COUNCIL OF THE EUROPEAN UNION

Brussels, 8 June 2010

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NOTE

from:	The General Secretariat of the Council
to:	Delegations
Subject:	Council Opinion on the updated Stability Programme of Cyprus 2009-2013

Delegations will find attached a Council Opinion on the updated Stability Programme of Cyprus 2009-2013, as adopted by the Council (Ecofin) on 8 June 2010.

Encl.:

ANNEX

COUNCIL OPINION

on the updated stability programme of Cyprus, 2009-2013

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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[1], and in particular Article 5(3) (for SP) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [8 June 2010] the Council examined the updated stability programme of Cyprus, which covers the period 2009 to 2013.

[1] 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/sgp/index_en.htm.

(2) In 2009 economic activity contracted by 1.7%. This is the first time Cyprus has experienced negative growth in the last thirty-five years. Weak domestic demand and an adverse external environment weighed strongly on growth. In particular, high household indebtedness together with tight lending conditions, a worsening labour market outlook and negative confidence effects led to a decline in private consumption. In parallel, investment recorded a strong correction, amidst a fall in foreign demand for housing, low capacity utilisation and the restructuring of corporate balance sheets. Government consumption was the only demand component supporting economic activity, partly due to the 1½% of GDP stimulus package implemented in line with the EERP. In addition to these discretionary measures, the contraction of economic activity, the fading out of the asset boom and a less tax-rich growth pattern has put public finances under significant pressure. As a result, government finances turned into a deficit of 6.1% of GDP from a surplus of 0.9% of GDP in 2008. The crisis has also highlighted the accumulation of a high external imbalance, which reflects not only the low private sector net savings but also a deterioration of the net position of general government and competitiveness losses. A weak domestic demand and a sluggish external recovery are expected to weigh on recovery prospects. GDP growth is forecast to shrink further, although to a lesser extent, in 2010 and to recover mildly in 2011. Therefore, in the medium term, Cyprus is facing the challenge of enhancing growth, against the backdrop of a frail global economic recovery, while addressing the existing macroeconomic imbalances through maintaining prudent fiscal policies. In the long term, the country is confronted with the need to strengthen the sustainability of public finances, in view of an ageing population.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential output has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Cyprus it is important to undertake reforms in the area of the labour market, especially to strengthen lifelong learning opportunities, in particular, with regard to the low-skilled, older workers and unemployed people as well as to ensure the timely and effective implementation of the planned reforms in technical and vocational education. Moreover, there is a need to better align wage growth with productivity, employment growth and competitiveness.

(4) The macroeconomic scenario underlying the programme envisages that real GDP growth will rise from -1.7% in 2009 to 0.5% in 2010, before recovering to an average rate of about 2.6% over the rest of the programme period. Assessed against currently available information[2], this scenario appears to be based on favourable growth assumptions throughout the programme period. In particular, private consumption is expected to follow a favourable trend, driven by a somewhat optimistic employment and wage growth. The Programme projects real construction investment growth to remain negative in the short-term and to recover in the second half of the programme period. However, forward-looking indicators suggest a stronger correction path for the construction sector in the medium-term than the one projected by the programme.

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[2] The assessment notably takes into account the Commission services' spring 2010 forecast, but also other information that has become available since then.

Moreover, despite the improving economic outlook, the fragility of recovery in Cyprus' main trading partners entails non-negligible downside risks to the macroeconomic scenario in the programme. Due to the contraction of economic activity in 2009 there was a significant, yet partial, correction of the external deficit, which nevertheless remains high, at 8.5% of GDP, and is projected in the programme to rise again sharply to 12.9% of GDP by 2013 as imports are expected to pick up. The external imbalance is likely to weigh on economic growth over the medium-term. High public sector dissavings would need to be financed by foreign debt or domestic private savings. Thus, the adjustment of the current account imbalance would require either higher cost of debt-financing or higher savings from the private sector. The latter would imply lower output growth through lower private consumption or investment (crowding-out effect). The programme's inflation projections appear realistic.

(5) According to the programme, the general government deficit deteriorated strongly in 2009, reaching a deficit of 6.1% of GDP from a surplus of 0.9% of GDP in 2008, reflecting mainly the impact of the crisis on government finances but was also brought about by stimulus measures amounting to 1½% of GDP which the government adopted in line with the European Economic Recovery Plan (EERP). According to the programme, fiscal policy is planned to be restrictive with a view to correcting the excessive deficit by 2013 under the assumed growth scenario.

