COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.2.2008
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Recommendation for a

COUNCIL OPINION

in accordance with the second paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the stability programme of Cyprus, 2007-2011

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Cyprus was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. Cyprus submitted annual updates of the convergence programme until end 2006, on which the Council also delivered opinion following the same procedure. Cyprus joined the euro area on 1 January 2008 and submitted its first stability programme on 7 December 2007[2]. In accordance with the regulation, the Council shall, within a period of three months from its submission, examine the stability programme and, acting on a recommendation from the Commission and after consulting the Economic and Financial Committee, shall deliver an opinion on the programme. The Commission recommends the attached Council opinion (see box for the main points covered by the assessment).

2. BACKGROUND FOR THE ASSESSMENT OF THE STABILITY PROGRAMME

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

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

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup;

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 Article 4 of Council Regulation (EC) No 1466/97 stipulates that "a Member State adopting the single currency at a later stage [i.e. later than 1 January 1999, when the first EU Member States adopted the single currency] shall submit a stability programme within six months of the Council decision on its participation in the single currency". On 10 July 2007 the Council adopted a decision on Cyprus's adoption of the single currency on 1 January 2008 in accordance with Article 122(2) of the Treaty (Council Decision 2007/503/EC, OJ L 186, 18.7.2007, p. 29).

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

2.1. The assessment in the Council opinion on the last update of the convergence programme

In its opinion of 27 February 2007, the Council summarised its assessment of the last update of the convergence programme, covering the period 2006-2010, as follows. "The Council considers that, after the correction of the excessive deficit in 2005, the programme is making good progress towards the MTO over the programme period, owing to expenditure restraint and in a context of strong growth prospects. The general government gross debt is foreseen to approach the 60% of GDP reference value by 2007 and to continue declining in the subsequent years". In the light of in particular the projected increase in age-related expenditure, the Council invited Cyprus to "control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances" and to "implement the fiscal consolidation path as foreseen in the programme".

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[3].

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[3] The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. In the area of budgetary policies, Cyprus was recommended to "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". In addition, all euro area Member States were recommended to "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" and "to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability".

2.4. 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[5] 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 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; 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.

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4 OJ L 92, 3.4.2007, p. 23.

5 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.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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

7 "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.

Recommendation for a

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in accordance with the second paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the stability programme of Cyprus, 2007-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[8], and in particular Article 5(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the first stability programme of Cyprus, which covers the period 2007 to 2011[9].

(2) 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.

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

9 The update was submitted 1 week beyond the 1 December deadline set in the code of conduct .

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.

(3) 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. Assessed against currently available information[10], 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 somewhat tilted on the upside.

(4) 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, due to especially high tax receipts brought by the strong profitability of the financial sector and the booming investment in real estate. Part of the increase in tax bases and in the associated revenues does not appear to be permanent. The 2007 estimated outturn respects the invitation in the Council opinion of 27 February 2007 on the last update of the convergence programme[11] to "implement the fiscal consolidation path as foreseen in the programme".

(5) 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

[10] 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.

[11] OJ C 71, 28.3.2007, p. 16.

decumulation of financial assets associated with the sinking funds. Thereafter, debt-to-GDP ratio is projected to decline further by 8 percentage points of GDP over the programme period.

(6) 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. 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.

(7) 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.

(8) 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.

(9) The stability programme is fully consistent with the October 2007 implementation report of the national reform programme. In particular, the budgetary projections incorporate the budgetary cost of the various projects and measures included in the national reform programme, for example to foster a knowledge-based economy, to promote R&D, to enhance human capital development.

(10) The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy.

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

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.

In view of the above assessment, Cyprus is invited to:

(i) avoid pro-cyclical fiscal policies by better controlling current expenditures, while using revenue windfalls to further reduce debt;

(ii) contain public expenditure, notably by reforming the pension system and timely implementing the adopted reforms in health care in order to improve the long-term sustainability of the public finances.

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12 In particular, the capital account data for the years 2007-2011 in the table of sectoral balances are not provided, which have the effect of making the assessment more difficult.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Dec 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 Dec 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*	*2.0*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Dec 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 Dec 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 Dec 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 Dec 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 Dec 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 Dec 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*	*0.3*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2007**	**65.2**	**60.0**	**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.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures according to the Commission services' autumn forecast. The stability 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 according to the Commission services.

Source:

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