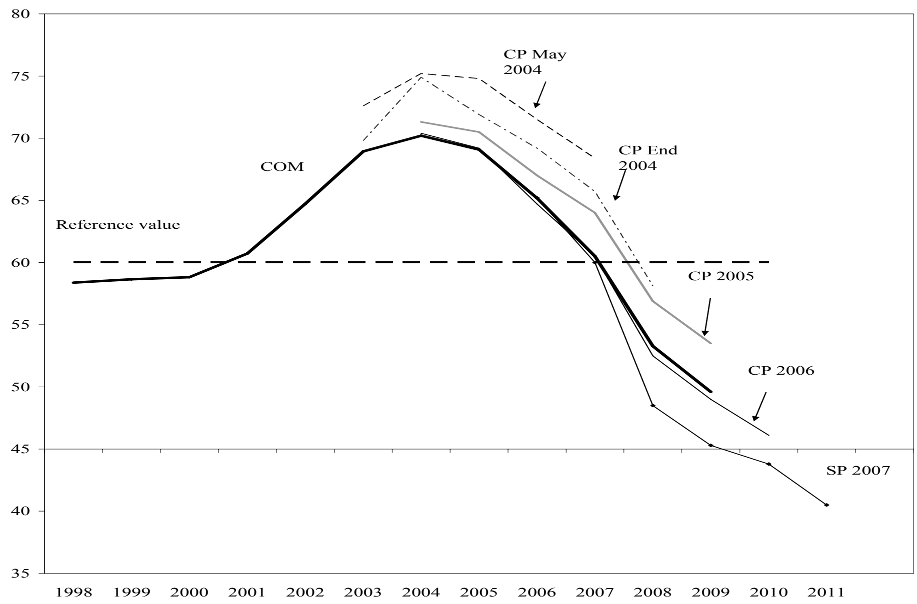
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The December 2007 update projects a progressively declining debt-to-GDP ratio over the programme's period planned to reach 40½% of GDP by 2011, from 60% in 2007, and 48½% in 2008, mainly driven by high primary surpluses. These targets are better compared with the December 2006 update's targets of 60½% and 52½% of GDP for 2007 and 2008 respectively.

Figure 7: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

The government debt in 2007 has been influenced by the positive impact on primary surplus and the stock-flow adjustments (SFA) of the budgetary turnaround in 2007. In the case of SFA, while they were negative at around -1% of GDP in 2006, they have turned positive in 2007 at about 0.6% of GDP. This is relatively low compared to Cyprus' track record of positive SFA (debt-increasing), which have been among the highest in the EU, with an annual average of about 2½% of GDP during 2000-2004. Such relatively high debt-increasing SFA are the consequence of the significant accumulation of financial assets held at the Central Bank, originated from the 2007 budgetary outcome, which could not be used for redeeming prematurely government debt. For 2008, the programme projects a significant negative SFA for 2008, amounting to around 7% of

GDP, associated with the anticipated elimination of most of the sinking fund deposits in the Central Bank[12]. This explains why most of the fall in government debt concentrates in 2008 (to 48½% of GDP). In contrast, SFA in 2009 and, especially in 2010, is projected to turn back to positive, on the back of unspecified drivers.

Table 9: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**68.2**	**65.2**	**60.5**	**60.0**	**53.3**	**48.5**	**49.6**	**45.3**	**43.8**	**40.5**
Change in the ratio	2.1	-3.9	-4.7	-5.2	-7.2	-11.5	-3.7	-3.2	-1.5	-3.3
Contributions[2] *:*										
Primary balance	**1.0**	**-2.1**	**-2.2**	**-4.7**	**-2.2**	**-3.4**	**-2.2**	**-2.9**	**-2.9**	**-2.8**
"Snow-ball" effect	**-0.4**	**-0.8**	**-1.1**	**-1.0**	**-0.9**	**-1.0**	**-0.4**	**-0.5**	**-0.4**	**-0.5**
Of which:										
Interest expenditure	3.3	3.3	3.1	3.2	3.0	2.9	2.8	2.4	2.2	2.1
Growth effect	-1.9	-2.5	-2.3	-2.6	-2.2	-2.3	-2.0	-1.8	-1.7	-1.6
Inflation effect	-1.9	-1.6	-1.9	-1.6	-1.7	-1.6	-1.3	-1.1	-0.9	-0.9
Stock-flow adjustment	**1.6**	**-1.0**	**-1.4**	**0.6**	**-4.0**	**-7.1**	**-1.0**	**0.2**	**1.9**	**0.0**
Of which:										
Cash/accruals diff.	0.4	-0.1		-0.3		0.0		0.0	0.0	0.0
Acc. financial assets	1.1	-0.9		1.0		-6.6		0.6	2.0	0.2
Privatisation	*0.0*	*0.0*		*n.a.*		*0.3*		*n.a.*	*n.a.*	*n.a.*
Val. effect & residual	0.1	0.1		0.1		0.0		0.0	0.0	0.0

