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COMMISSION OPINION

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THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

1. Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

2. The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

LEGAL BACKGROUND

3. Article 126 of the Treaty on the Functioning of the European Union lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact.

4. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "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 10 November 2009, available at http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm.

product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

5. Article 126(3) of the Treaty stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

6. On the basis of the data notified by the Cypriot authorities in March 2010[2] and taking into account the Commission services' spring 2010 forecast, the Commission adopted a report under Article 126(3) for Cyprus on 12 May 2010[3].

7. Subsequently, and in accordance with Article 126(4) of the Treaty, the Economic and Financial Committee formulated an opinion on the Commission report on [27 May 2010].

8. Article 126(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the conclusions of its report under Article 126(3) and (ii) the opinion of the Economic and Financial Committee on this report. On the basis of these elements, the Commission has established a number of considerations for Cyprus.

CONSIDERATIONS CONCERNING CYPRUS

9. Immediately following its accession to the EU in May 2004, an EDP for Cyprus was initiated by the Commission[4] with the adoption of a report under Article 104(3) of Treaty Establishing the European Community (TEC) in view of a deficit of 6.3% of GDP in 2003, i.e. above the reference value of 3% of GDP. In July 2004, following recommendations from the Commission, the Council decided, in accordance with Article 104(6) TEC, that an excessive deficit existed in Cyprus and addressed a recommendation in accordance with Article 104(7) TEC to Cyprus with a view to bringing the excessive deficit situation to an end as rapidly as possible and by 2005 at the latest. In July 2006, following an overall assessment which showed that the

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2 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Cyprus can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

3 All EDP-related documents for Cyprus can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.

4 Documents related to the excessive deficit procedure for Cyprus are available at: http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm

deficit was reduced to 2.4% of GDP in 2005, the Council decided to abrogate its decision on the existence of an excessive deficit under Article 104(12) TEC.

10. After the end of the excessive deficit procedure, the Cypriot government balance remained well below the deficit threshold of 3% of GDP. In particular, in 2006 the deficit declined further to 1.2% of GDP, while in 2007 and 2008 the budget balance turned into a surplus of 3.4% and 0.9% of GDP respectively. In parallel, the structural balance turned from a deficit of 1¼% of GDP in 2006 to a surplus of 2½% in 2007, in excess of the medium-term budgetary objective (MTO) of Cyprus, which is a balanced budget in structural terms. Thereafter, the structural surplus of the previous years turned back into negative territory. During the period 2006-2008, the general government gross debt ratio declined by about 16¼ pp. of GDP to 48.4% in 2008, well below the 60% of GDP Treaty reference value. The debt reduction was driven by primary surpluses, high nominal growth and sizeable stock-flow adjustments (SFA) associated with the planned reduction of deposits at the central bank (sinking funds) and other accumulated financial assets used to repay maturing debt.

11. According to data notified by the Cypriot authorities in April 2010, the general government deficit in Cyprus reached 6.1% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 126(3) considered that the deficit was not close to the 3% of GDP reference value and that the excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' 2010 spring forecast, real GDP in Cyprus is projected to shrink further, although to a lesser extent, by almost ½% in 2010 compared with 1¾% in 2009. However, the planned excess over the reference value cannot be considered temporary. According to the Commission services' spring 2010 forecast, the budgetary deficit is projected to reach about 7¾% of GDP in 2011 on a no-policy change basis. The deficit criterion in the Treaty is not fulfilled.

12. According to data notified by the Cypriot authorities in April 2010, the general government gross debt remains below the 60% of GDP reference value and stood at 56.2% of GDP in 2009. For 2010, Cyprus notified a planned debt of 62% of GDP, thus exceeding 60% of GDP Treaty reference value. The Commission services' spring 2010 forecast projects debt to rise to 62.3% of GDP in 2010 and further to 67.6% in 2011 on the back of a deteriorated primary balance. In view of these trends, the debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

13. In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Cyprus, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

14. The opinion of the Economic and Financial Committee in accordance with Article 126(4) of the Treaty is consistent with the assessment in the Commission report under Article 126(3).

CONCLUSION

15. The monitoring of the budgetary situation in Cyprus and, in particular, the examination of the compliance with the criteria laid down in Article 126(2) has led the Commission to prepare a report in accordance with Article 126(3) of the Treaty. The Commission, having taken into account its report and the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in Cyprus.