(6) According to the update, the budgetary target for 2010 is a deficit of 6% of GDP. The 2010 budget law (approved by the Parliament on 24 December 2009) targeted a deficit of 4.5% of GDP on the basis of an estimated outturn for the deficit in 2009 of about 3% of GDP. Given that the final outturn for 2009 was a deficit of 6% of GDP, the budget law would imply an even higher deficit. However, the programme includes measures which aim to stop further budgetary deterioration and stabilise the deficit at the same levels as in 2009. The update projects the revenue-to-GDP ratio to rise by about 1¼ percentage points in 2010 compared with the outturn of 2009. Public expenditure is expected to increase by 1¼ percentage points of GDP. Primary expenditure is planned to rise further mainly driven by a further rise in social transfers, subsidies and in the public wage bill. According to the update, interest payments are set to continue their declining trend, falling by a ¼ percentage point of GDP, despite the rising stock of debt. Public investment is planned to remain at 2009 levels. Overall, the fiscal policy stance, as measured by the structural balance (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), implied by the Programme will be tightening in 2010 of an order of ½% of GDP.

(7) The main goal of the programme's medium-term budgetary strategy is to bring the general government balance below the 3% of GDP reference value by 2013. The programme projects the nominal budget deficit to decline to 4.5% of GDP in 2011 (from 6.1% in the previous year) and 3.4% in 2012 before it eventually reaches 2.5% in 2013. The primary balance is expected to follow a similar pattern and reach a balanced position by the end of the period, from a deficit of 3.7% of GDP in 2010. The structural deficit, calculated according to the commonly agreed methodology, would continue to improve after 2010, to reach around 3½% of GDP in 2011, just below 3% in 2012 and 2¼% in 2013. The annual fiscal effort would average at 3/4% of GDP per year over the period 2010-2013. The adjustment appears front-loaded, although measures taken in 2010 will have their full effect only in 2011. Moreover, measures taken within the context of the EERP will only be phased out by the end of 2010.

Consolidation is planned to be achieved mainly from the revenue side of the budget, which is projected to increase by 2.6 pp. of GDP between 2010 and 2013, while expenditure retrenchment would contribute an additional percentage point of GDP. Revenue supporting measures include the fight against tax evasion, a town planning amnesty, harmonisation of the minimum excise duties on petroleum products and application of the reduced VAT on foodstuff and pharmaceutical products as well as dividend income from semi-governmental organisations. As regards expenditure measures, the bulk of the programme's adjustment comes from controlling operational expenditure and reducing current transfers. The programme lists the targeting of social transfers and the containment of size and the rate of growth of public wage bill as expenditure categories for consolidation when consensus would be reached among social partners. The update confirms the commitment to the country-specific medium-term budgetary objective (MTO), which is a balanced budgetary position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures). Given the most recent projections and debt level, the MTO adequately reflects the objectives of the Pact. The structural balances corresponding to the programme's deficit targets imply that the MTO will not be reached within the programme period.

(8) The budgetary outcomes could be worse than targeted in the programme. 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 2010-2011, 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 moderate economic recovery and the pressure to stimulate domestic demand through increased public expenditure, the risks of potential overruns are non negligible. These risks are mainly associated to the practise of submitting expenditure-increasing supplementary budgets during the course of the year which, beyond the intended reallocation of funds, has implied an increase in current expenditure. Moreover, social transfers might turn higher than expected in view of the recent past track record and the absence of a targeting mechanism at place as well as of the somewhat optimistic employment (thus unemployment) growth projections.

(9) The government gross debt-to-GDP ratio is estimated at 56.2% of GDP in 2009, up from 48.4% in the year before. Apart from the increase in the deficit and the decline in GDP growth, a stock-flow adjustment accounting for 1 percentage point of GDP contributed to the rise in the debt ratio. The latter reflects an accumulation of government assets, due to over-financing at the end of 2009 in order to meet obligations arising early in January of 2010. The debt ratio is projected to increase over the programme period, mainly driven by continued although declining primary deficits. The debt ratio will breach the reference value of 60% of GDP in 2010 and is projected to remain above the reference value throughout the programme period. It is projected to increase to around 63% of GDP in 2011 and 2012, thereafter slightly declining. In view of the downward risks to the macroeconomic scenario and the budgetary targets, the evolution of the debt ratio may be less favourable than projected in the programme.

(10) Medium-term debt projections that assume GDP growth rates to gradually recover to the values projected before the crisis, tax ratios to return to pre-crisis levels, and include the projected increase in age-related expenditure show that the budgetary strategy envisaged in the programme, taken at face value and with no further policy change, would almost be enough to stabilise the debt-to-GDP ratio by 2020.

