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Recommendation for a

COUNCIL RECOMMENDATION

**with a view to bringing an end to the situation of an excessive government deficit in
Cyprus**

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof;

Having regard to the recommendation from the European Commission;

Whereas:

- (1) According to Article 126 of the Treaty Member States shall avoid excessive government deficits.
- (2) 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.
- (3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It 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.
- (4) The Council has decided on [13 July 2010], in accordance with Article 126(6) of the Treaty, that an excessive deficit exists in Cyprus.
- (5) In accordance with Article 126(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹ (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In deciding whether special circumstances exist, “relevant factors” as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account.

¹ OJ L 209, 2.8.1997, p. 6.

Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of 0.5% of GDP as a benchmark.

- (6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Cyprus. In 2009, for the first time in 35 years, economic activity contracted. The recession reflected a significant fall in domestic demand and an adverse external environment. In particular, high household indebtedness together with tighter 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 restructuring of corporate balance sheets. Moreover, exports of goods and services, especially tourism, plummeted as a consequence of the financial crisis and the global slowdown, in particular the much lower growth prospects of the main trading partners (United Kingdom, Euro Area, Russia). The deficit in 2009 is a consequence of both the economic downturn and the stimulus measures taken in line with the EERP by the Cypriot authorities. The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework.
- (7) In the years prior to the crisis and in a context of good economic times, supported by an asset boom and buoyant tax receipts, Cyprus was able to build up budgetary surpluses and reduced its gross debt ratio to 48.4% of GDP in 2008 (from 70.2% in 2004). In 2009, however, the economic crisis weighed heavily on public finances. As a result, the budget balance plunged from a surplus of 0.9% of GDP in 2008 to a deficit of 6.1% of GDP in 2009. This was also the result of a number of discretionary measures in response to the economic downturn (in line with the EERP) and of rather large composition effects on account of a much less tax-rich GDP growth pattern. The deficit is projected to widen further to 6.2% of GDP in 2010 according to the March 2010 EDP notification presented by the Ministry of Finance. However, the budgetary projections of the Commission services' spring 2010 forecasts indicate that the budgetary deficit would reach about 7% of GDP in 2010. Potential extra-budgetary measures still under discussion with uncertain or no information on their modalities and timing of implementation, were not incorporated.
- (8) Considering the special circumstances and the EERP framework, an average annual fiscal effort is recommended. The fiscal effort should take into account all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual fiscal effort, the 2011 deficit in the Commission services' spring 2010 forecast is taken as the starting point. The total fiscal effort needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.
- (9) Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2012. In particular, in view of the high external and domestic imbalances, a credible and

sustainable adjustment path would require Cypriot authorities to strengthen the fiscal strategy in 2010 with measures to control current expenditure, to reduce the deficit to below 6% of GDP in 2010, and take timely action to define an expenditure-driven consolidation strategy. To this effect, the Cypriot authorities should ensure an average annual fiscal effort of 1¾% of GDP over the period 2010-2012; specify the measures that are necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. In its stability programme submitted to the Commission and the Council on 1 April 2010, Cyprus committed to reduce its deficit to 4.5% of GDP in 2011 and 3.4% of GDP in 2012. Therefore, the additional effort requested to Cyprus in this recommendation compared to the initial plan of the Cypriot authorities is considered to be doable and necessary. The budgetary consolidation should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus.

- (10) In the recent past, Cyprus' budgetary framework has been improved with the adoption of the Financial Management Accounting System (FIMAS). As from 2006, Cyprus also enacted the gradual adoption of a three-year medium term budgetary framework (MTBF) and as from 2007 it introduced a Programme and Performance Budgeting (PPB). Nevertheless, the new framework is still phasing in 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 public finances. The existing practice of adopting supplementary budgets during the course of the year has implied an increase in current expenditure beyond the intended reallocation of funds. Once the new budgeting framework is fully implemented, it is expected to end this practise and lead to a more effective and efficient budgeting process and contribute to containing expenditure by ministry according to the ceilings set. At the same time, the new budgeting process would set a sound basis for reallocating expenditure in favour of growth enhancing activities.
- (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. A pension reform introduced in April 2009 would slightly reduce the increase in pension expenditure and, more significantly, raise the social security contribution rates. The reform should 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 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 Report² as high.

² 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

- (12) According to data notified by the Cypriot authorities in April 2010, general government gross debt was 56.2% of GDP in 2009. This increase was mainly the result of the significant deterioration in the primary balance and debt-increasing "snowball" effects on the back of falling nominal GDP. Stock-flow adjustments also had a negative contribution to the debt level equivalent to about 1 percentage point of GDP, due to accumulation of government assets at the end of the year in order to meet debt maturity obligations arising early in January of 2010, as well as, differences between cash and accruals. For 2010, Cyprus notified a planned debt of 62% of GDP, thus exceeding the 60% of GDP Treaty reference value (the April 2010 stability programme plans a slightly lower figure (61%) and foresees a further increase to 63.2% of GDP in 2011). 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 planned. The Commission services spring 2010 forecast projects debt to rise further to 62.3% of GDP in 2010 and 67.6% in 2011, on the back of a deteriorated primary balance.
- (13) Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the forthcoming updates of the Cypriot stability programme could usefully be devoted to this issue.
- (14) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

HAS ADOPTED THIS RECOMMENDATION:

- (1) Recognising that Cyprus' budgetary position in 2009 resulted from measures amounting to about 1½% of GDP in 2009, which is an adequate response to the downturn and were in line with the European Economic Recovery Plan, as well as from the free play of automatic stabilisers, Cyprus' authorities should put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2012.
- (2) The Cypriot authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Cypriot authorities should:
 - (a) take necessary measures to reduce the 2010 deficit to below 6% of GDP and define an expenditure-driven consolidation strategy, in order to bring the deficit below the reference value by 2012;
 - (b) to this end ensure an average annual fiscal effort of at least 1¾% of GDP over the period 2010-2012, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus;

the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

- (c) specify and rigorously implement the measures that are necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.
- (3) To limit risks to the adjustment, Cyprus should strengthen the binding nature of its medium-term budgetary framework as well as improve the monitoring of the budget execution throughout the year.
- (4) 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.
- (5) In addition, the Cypriot authorities should seize opportunities beyond the fiscal effort, including from better economic conditions, to accelerate the reduction of the gross debt ratio back towards the reference value.
- (6) The Council establishes the deadline of [13 January 2011] for the Cypriot government to take effective action to specify the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2010 forecast.

The Cypriot authorities should report on progress made in the implementation of these recommendations in a separate chapter in the forthcoming updates of the stability programmes until the abrogation of the excessive deficit procedure.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for appropriate budgetary management of economic downturns. It therefore invites the Cypriot authorities to ensure that budgetary consolidation towards the medium-term objective for the budgetary position – a balanced budget in structural terms – is sustained after the excessive deficit will have been corrected. The adherence to the budgetary targets and the firm containment of expenditure over the medium-term could be improved by the full implementation, as envisaged, of an effective multi-annual budgetary framework.

This recommendation is addressed to the Republic of Cyprus.

Done at Brussels,

*For the Council
The President*