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

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

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

Compared to the Commission services' 2007 autumn forecast, the 2007 target appears broadly in line. However, the contribution of the stock-flow adjustments (SFA) and the primary balance are significantly different. This is explained by the unexpected budgetary turnaround in 2007. For 2008 and 2009, government targets appear favourable. The Commission services' autumn 2007 forecast projects a slower decline in the debt-to-GDP ratio, especially in 2008. This is mainly explained by the significant negative SFA resulting form a large reduction in sinking funds, information which was not available at the cut-off date of the Commission forecast, but also by the programme's

[12] According to the provisions of the Development Loans Law the Cypriot Government was obliged to contribute annually, for every government stock issued, to a so-called 'sinking fund' held in the national central bank. The purpose of these contributions was to accumulate by the maturity of every stock issued the amount that was to be repaid. The contributions to the sinking funds were financed by borrowing, thus leading to an increase of gross government debt. Repayments of debt using the sinking funds contribute to the reduction of gross government debt.

more favourable outlook for growth and for primary balance, with the latter projected to reach 3¼% of GDP in 2008 vis-à-vis 2¼% of GDP in the Commission forecasts.

As for the deficit targets, the risks to the projected debt deduction path appear to be broadly balanced. The programme builds on the achievement of the debt targets in 2006 and 2007 and projects a substantial decline in 2008, mainly on the back of a large debt decreasing SFAs in the year. The programme includes an analysis of the sensitivity of debt to real GDP growth rate and interest rate variations. Three different scenarios are considered. They assume that, while automatic stabilizers would be allowed to operate fully, the planned (non cyclical) expenditure paths could not be altered. The first alternative scenario assumes that the GDP growth rate is 1 percentage point higher each year, compared with the baseline scenario. Other things being equal, the debt-to-GDP ratio would decline by an additional 1.6 percentage points of GDP, by the end of the programme horizon. The second scenario assumes a lower real GDP growth rate by 2 percentage points per year. Respectively, the debt-to-GDP ratio would be higher by 4.8 percentage points of GDP compared with the baseline scenario, by the end of the programme horizon. The third alternative scenario assumes that interest rates remain 100 basis points above baseline in each year during 2008-2011. The programme estimates that the debt-to-GDP ratio would be some 1½ percentage points of GDP lower than the baseline, by the end of the programme's period.

The sensitivity analysis points out the high importance of growth assumptions for the envisaged consolidation path. The moderate impact from interest rates differentials is because the bulk of the debt stock is at fixed interest rates and relatively long maturities. According to the programme, the share of short-term debt has been reduced significantly during 2007 at almost 2%, from 5.7% last year. During the period covered by the programme, the Government plans to keep short-term debt (below one-year maturity) at low level, as a share of the total outstanding debt. The foreign exchange risk exposure of debt remained similar to last year's level, as foreign currency denominated debt remained at 23% of total debt during 2007. However, the euro adoption will reduce substantially Cyprus' foreign debt, since the largest part of it is currently denominated in euro. In view of the projected path and the broadly neutral risk assessment, the debt ratio is projected to fall below the reference value by 2008 and seems to be sufficiently diminishing thereafter, towards 40% in 2011.

5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 10 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology. [13] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

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13 See the accompanying "methodological paper" for a description of the property income projections.

Table 10: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
Total age-related spending	16.4	16.5	17.6	20.5	23.4	28.2	11.8
- Pensions	6.9	8.0	9.9	12.2	15.0	19.8	12.9
- Healthcare	2.9	3.1	3.4	3.6	3.9	4.0	1.1
- Long-term care	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Education	6.3	5.1	4.0	4.3	4.2	4.0	-2.2
- Unemployment benefits	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Property income received	1.0	0.8	0.7	0.6	0.6	0.6	-0.4

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in Cyprus is significantly above the average of the EU, rising by 11.8% points of GDP between 2004 and 2050. The bulk of this increase is due to the expected increase in expenditure on pensions, which are projected to rise by 12.9% points, the highest in the EU. The increase in health-care expenditure is projected to be 1.1% points of GDP, which is below the EU average. No projections of the long-term care were available in the Ageing Report.