(11) The long-term budgetary impact of ageing is significantly 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 discusses a pension reform introduced in April 2009 that is projected to slightly reduce the increase in pension expenditure and, more significantly, increase the social security contribution rates. The reform would improve the long-term balance of the pension system and reduce risks to sustainability, however without having an effect on the overall assessment. The budgetary position in 2009 as estimated in the programme compounds the budgetary impact of population ageing on the sustainability gap. Improving the primary balance over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditure, especially pension and healthcare expenditure, would contribute to reducing the risks to the sustainability of public finances, which were assessed in the Commission 2009 Sustainability Report[3] as high.

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3 In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

(12) In recent years, Cyprus has over-achieved its budgetary targets, albeit in a context of buoyant economic activity and tax-rich composition of growth. In the recent past, the budgetary framework has been improved by the adoption of the Financial Management Accounting System (FIMAS), the gradual introduction of a three-year medium-term budgetary framework (MTBF) and of Programme and Performance Budgeting (PPB). However, the practice 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 practice 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. Therefore, its impact could become effective only in the medium-term. The new framework's timely implementation would be critical for a successful and lasting consolidation of the public finances.

(13) As regards the quality of public finances, the programme acknowledges its importance as a means to support potential growth and to ensure the long-term sustainability of public finances. In particular, the programme notes the impact the MTBF and PPB budgeting will have upon full implementation on the better allocation of resources to high-priority, growth enhancing areas in tandem with better control of non-productive expenditure. On the expenditure side, the programme includes a review of recent projects aimed at enhancing infrastructure, through Private Public Partnerships (PPP), as well as measures to improve education, through the increased use of computers in primary and secondary education and improvements in research and academic institutions. The update also includes the allocation of funds to restructure public hospitals into autonomous units and the adoption of a National Health Scheme, with the aim of improving effectiveness via regulated competition and cost containment. This seems essential as a means to control the anticipated expenditure increases associated to an ageing population. On the revenue side, the programme emphasizes the positive impact the introduction of the MTBF would have on improving the accuracy and sensitivity of revenue forecasts over the medium-term. The authorities note that given the volatility of tax elasticities in recent years due to the asset boom, revenue projections were adapted to take into account the impact of asset prices and the composition of GDP growth. The programme also notes the constant monitoring of the tax-benefit system by the authorities in order to endure that work pays while ensuring the support to vulnerable social groups.

(14) Overall, taking into account the risks to the budgetary targets mentioned above, the strategy to maintain supportive fiscal policies also in 2010 can be considered in line with the EERP. However, following the negative effects of the economic crisis, the general government deficit is to remain at 6% of GDP in 2010, gradually abating below the 3% reference value thereafter. While the programme's strategy foresees an average annual fiscal effort of ¾ percentage points of GDP over the period 2010-2013, this is subject to downside risks. Therefore, in view of the risks, the fiscal effort may not be sufficient to bring the deficit below the 3% of GDP reference value by 2013 as planned. Moreover, the composition of the consolidation strategy of the programme appears to be based largely on revenue-increasing measures with expenditure retrenchment being minimal. In fact, the programme projects the expenditure-to-GDP ratio to stabilise at a higher level in 2013 than the 2009 outturn. Measures that could reverse this situation are still under discussion with the social partners and, thus, subject to risks regarding the modalities and the timing of their implementation. As a result, the evolution of the debt ratio, which is planned to exceed 60% of GDP from 2010 onward, may also be less favourable than projected in the update.

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

The overall conclusion is that Cyprus' public finances deteriorated significantly as a result of the economic downturn and an expansionary fiscal stance due to the adoption of significant stimulus measures in line with the EERP. As a result, the budgetary balance turned to a deficit of 6.1% of GDP in 2009 from a surplus of 0.9% of GDP in 2008. The programme outlines a consolidation path starting in 2010 which aims to bring the general government balance below the 3% of GDP reference value by 2013. However, the adjustment is planned to be achieved mainly from the revenue side of the budget while the expenditure-to-GDP ratio remains at historically high levels. Moreover, against the background of a frail global economic recovery, the budgetary strategy is subject to significant downside risks, as the growth assumptions underlying the macroeconomic scenario of the programme are favourable. In the light of the high domestic and external imbalances, maintaining prudent policies and strengthening fiscal sustainability should be a priority. Therefore, controlling current expenditure through the implementation of an effective multi-annual budgetary framework would be an essential instrument to support the achievement of the consolidation plans and budgetary targets. 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, notably by lifting potential GDP, enhancing competitiveness and further narrowing the external imbalance.

