COUNCIL OPINION

of 5 July 2004

on the Convergence Programme of Cyprus, 2004-2007

(2004/C 320/03)

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 ([1]), and in particular Article 9(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 5 July 2004 the Council examined the convergence programme of Cyprus, which covers the period 2004 to 2007. The programme largely complies with the data requirements of the revised 'code of conduct on the content and format of stability and convergence programmes'.

The budgetary strategy underlying the programme aims at reducing the general government deficit from 6,3 % of GDP in 2003 to 2,9 % of GDP by 2005 to comply with the Maastricht deficit criterion by 2005 and further reduce the deficit to 2,2 % of GDP in 2006 and 1,6 % of GDP by 2007. To this end, the convergence programme envisages creating a rising primary balance surplus from a projected −1,6 % of GDP in 2004 to 2 % of GDP by 2007; and to reverse significantly the upward trend of the debt-to-GDP ratio from 75,2 % of GDP in 2004 to below 69 % by the end of the projection period. This is underpinned by a package of mostly structural measures to contain expenditure and to increase revenue, to about an equal degree. The measures are mostly implemented from 2005 onward.

The programme focuses on revenue enhancement and on expenditure control, which is where historically most of the slippage occurred. The particular adjustment path presented in the programme reflects the government commitment to improve public finances, given their intention to adopt the euro by 2007; this is the main factor behind the strong frontloading of the fiscal adjustment to decrease the general government budget deficit by 2,3 percentage points of GDP in 2005. Given the mixed record on fiscal consolidation, this looks rather ambitious and therefore requires strong commitment, including taking additional measures if necessary, for its implementation.

The macro-economic scenario underlying the programme, which projects real GDP growth to accelerate from 3,5 % in 2004 to 4,5 % in 2007, seems to reflect plausible growth assumptions. The projection for inflation also appears realistic. The programme contains four different scenarios for the macroeconomic and budgetary projections: a 'central' scenario, an 'upper' scenario, a 'lower' scenario and a 'higher interest rate' scenario. The so-called 'central' scenario is considered as the reference scenario for assessing budgetary projections because, on the basis of currently available information, it seems to reflect plausible growth assumptions.

The programme foresees the deficit to be reduced to (below) the 3 % of GDP reference value in 2005 and to fall further thereafter, although these targets are not consistent with a position of close-to-balance during the programme period.

([1]) OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

The budgetary outcome could be worse than projected. Given the size of the adjustment and the fiscal consolidation record of Cyprus, the objective for 2005 is subject to considerable uncertainty. The budgetary stance in the programme may not be sufficient to reduce the deficit to (below) the 3 % of GDP deficit threshold by 2005. It also may not provide a sufficient safety margin against breaching this threshold with normal macroeconomic fluctuations,

In the programme, the debt ratio peaks at 75,2 % in 2004 and then declines by almost 7 percentage points to reach 68,4 % of GDP by 2007. This strong decrease is mainly driven by increasingly positive primary balances and nominal GDP growth exceeding interest payments on government debt in 2005-2007. The evolution of the debt ratio may be less favourable than projected given the risks to the deficit outcomes mentioned above.

Regarding long-term sustainability, Cyprus faces risks of budgetary imbalances in meeting the costs of an ageing population. While the health care system reform is to be implemented in 2006, measures to reform the pension scheme are only in the initial stage. A timely and effective implementation of such reforms, together with the others measures necessary to secure an adequate primary surplus is essential to put public finances on a sustainable footing.

On 5 July 2004, on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in Cyprus in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Cyprus with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of Cyprus

	2003	2004	2005	2006	2007
Real GDP growth (%)	2,0	3,5	4,3	4,4	4,5
Employment growth (%)	0,9	1,0	1,0	2,0	3,0
CPI inflation (%)	4,1	2,0	2,0	2,0	2,0
General government balance (% of GDP)	– 6,3	– 5,2	– 2,9	– 2,2	– 1,6
Government gross debt (% of GDP)	72,6	75,2	74,8	71,5	68,4