



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.3.2009
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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Cyprus, 2008-2012

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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to the definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Cyprus, submitted on 13 February 2009, and has adopted a recommendation for a Council opinion on it.

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

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan").
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme)

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by

¹ OJ L 209, 2.8.1997, 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 Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2011, as follows. "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 base. 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 pro-cyclical. 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 this assessment, the Council invited Cyprus to "avoid pro-cyclical fiscal policies by further improving the control of current expenditures, while using revenue windfalls to further reduce debt" and to "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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On the updated stability programme of Cyprus, 2008-2012

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 policies³, and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [24 April 2009] the Council examined the updated stability programme of Cyprus, which covers the period 2008 to 2012.
- (2) Cyprus has experienced strong economic growth at about 4% on average in recent years, in conditions of almost full employment and low inflation. According to the Commission services January 2009 interim forecast, GDP growth decelerated slightly to 3.7% in 2008. Under the drag of falling external demand and worsening consumer and investor confidence, GDP growth is expected to slow sharply to just above 1% in 2009 and to remain positive but below potential in 2010. Since the end of 2008, the Cypriot authorities have adopted various fiscal measures to stimulate economic activity amounting to about 1½% of GDP in 2009 in line with the European Economic Recovery Plan (EERP). In addition to these discretionary measures, the slowdown combined with a less tax-rich growth pattern will put public finances under pressure. Cyprus also faces a large net borrowing vis-à-vis the rest of the world, which reflects not only the low private sector net savings but also a deterioration of the net position of general government. Therefore, Cyprus is facing the challenge of enhancing growth in a severe and protracted global economic downturn, while addressing the existing macroeconomic imbalances through maintaining prudent fiscal policies. In the long

³ OJ L 209, 2.8.1997, 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.

term, the country is confronted with the need to improve the sustainability of public finances in view of an ageing population.

- (3) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate from 3.8% in 2008 to 2.1% in 2009, before recovering to an average rate of almost 3% over the rest of the programme period. Assessed against currently available information⁴, this scenario appears to be based on favourable growth assumptions for 2009 and thereafter. In particular, the projected shift in the growth composition towards a less negative contribution of net exports is based on a positive export growth in 2009, which is inconsistent with the expected slowdown in world trade and economic growth in Cyprus' main trading partners. Furthermore, private consumption and investment are expected to follow a favourable trend after 2009. On the back of a gradual reduction in the balance of goods deficit, the programme envisages a slow decline of the external deficit from 12.4% of GDP in 2008 to 10.2% of GDP in 2012, which is consistent with a more moderate growth of domestic demand. The programme's inflation projections appear realistic.
- (4) In 2008, the general government surplus is estimated to have fallen to 1%, down from 3.4% of GDP in 2007, and the structural balance (i.e. the cyclically adjusted balance net of one-off and other temporary measures as recalculated by Commission services on the basis of the information in the programme) to have fallen from 3½% of GDP to ¾%. These changes mainly reflect revenue shortfalls, due to subdued activity in the real estate sector, and expenditure overruns. Specifically, subsidies and other expenditure accounted for an increase in expenditure of about ½ a percentage point of GDP each. Of these, the increased expenditure related to the drought and to the associated expenses to maintain water supply as well as compensation to farmers accounts for ¾ of a percentage point of GDP. Moreover, social transfers and other social cohesion measures (to pensioners, persons with disabilities and other welfare recipients) accounted for almost ½ percentage point of GDP of additional increase in expenditure. The 2008 surplus is nonetheless above the target of 0.5% of GDP set in the 2007 stability programme benefiting from a higher than expected revenue, lower interest payments and a positive base effect from 2007, when the final budget surplus rose to 3.4% of GDP compared to an anticipated outcome of 1.5%. Overall, fiscal policy was procyclical in a context of still good times (GDP is estimated to have grown by 3.7% according to the latest available data).
- (5) According to the update, the budgetary target for 2009 is a deficit of 0.8% of GDP, broadly in line with the Commission services' interim forecast. Compared with the surplus of 1% of GDP surplus targeted in the 2009 budget law (approved by the Parliament on 18 December 2008), it represents a downward revision by 1¾ percentage points of GDP. This is explained by a downward revision of total revenue projections, consistent with slower growth prospects. The update projects the revenue-to-GDP ratio to decline by 1½ percentage points in 2009 compared with the outturn of 2008 mainly due to subdued activity in the real estate sector and reduced corporate profitability as well as the absence of dividend income from semi-governmental organisations. Public expenditure is expected to increase only slightly. Higher social