Table 11: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	-0.9	4.1	8.9	1.5	6.3	9.0
of which:						
Initial budgetary position (IBP)	-4.7	-4.4	-	-2.5	-2.1	-
Debt requirement in 2050 (DR)	-0.6	-	-	-0.4	-	-
Long-term change in the primary balance (LTC)	4.4	8.5	-	4.4	8.5	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 11 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the “2007 scenario”, the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.1% of GDP.[14] It is significantly lower, by 3p.p. of GDP, compared to last year's assessment, as a result of the significant improvement in the structural primary balance in 2007 (5% of GDP) compared to 2006 (2.5p.p. of GDP as estimated today and 1.8p.p. as estimated a year ago).

The initial strong budgetary position with a structural primary balance of 5% of GDP contributes to the reduction of gross debt and the accumulation of financial assets. According to both sustainability gaps, the long-term budgetary impact of ageing is one of the highest in the EU.

The estimated reduction in the primary balance over the programme period of around 2p.p. of GDP (which inter alia reflects the fading out of temporary factors on the budget balance such as the real estate boom) has a negative impact on the sustainability gap,

[14] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -0.9% of GDP the '2007 scenario' and 1.5% of GDP in the 'programme scenario'.

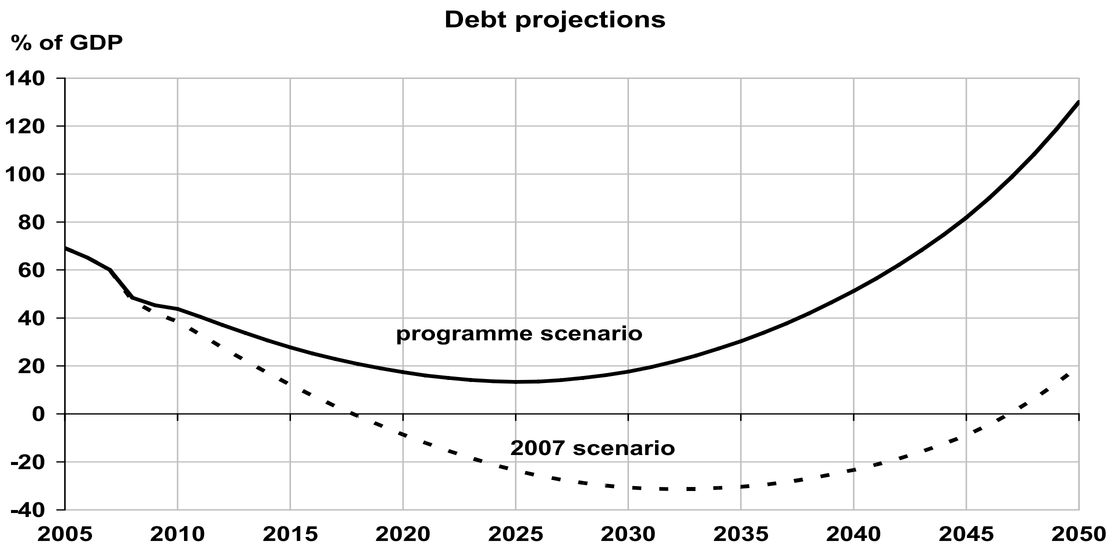
showing the importance of maintaining a strong structural budgetary position to contain risks to the sustainability of public finances.

The required primary balance (RPB) is almost 9% of GDP, significantly higher that the structural primary balance of about 3% of GDP in the last year of the programme's period.

The sustainability gap indicators would increase by up to 0.4p.p. of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is estimated in the programme at 60% of GDP in 2007. According to the 'programme scenario', the debt ratio would decrease up to the mid-2020s and then increase significantly to be above 100% of GDP in 2050. According to the "2007 scenario", the debt ratio would remain below the 60% reference value for the whole projection period,[15] thanks to the strong budgetary position in 2007, which according to the budgetary plans included in the programme would not be maintained during the programme period.

Figure 8: Long-term projections for the government debt ratio



5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

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[15] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

First, the sustainability indicators are calculated on the basis of the long-term budgetary projections in the Ageing Report. The programme presents another set of long-term projections[16], which are based on somewhat different demographic and economic assumptions, notably higher net immigration,[17] from those of the Ageing report. As a result, the increase in pension expenditure, while being among the highest in the EU, is significantly lower (+8.6p.p. of GDP between 2010 and 2050 compared to 11.8p.p. of GDP). Higher migration leads immediately to a higher labour supply and therefore to higher GDP but should translate over the long run into higher pension expenditure as well, with higher pension rights accrued to be paid to new immigrants. The overall effect on sustainability should therefore be more limited than what could be inferred from projections stopping in 2050 when only a small share of new migrants has retired.