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

(i) reduce the 2010 deficit to below 6% of GDP by reinforcing the consolidation measures, notably in case macroeconomic developments proves less favourable than the programme scenario, and take timely action to define a more expenditure-driven consolidation strategy; seize opportunities beyond the announced fiscal effort to accelerate fiscal consolidation and to ensure a swift reduction of the gross debt ratio back below the reference value;

(ii) implement, as envisaged, an effective multi-annual budgetary framework in order to ensure the adherence to the budgetary targets and to firmly contain expenditure over the medium-term;

(iii) improve the long-term sustainability of public finances by implementing reform measures to control pension and health care expenditure in order to curb the projected increase in age-related expenditure.

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012	2013
Real GDP (% change)	**SP Apr 2010**	**3.6**	**-1.7**	**0.5**	**1.5**	**3.0**	**3.2**
	COM May 2010	3.6	-1.7	-0.4	1.3	n.a.	n.a.
	SP Feb 2009	*3.8*	*2.1*	*2.4*	*3.0*	*3.2*	*n.a.*
HICP inflation (%)	**SP Apr 2010**	**4.4**	**0.2**	**2.7**	**2.0**	**2.0**	**2.0**
	COM May 2010	4.4	0.2	2.7	2.5	n.a.	n.a.
	SP Feb 2009	*4.4*	*2.0*	*2.5*	*2.5*	*2.5*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Apr 2010**	**2.9**	**-1.3**	**-2.4**	**-2.5**	**-1.6**	**-0.5**
	COM May 2010	3.4	-0.7	-2.1	-1.6	n.a.	n.a.
	SP Feb 2009	*0.8*	*-0.1*	*-0.6*	*-0.5*	*-0.2*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Apr 2010**	**-17.7**	**-8.5**	**-11.5**	**-12.2**	**-12.6**	**-12.9**
	COM May 2010	-17.6	-8.2	-6.8	-6.7	n.a.	n.a.
	SP Feb 2009	*-12.4*	*-12.1*	*-11.5*	*-10.9*	*-10.2*	*n.a.*
General government revenue (% of GDP)	**SP Apr 2010**	**43.5**	**40.3**	**41.6**	**42.8**	**43.6**	**44.2**
	COM May 2010	43.5	40.3	41.2	41.3	n.a.	n.a.
	SP Feb 2009	*45.3*	*43.8*	*44.0*	*44.4*	*44.8*	*n.a.*
General government expenditure (% of GDP)	**SP Apr 2010**	**42.6**	**46.4**	**47.6**	**47.2**	**47.0**	**46.7**
	COM May 2010	42.6	46.4	48.3	49.0	n.a.	n.a.
	SP Feb 2009	*44.3*	*44.6*	*45.5*	*46.3*	*47.1*	*n.a.*
General government balance (% of GDP)	**SP Apr 2010**	**0.9**	**-6.1**	**-6.0**	**-4.5**	**-3.4**	**-2.5**
	COM May 2010	0.9	-6.1	-7.1	-7.7	n.a.	n.a.
	SP Feb 2009	*1.0*	*-0.8*	*-1.4*	*-1.9*	*-2.2*	*n.a.*
Primary balance (% of GDP)	**SP Apr 2010**	**3.7**	**-3.6**	**-3.7**	**-2.1**	**-1.0**	**0.1**
	COM May 2010	3.7	-3.6	-4.4	-4.8	n.a.	n.a.
	SP Feb 2009	*3.9*	*1.5*	*0.8*	*0.2*	*-0.2*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Apr 2010**	**-0.2**	**-5.6**	**-5.1**	**-3.5**	**-2.8**	**-2.3**
	COM May 2010	-0.4	-5.8	-6.3	-7.1	n.a.	n.a.
	SP Feb 2009	*0.7*	*-0.8*	*-1.2*	*-1.7*	*-2.1*	*n.a.*
Structural balance[3] (% of GDP)	**SP Apr 2010**	**-0.2**	**-5.6**	**-5.2**	**-3.6**	**-2.9**	**-2.3**
	COM May 2010	-0.4	-5.8	-6.3	-7.1	n.a.	n.a.
	SP Feb 2009	*0.7*	*-0.8*	*-1.2*	*-1.7*	*-2.1*	*n.a.*
Government gross debt (% of GDP)	**SP Apr 2010**	**48.4**	**56.2**	**61.0**	**63.2**	**63.1**	**62.3**
	COM May 2010	48.4	56.2	62.3	67.6	n.a.	n.a.
	SP Feb 2009	*49.3*	*46.8*	*45.4*	*44.2*	*44.2*	*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 2.0%, 2.8%, 2.8%, 2.8% and 2.8% respectively in the period 2009-2013.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% in years 2010, 2011 and 2012(all deficit reducing) according to the most recent programme. There are no one-off and other temporary measures in the Commission services' spring 2010 forecast.

Source:

Stability programme (SP); Commission services' spring 2010 forecasts (COM); Commission services' calculations.