⁴ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

transfers are offset by savings in interest payments. Overall, the stance of fiscal policy will be expansionary in 2009, in line with the EERP.

- (6) The programme foresees the headline deficit to deteriorate gradually from a target of 0.8% of GDP in 2009 to 2.2% in 2012. The primary surplus will decline in tandem from 1.5% of GDP in 2009 to 0.2% in 2011 and turn into a deficit of 0.2% in 2012. The structural deficit points to a deterioration from a deficit of $\frac{3}{4}$ % of GDP in 2009 to a deficit of about 2% of GDP in 2012 in a context of expected buoyant growth. This marks a deviation from the MTO, defined as a balanced budget in structural terms, already from 2009, which accentuates during the programme period. The projected deterioration of the fiscal balance is mainly explained by an increase in current primary expenditure, in particular social payments, wages and other expenditure. The government gross debt, estimated at 49.3% of GDP in 2008, is projected to decline to 44.2% of GDP in 2012, benefiting from sustained although rapidly decreasing primary surpluses.
- (7) The budgetary outcomes are subject to downside risks. In particular, the macroeconomic scenario projected in the update appears to be based on favourable growth assumptions throughout the programme period. On the revenue side, risks for public finances, particularly in 2009-2010, are higher than in previous years and are associated with a possible sharper contraction and rebalancing of economic growth towards a less tax rich composition of growth. In view of the expected economic slowdown and the pressure to stimulate domestic demand through increased public expenditure, the risks of potential overruns are non negligible. The evolution of the debt ratio may be less favourable than projected in the update, given the risks to the macroeconomic scenario and the budgetary targets.
- (8) The long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades partly due to the fact that the pension scheme is still in a maturing phase. The programme introduces a recently adopted pension reform that is projected to reduce the increase in pension expenditure. However, until the updated projections are not finally validated by the Economic Policy Committee, they can only be considered as "national projections". While the budgetary position in 2008 would have contributed to partly offsetting the projected long-term budgetary impact of ageing populations, the contrary would result from the budgetary developments projected in the programme. Improving the primary balance over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditure would contribute to reducing high risks to the sustainability of public finances.
- (9) Cyprus' budgetary framework has demonstrated a good track record by overachieving the budgetary targets, in a context of buoyant economic growth. In the recent past, the framework has been improved by the adoption of the Financial Management Accounting System (FIMAS), the gradual adoption as from 2006 of a 3-year medium term budgetary framework (MTBF) and the introduction in 2007 of a Programme and Performance Budgeting (PPB). The hitherto practise of adopting supplementary budgets during the course of the year, has implied an increase in current expenditure beyond the intended reallocation of funds. According to the Programme, the new budgeting framework is expected to cease this practise when fully implemented and lead to a more effective and efficient budgeting process, contributing to containing

expenditure. At the same time, the new budgeting process would set a sound basis for reallocating expenditure in favour of growth enhancing activities consistent with the priorities set by the National Reform Programme. However, the new framework is still at an early stage of implementation and is only foreseen to be fully in place in 2012.