Second, the programme mentions discussions of a reform of the social security schemes that could be agreed in the first half of 2008. This reform includes:

- a significant increase in contribution rates over the long-term, possibly seven increases of 1.3 p.p. every five years starting in 2008. According to the programme, it should increase the revenue to GDP ratio by 3.5p.p. of GDP in 2050;[18]
- some parametric changes (notably stricter eligibility conditions to obtain old age pension) which, according to the programme, could reduce pension expenditure by around 1p.p. of GDP.

5.2.3. Assessment

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. Maintaining high primary surpluses and adopting pension reform measures aimed at containing the significant increase in age-related expenditures, as currently envisaged, would contribute 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.

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[16] Those projections were not submitted to a peer review within the AWG.

[17] This change in assumptions is based notably on recent figures which show significantly higher net inflows of migrants for the year 2004 and 2005 than assumed in the Ageing report. With the change in assumptions, net migration would be 50% higher in cumulated terms over the period up to 2050. It could be noted that Cyprus is already assumed in the population projections of the Ageing report to have, together with Malta and Luxembourg, the highest cumulated net inflow of migrants up to 2050 compared to its population in 2004 (of around 30%).

[18] The issue of how to take into account projected changes in the revenue ratio is discussed further in Section IV.3.2 of the Sustainability Report. Changes in contribution rates are not considered to be a risk-reducing factor.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The programme a presentation of the government's policy strategy for the improvement and long term sustainability of public finances and the creation of a growth supportive environment, in the context of the Lisbon strategy.

In the framework of the euro adoption, the programme points out that structural reforms will assist in the development of sound and flexible public finances and enable Cyprus to develop a robust and flexible economy, able to withstand external shocks. It also indicates that budgetary reforms aiming at the preparation of their annual budgets, using the Medium Term Budgetary Framework (MBTF) and the Programme-Performance Budgeting (PPB) methods, would support these objectives. The gradual implementation of the MTBF, initiated in 2006, is supplemented by the pilot introduction of the PPB covering three ministries in 2007, and it will be required by all ministries and agencies as from 2008 onwards. For a period of two years, it will be used in parallel to the existing methodology. The MTBF-PPB framework will become the official budget method from 2011 onwards, while in the meantime the existing Financial Management Accounting System (FIMAS) will be upgraded to support it. This is expected to contribute to a more effective and efficient budgeting process, conducive in containing the expenditures by ministry according to the ceilings set. At the same time, it sets a sound basis for reallocating expenditures in favour of growth enhancing activities consistent with the priorities set by the National Reform Programme.

The reform agenda includes also expanding further and upgrading basic infrastructure, also through Private Public Partnerships (PPPs). The agenda plans the enhancement of public transportation in Cyprus, fostering a knowledge-based economy and sustainable development, promoting R&D, innovation and facilitation of ICT diffusion and enhancing human capital development. Measures include the creation of a technological park, a research centre on energy environment and water in cooperation with the Massachusetts Institute of Technology (MIT), the substantial increase in the Framework Programme of the Research Promotion Foundation's budget, the computerization of all primary and secondary schools and the creation of new research and academic institutes (Cyprus University of Technology, Open University, Cyprus Institute).

The programme reiterates a number of planned reforms of healthcare and pension systems. The healthcare system reform strategy is outlined in detail in the Implementation Report of the National Reform Programme. According to the programme, the central objectives of the National Health Insurance System (NHIS) are to improve the effectiveness via regulated competition and to contain costs. This would be achieved through, *inter alia*, restructuring public hospitals to autonomous units, with operational independence aiming at ensuring cost and efficiency gains, with a gradual phasing-out of public financial support. The implementation strategy of the NHIS was submitted to the Health Insurance Organization (HIO) and measures have already been taken that will enable the system to begin by the end of 2008.