- (10) The Cypriot government has not adopted any specific package to stabilize the financial sector. However, in order to enhance the confidence in the banking system the deposit guarantee level was raised from EUR 40,000 to EUR 100,000. Moreover, the Government issued treasury bills in early January 2009, with maturity in October 2009 which was then prolonged to December 2009, for financing its short term (cash flow) needs and for increasing the liquidity conditions in the banking system. The total value is of the order of EUR 1.4 billion (8% of GDP), of which about one half will be deposited in banks and credit institutions.
- (11) The Cypriot government adopted discretionary fiscal measures in response to the economic downturn. The stimulus package for 2009 is in line with the EERP and represents an adequate response to the economic downturn, yielding a temporary support to economic activity in 2009. The total budgetary cost amounts to about 1½% of GDP, of which ¼ of a percentage point has already been included in the 2009 Budget. It aims at mitigating the impact of the crisis on the most exposed economic sectors, particularly the construction (1¼% of GDP) and tourism sectors (about ¼% of GDP). The government has also adopted a targeted measure for the provision of loans at favourable terms for low income families for the acquisition of their primary residence, with an estimated impact on debt of about 1% of GDP over 2009-2013. Overall, the package is timely, targeted and temporary. It broadly responds to the main policy objectives in terms of the short term outlook. The update also includes a series of structural measures, which are part of the longer-term policy reform agenda, but help to address the current challenges posed by the downturn. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. They aim at augmenting the growth potential, strengthening competitiveness and enhancing the physical and human capital.
- (12) The overall fiscal stance is expansionary throughout the programme period. More specifically, there is a significant deviation from the MTO of a balanced budget in structural terms from 2009 onwards, which is problematic in the light of the large external imbalance of the Cypriot economy. Considering that the risks over the medium term are tilted to the downside, the budgetary targets could be worse than projected. Since, in view of its high level of net borrowing vis-à-vis the rest of the world, Cyprus has only limited fiscal room of manoeuvre, further fiscal deterioration in the latter years of the programme is not compatible with the correction of the country's imbalances and the adjustment towards achieving the MTO.
- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and almost all optional data⁵.

⁵ In particular, the data on the balance of primary incomes and transfers are not provided.

The overall conclusion is that fiscal stance in 2009 will be expansionary due to the adoption of significant stimulus measures in 2009 in line with the EERP. In the subsequent years, the structural balance is projected to continue worsening, progressively deviating from the MTO. This does not appear justified in view of the relatively good economic prospects, which imply a procyclical fiscal loosening, and the existence of a large external imbalance. Moreover, against the background of a sharp deterioration in the global economic environment, the budgetary strategy is subject to significant downside risks, with the growth assumptions underlying the macroeconomic scenario of the programme being favourable. In the light of the high external imbalances, maintaining prudent policies and strengthening fiscal sustainability should be a major priority. Therefore, controlling current expenditure and avoiding procyclicality represents a major challenge for the fiscal policy in Cyprus. In addition, fostering the quality of public finances is important also with a view to underpinning a smooth adjustment of the economy in the light of the imbalances it is faced with.

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

- (i) Implement the measures in line with the EERP as planned, while avoiding further deterioration of public finances in 2009 compared to the target;
- (ii) Reverse the projected fiscal loosening in 2010 and beyond, by restraining expenditures in order to ensure a sound fiscal position in the medium term;
- (iii) In view of the ongoing fiscal deterioration and of the projected impact of ageing on government expenditure, improve the long-term sustainability of public finances by pursuing the reform of the pension and health care systems.

Comparison of key macroeconomic and budgetary projections

| | | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|--|---------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Real GDP (% change) | SP Jan 2009 | 4.4 | 3.8 | 2.1 | 2.4 | 3.0 | 3.2 |
| | COM Jan 2009 | 4.4 | 3.6 | 1.1 | 2.0 | n.a. | n.a. |
| | CP Dec 2007 | 4.2 | 4.1 | 4.0 | 4.0 | 4.0 | n.a. |
| HICP inflation (%) | SP Jan 2009 | 2.2 | 4.4 | 2.0 | 2.5 | 2.5 | 2.5 |
| | COM Jan 2009 | 2.2 | 4.4 | 2.0 | 2.3 | n.a. | n.a. |
| | CP Dec 2007 | 2.2 | 2.5 | 2.0 | 2.0 | 2.0 | n.a. |
| Output gap ¹ (% of potential GDP) | SP Jan 2009 | 0.2 | 0.8 | -0.1 | -0.6 | -0.5 | -0.2 |
| | COM Jan 2009 ² | 1.1 | 1.9 | 0.5 | 0.1 | n.a. | n.a. |
| | CP Dec 2007 | -0.7 | -0.6 | -0.6 | -0.4 | n.a. | n.a. |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | SP Jan 2009 | -11.7 | -12.4 | -12.1 | -11.5 | -10.9 | -10.2 |
| | COM Jan 2009 | -9.7 | -13.2 | -11.8 | -10.8 | n.a. | n.a. |
| | CP Dec 2007 | -6.6 | -6.5 | -6.3 | -5.9 | -5.6 | n.a. |
| General government revenue (% of GDP) | SP Jan 2009 | 46.4 | 45.3 | 43.8 | 44.0 | 44.4 | 44.8 |
| | COM Jan 2009 | 46.4 | 45.6 | 44.1 | 44.1 | n.a. | n.a. |
| | CP Dec 2007 | 45.9 | 44.3 | 44.5 | 44.6 | 44.7 | n.a. |
| General government expenditure (% of GDP) | SP Jan 2009 | 42.9 | 44.3 | 44.6 | 45.5 | 46.3 | 47.1 |
| | COM Jan 2009 | 42.9 | 44.7 | 44.7 | 45.1 | n.a. | n.a. |
| | CP Dec 2007 | 44.4 | 43.8 | 44.0 | 44.0 | 44.1 | n.a. |
| General government balance (% of GDP) | SP Jan 2009 | 3.4 | 1.0 | -0.8 | -1.4 | -1.9 | -2.2 |
| | COM Jan 2009 | 3.4 | 1.0 | -0.6 | -1.0 | n.a. | n.a. |
| | CP Dec 2007 | 1.5 | 0.5 | 0.5 | 0.7 | 0.7 | n.a. |
| Primary balance (% of GDP) | SP Jan 2009 | 6.5 | 3.9 | 1.5 | 0.8 | 0.2 | -0.2 |
| | COM Jan 2009 | 6.5 | 3.9 | 1.8 | 1.2 | n.a. | n.a. |
| | CP Dec 2007 | 4.7 | 3.4 | 2.9 | 2.9 | 2.8 | n.a. |
| Cyclically-adjusted balance ¹ (% of GDP) | SP Jan 2009 | 3.4 | 0.7 | -0.8 | -1.2 | -1.7 | -2.1 |
| | COM Jan 2009 | 3.0 | 0.2 | -0.8 | -1.1 | n.a. | n.a. |
| | CP Dec 2007 | 1.8 | 0.7 | 0.7 | 0.8 | 0.7 | n.a. |
| Structural balance ³ (% of GDP) | SP Jan 2009 | 3.4 | 0.7 | -0.8 | -1.2 | -1.7 | -2.1 |
| | COM Jan 2009 | 3.0 | 0.2 | -0.8 | -1.1 | n.a. | n.a. |
| | CP Dec 2007 | 0.3 | 0.7 | 0.7 | 0.8 | 0.7 | n.a. |
| Government gross debt (% of GDP) | SP Jan 2009 | 59.4 | 49.3 | 46.8 | 45.4 | 44.2 | 44.2 |
| | COM Jan 2009 | 59.4 | 48.1 | 46.7 | 45.7 | n.a. | n.a. |
| | CP Dec 2007 | 60.0 | 48.5 | 45.3 | 43.8 | 40.5 | 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 3.1%, 2.8%, 2.6% and 2.4% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures according to the most recent programme and according to the Commission services' January interim forecast.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.