On pensions' reform, the programme explicitly admits that no concrete measures have been adopted yet, despite the intensification of dialogue with the social partners in 2007. Nonetheless, it presents a set of initial reforms on which consensus has been achieved and should most likely be agreed in the first half of 2008. These 'first-wave' parametric reforms would probably include phased increases in social security contribution rates, stricter eligibility conditions to obtain old-age pension, maximum limit of 4 years on credits granted to an insured person in the lower band for any period of full time education or approved training after the age of 16 (under the existing legislation there is not any maximum limit imposed) and stricter eligibility conditions for the payment of a lump sum at age 68. There was no agreement on the issue of extending further the retirement age from 63 to 65 years of age.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The macro-economic and fiscal policy focus in the National Reform Programme (NRP) and the October 2007 Implementation report is on enhancing of the quality of public finances and debt reduction, through expenditure restraint. The NRP also targets the improvement of fiscal management via gradual implementation of 3-year medium-term budgetary frameworks (MTBF) and Programme and Performance Budgeting (PPB) methods. The enhancement of the quality of public finances, by better expenditure control and linking medium-term targets with the annual budgetary procedure, as set out in the stability programme, stands fully in line with the measures in the NRP described in preceding sections. The measures analysed in the December 2007 programme to address the long-term sustainability of public finances, including labour supply and reforms in health care are fully consistent within the context of the NRP. Moreover, the positive developments from the dialogue with the social partners on the pension system reforms and the initial consensus on the first wave of measures lies in line with the October 2007 implementation report of the NRP.

The programme contains a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy. In fact, the majority of the measures and actions planned for 2007 and 2008, included in the NRP and the relevant budgetary provisions have been included in the Budget Law for 2007 and the Budget Bill for 2008. The initiatives promoted within the framework of the implementation of the Lisbon programme are financed through national an EU funds and public private partnerships. The budgetary projections in the programme fully incorporate the public finance implications of the actions envisaged in the NRP, specifically those resulting in a reduction in current expenditure through the MTBF and PPB implementation, and are consistent with the priorities of the NRP. Moreover, the programme provides systematic information on the direct budgetary costs associated with the reforms related to the microeconomic and employment areas, as envisaged in the NRP. The proposed policies require national funds amounting to around 2% of GDP in 2007, while the estimation rises to 2.7% in 2008 and 2009 and similar amounts thereafter. In addition, the programme provides a brief description of specific measures and actions of wider economic importance, such as infrastructure projects, though their financial cost is not specifically projected. Overall, taking into account the analysis provided in the NRP and the October 2007 implementation report as well as the December 2007 stability programme, it appears that the two programmes are fully integrated.

Box 4: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Cyprus' national reform programme[19] and is summarised as follows.

Cyprus' 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 is that Cyprus has made good progress in the implementation of its National Reform Programme over the 2005-2007 period. Cyprus had made good progress in fulfilling the specific commitments agreed at the 2006 Spring European Council in the priority areas.

Against the background of strengths and weaknesses identified, the Commission recommends that Cyprus is recommended to take action in the areas of: pension and health care systems reforms; enhancing life long learning; employment and training opportunities for young people.

Against the background of progress made, the Commission recommends that Cyprus is encouraged to also focus on the areas of: improving competition in professional services; further stimulate private sector R&D; and address the very high gender pay gap.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the country-specific recommendations / points to watch and the recommendations for the euro area.

Table 12: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].		X		
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate,				X

[19] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
contributing to their correction via fiscal policies.				
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		
Notes: [1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure. *Source:* *Commission services*				

Table 13: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– take steps to implement reforms of the pension and health care systems and set a timetable for their implementation with a view to improving long-term sustainability.		X		
2. Points to watch				
– *none*				X
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark				X
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability		X		
Source: *Commission services*				

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme does not fully adhere to the model structure prescribed by code of conduct. In specific, Section 7 on Institutional features of public finances is missing. The programme adds an appendix on HICP inflation prospects for 2007-2001.

(ii) Data requirements

The programme does not fully respect the data requirements of code of conduct (Annex 2 thereof) as amended by the September 2007 EFC. In specific, regarding the provision of compulsory data, Table 1d (Sectoral balances) contains a gap in line 4 (Statistical discrepancy) for 2006. Regarding the provision of optional data, Table 1d (Sectoral balances) contains gaps on capital account data for the years 2007-2011, and -Table 7 (Long-term sustainability of public finances) contains gaps on long-term care and pension reserve fund assets.

The tables on the following pages show the data presented in the December 2007 stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other data requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].	X		
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable.
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable.
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			

The SCP…	Yes	No	Comments
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable.
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable.
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Real GDP	B1*g	*12027.9*	3.8	4.2	4.1	4.0	4.0	4.0
2. Nominal GDP	B1*g	*14317.6*	6.4	7.0	7.0	6.4	6.3	6.3
Components of real GDP								
3. Private consumption expenditure	P.3	*7958*	4.2	4.9	4.2	4.0	4.0	4.0
4. Government consumption expenditure	P.3	*2085.7*	7.4	2.2	4.2	4.2	3.7	3.7
5. Gross fixed capital formation	P.51	*2332.6*	5.8	8.0	4.5	4.2	3.6	3.3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*41.9*	0.3	0.3	0.3	0.3	0.3	0.3
7. Exports of goods and services	P.6	*6323.9*	4.8	1.6	2.7	3.3	3.7	3.9
8. Imports of goods and services	P.7	*6714.1*	6.8	3.3	3.1	3.5	3.5	3.6
Contributions to real GDP growth								
9. Final domestic demand		-	5.1	5.2	4.4	4.2	4.0	4.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.0	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-1.2	-1.0	-0.3	-0.2	-0.1	0.0

Table 1b. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. GDP deflator		*119*	2.4	2.7	2.9	2.3	2.3	2.2
2. Private consumption deflator		*116.6*	2.4	2.5	2.8	2.3	2.3	2.3
3. HICP[1]		*102.2*	2.2	2.2	2.5	2.0	2.0	2.0
4. Public consumption deflator		*128.6*	2.9	2.5	2.8	2.3	2.3	2.3
5. Investment deflator		*122.4*	2.6	3.0	2.5	1.7	1.7	1.6
6. Export price deflator (goods and services)		*109.4*	1.6	2.5	2.8	2.3	2.3	2.3
7. Import price deflator (goods and services)		*111.3*	2.1	2.5	2.6	2.1	2.1	2.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*356.7*	2.1	1.9	1.8	1.8	1.8	1.7
2. Employment, hours worked[2]		*704.8*	3.4	1.9	1.8	1.8	1.8	1.7
3. Unemployment rate (%)[3]		*n.a.*	4.5	4.2	4.0	3.9	3.7	3.6
4. Labour productivity, persons[4]		*33710.7*	1.7	2.3	2.2	2.2	2.2	2.2
5. Labour productivity, hours worked[5]		*10*	0.4	2.3	2.2	2.2	2.2	2.2
6. Compensation of employees	D.1	*8132.6*	7.7	6.7	6.9	6.4	6.3	6.3
7. Compensation per employee		*22799.6*	5.5	4.8	5.0	4.5	4.5	4.5

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.9	-6.6	-6.5	-6.3	-5.9	-5.6
of which :							
- Balance on goods and services		-4.1	-4.6	-4.6	-4.6	-4.4	-4.2
- Balance of primary incomes and transfers		-1.8	-2.0	-1.8	-1.7	-1.5	-1.4
- Capital account		16.4	n.a.	n.a.	n.a.	n.a.	n.a.
2. Net lending/borrowing of the private sector	B.9	-4.7	-8.1	-7.0	-6.8	-6.6	-6.3
3. Net lending/borrowing of general government	EDP B.9	-1.2	1.5	0.5	0.5	0.7	0.7
4. Statistical discrepancy		n.a.	optional	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	*-172.6*	-1.2	1.5	0.5	0.5	0.7	0.7
2. Central government	S.1311	*-536.2*	-3.7	-0.7	-1.6	-1.3	-0.8	-0.5
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-10.8*	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	*374.4*	2.6	2.3	2.1	1.8	1.5	1.2
General government (S13)								
6. Total revenue	TR	*6098.5*	42.6	45.9	44.3	44.5	44.6	44.7
7. Total expenditure	TE[1]	*6271.1*	43.8	44.4	43.8	44.0	44.0	44.1
8. Net lending/borrowing	EDP B.9	*-172.6*	-1.2	1.5	0.5	0.5	0.7	0.7
9. Interest expenditure	EDP D.41	*470.4*	3.3	3.2	2.9	2.4	2.3	2.2
10. Primary balance[2]		*297.8*	2.1	4.7	3.4	2.9	2.9	2.8
11. One-off and other temporary measures[3]		*0*	0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		*4101.8*	28.6	33.2	32.1	32.3	32.4	32.6
12a. Taxes on production and imports	D.2	*2545.8*	17.8	19.6	18.9	18.9	18.9	18.9
12b. Current taxes on income, wealth, etc	D.5	*1555.2*	10.9	13.5	13.2	13.4	13.5	13.7
12c. Capital taxes	D.91	*0.9*	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*1128.4*	7.9	7.9	7.9	8.0	8.0	8.0
14. Property income	D.4	*165.7*	1.2	0.7	0.4	0.4	0.4	0.4
15. Other[4]		*702.6*	4.9	4.1	3.8	3.8	3.8	3.8
16=6. Total revenue	TR	*6098.5*	42.6	45.9	44.3	44.5	44.6	44.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			36.5	41.1	40.0	40.3	40.4	40.6
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	*2933.3*	**20.5**	**20.1**	**19.9**	**20.0**	**20.0**	**19.9**
17a. Compensation of employees	D.1	*2128.6*	14.9	14.6	14.5	14.5	14.4	14.4
17b. Intermediate consumption	P.2	*804.8*	5.6	5.5	5.5	5.5	5.5	5.5
18. Social payments (18=18a+18b)		*1777.8*	12.4	13.1	12.8	13.4	13.4	13.6
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*19.3*	0.1	0.2	0.2	0.2	0.2	0.1
18b. Social transfers other than in kind	D.62	*1758.5*	12.3	12.9	12.6	13.2	13.3	13.5
19=9. Interest expenditure	EDP D.41	*470.4*	3.3	3.2	2.9	2.4	2.3	2.2
20. Subsidies	D.3	*76.7*	0.5	0.6	0.6	0.5	0.5	0.5
21. Gross fixed capital formation	P.51	*431.1*	3.0	3.0	3.0	2.9	2.9	2.9
22. Other[6]		*581.8*	4.1	4.5	4.6	4.8	4.9	5.0
23=7. Total expenditure	TE[1]	*6271.1*	43.8	44.4	43.8	44.0	44.0	44.1
p.m.: Government consumption (nominal)	P.3	*2682.5*	18.7	18.4	18.4	18.4	18.4	18.3

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2005**	**2010**
1. General public services	1	9.0	8.5
2. Defence	2	2.1	1.6
3. Public order and safety	3	2.0	1.8
4. Economic affairs	4	6.1	5.5
5. Environmental protection	5	0.0	0.0
6. Housing and community amenities	6	4.0	4.1
7. Health	7	3.0	3.3
8. Recreation, culture and religion	8	0.6	0.7
9. Education	9	6.8	6.6
10. Social protection	10	10.0	12.5
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	43.6	44.6

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
1. Gross debt[1]		65.2	60.0	48.5	45.3	43.8	40.5
2. Change in gross debt ratio		-3.9	-5.2	-11.5	-3.1	-1.6	-3.2
Contributions to changes in gross debt							
3. Primary balance[2]		2.1	4.7	3.4	2.9	2.9	2.8
4. Interest expenditure[3]	EDP D.41	3.3	3.2	2.9	2.4	2.3	2.2
5. Stock-flow adjustment		-1.8	0.8	-6.6	0.6	2.0	0.2
of which:							
- Differences between cash and accruals[4]		-0.2	-0.3	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		-1.5	1.0	-6.6	0.6	2.0	0.2
of which:							
- privatisation proceeds		n.a.	n.a.	0.3	n.a.	n.a.	n.a.
- Valuation effects and other[6]		-0.1	0.1	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt[7]		4.7	4.9	4.9	5.0	5.0	5.0
Other relevant variables							
6. Liquid financial assets[8]		6.7	7.7	1.1	1.7	3.7	3.9
7. Net financial debt (7=1-6)		58.5	52.3	47.4	43.7	40.1	36.6

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		3.8	4.2	4.1	4.0	4.0	4.0
2. Net lending of general government	EDP B.9	-1.2	1.5	0.5	0.5	0.7	0.7
3. Interest expenditure	EDP D.41	3.3	3.2	2.9	2.4	2.3	2.2
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.7	3.7	3.7	3.7	3.7	3.7
contributions:							
- labour		0.7	0.7	0.7	0.7	0.7	0.7
- capital		1.6	1.6	1.6	1.6	1.6	1.6
- total factor productivity		1.4	1.4	1.4	1.4	1.4	1.4
6. Output gap		-2.0	-1.5	-1.0	-0.7	-0.3	0.0
7. Cyclical budgetary component		-0.8	-0.6	-0.4	-0.3	-0.1	0.0
8. Cyclically-adjusted balance (2 - 7)		-0.3	2.2	0.9	0.8	0.8	0.7
9. Cyclically-adjusted primary balance (8 + 3)		3.0	5.4	3.8	3.2	3.0	2.8
10. Structural balance (8 - 4)		-0.3	0.7	0.9	0.8	0.8	0.7

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		3.7	3.9	4.1	4.1	4.1	n.a.
Current update		3.8	4.2	4.1	4.0	4.0	4.0
Difference		0.1	0.3	0.0	-0.1	-0.1	n.a.
General government net lending (% of GDP)	EDP B.9						
Previous update		-1.9	-1.6	-0.7	-0.4	-0.1	n.a.
Current update		-1.2	1.5	0.5	0.5	0.7	0.7
Difference		-0.7	-3.1	-1.2	-0.9	-0.8	n.a.
General government gross debt (% of GDP)							
Previous update		64.7	60.5	52.5	49.0	46.6	n.a.
Current update		65.2	60.0	48.5	45.3	43.8	40.5
Difference		0.5	-0.5	-4.0	-3.7	-2.8	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	37.0	43.6	44.0	44.5	46.7	56.0
Of which: age-related expenditures	14.3	16.7	17.8	19.4	22.0	26.8
Pension expenditure	6.2	6.9	7.5	9.2	11.5	16.1
Social security pension	4.3	4.8	5.2	6.8	8.8	12.6
Old-age and early pensions	3.8	4.4	4.6	6.0	7.9	11.1
Other pensions (disability, survivors)	0.5	0.4	0.6	0.8	0.9	1.5
Occupational pensions (if in general government)	1.9	2.1	2.3	2.4	2.7	3.5
Health care	2.4	3.0	3.3	3.5	3.9	4.0
Long-term care *(this was earlier included in the health care)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	5.2	6.8	6.6	6.3	6.1	5.7
Other age-related expenditures	0.5	1.0	0.8	0.8	0.8	1.0
Interest expenditure	3.3	3.5	2.3	1.1	1.3	6.9
Total revenue	34.7	41.2	44.7	44.5	43.4	38.6
Of which: property income	0.9	0.7	0.4	0.5	0.5	0.5
Of which : from pensions contributions (or social contributions if appropriate)	6.5	6.3	5.7	5.6	5.4	5.3
Pension reserve fund assets	35.5	37.6	38.8	32.2	7.5	-105.5
Of which : consolidated public pension fund assets (assets other than government liabilities)	0.9	0.8	0.9	0.9	1.0	1.0
Assumptions						
Labour productivity growth	2.9	1.7	1.7	2.5	2.5	2.2
Real GDP growth	5.0	3.9	4.3	3.2	2.6	1.9
Participation rate males (aged 20-64)	81.3	82.2	83.2	85.9	85.5	86.0
Participation rates females (aged 20-64)	57.3	62.3	66.9	74.7	74.9	77.2
Total participation rates (aged 20-64)	68.9	72.4	75.0	80.3	80.2	81.6
Unemployment rate	3.3	5.3	3.7	3.5	3.5	3.5
Population aged 65+ over total population	11.3	12.1	13.1	16.5	20.3	26.8

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	3.5	4.2	4.4	4.3	4.2	4.1
Long-term interest rate (annual average)	4.1	4.4	4.6	4.7	4.8	4.8
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.27	1.36	1.42	1.42	1.42	1.42
Nominal effective exchange rate	0.6	1.3	0.5	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	6.0	5.6	5.3	5.5	5.4	5.4
World excluding EU, GDP growth	6.0	5.6	5.3	5.5	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4	2.5
Growth of relevant foreign markets	8.0	7.5	7.0	7.0	6.9	7.0
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.6	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	75.0	75.0

[1]If necessary, purely technical assumptions.

Annex 2: Key economic indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Cyprus. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

Table: Key economic indicators

	Cyprus						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	3.5	3.8	3.2	3.9	3.8	3.8	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*3.8*	*3.8*	*3.8*	*3.1*	*3.9*	*4.0*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*-0.3*	*0.0*	*-0.6*	*0.7*	*-0.1*	*-0.2*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	86	85	86	86	85	84	113	114	112	110	110	109
Real GDP per capita (% change)	1.9	2.5	1.4	1.4	2.1	1.9	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	2.7	2.9	2.5	2.0	2.2	2.0	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.3	2.5	0.1	0.3	1.1	2.4	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	0.1	-0.6	0.8	-1.1	-1.4	-1.4	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	2.2	1.2	3.1	3.6	2.7	1.5	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	4.0	3.8	4.3	5.2	4.6	4.3	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	1.1	-1.2	3.4	-0.2	-0.3	-1.2	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	-2.7	-3.5	-2.0	-0.7	-6.2	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.0	-4.0	n.a.	n.a.	n.a.	n.a.	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	-3.8	-3.6	-3.9	-2.4	-1.2	-1.0	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	61.4	56.1	66.7	69.1	65.2	60.5	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	-5.2	-2.7	-0.7	-0.6	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	2.0	3.2	1.5	1.8	0.9	1.7	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	3.3	4.1	2.7	2.7	1.6	1.8	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:
[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.
[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.
[3]Using GDP deflator.

Source :
Commission services