



**STABILITY PROGRAMME**  
**OF THE**  
**REPUBLIC OF CYPRUS**  
**2008-2012**

**Ministry of Finance**



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OF THE  
REPUBLIC OF CYPRUS**

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## INTRODUCTION

On January 1<sup>st</sup> 2008 Cyprus adopted the euro as its official currency. One year after, and in accordance with the Council's Regulation (EC) 1055/2005, Cyprus submits its Stability Programme (SP) for the period 2008-12. This revised Programme has been prepared in line with the updated guidelines set out in the "Guidelines on the format and content of the Stability and Convergence Programmes (2005 Code of Conduct)". It also takes into account the recent European Commission proposal for a coordinated recovery plan to address the current economic downturn, and the joint conclusion taken at the European Council in December 2008. Since last year there have been no institutional developments pertaining to national budgetary rules and procedures, thus the current SP does not include a separate chapter covering these issues.

The Stability Programme for the Period 2008-2012 has been approved by the Council of Ministers on December 17, 2008 and subsequently amended on February 3<sup>rd</sup>, 2009.

With the adoption of the euro the policy framework in Cyprus has changed fundamentally. Decision making on monetary policy has been transferred from the Central Bank of Cyprus to the European Central Bank (ECB). Monetary policy decisions made by the ECB are based on considerations about the euro area economy as a whole. At the same time, fiscal policy is guided by the Stability and Growth Pact, and by the national fiscal framework, which aims at safeguarding fiscal discipline, the quality of public finances and long-term fiscal sustainability.

This is the first Stability Programme of the new Government of the Republic of Cyprus, headed by President Christofias, who was elected in February 2008. A key policy aim of the new Government is to promote growth and strengthen social cohesion. In this regard, the Government aims at re-directing resources in favour of social expenditure and growth-enhancing expenditure categories, improving physical infrastructure in various segments of the economy while, at the same time, safeguarding macroeconomic stability.

To achieve an enduring consolidation of public finances, especially in view of the prospective ageing of the population, a series of fiscal structural reforms are being undertaken, centred around the gradual introduction of a Medium-Term Budgetary Framework, using a programme and performance based budgeting method. These reforms will constitute an important ingredient of the policy framework of the new Government. Furthermore, the framework for debt and cash management is being strengthened which will also result in significant savings and allow the Government to boost its social spending for those in greater need. A key strategic aim of the new Government is to lower the public debt to GDP ratio significantly over the medium term and, thus, allow for more flexibility in fiscal policy making.

The unfolding international financial crisis has deepened appreciably since September 2008 and the prospects for the world economy have become gloomier in recent weeks. World growth is expected to slow significantly and the Euro zone has experienced its first recession, with two consecutive quarters of negative growth in 2008. Cyprus has so far weathered the storm, but the prospects for 2009 are more uncertain. As anticipated in the previous Stability Programme, revenues relating to the real estate activity have declined and the surplus achieved in 2007 is estimated to have contracted in 2008.

In the event of a more protracted slowdown, the Government has the necessary room to manoeuvre, given the underlying sound fiscal position and stands ready to implement additional measures, if required.

Nevertheless, and despite the unfolding economic crisis and prospective slowdown of economic activity in the EU and Euro area—and conscious of the need to safeguard the important achievements so far—this Stability Programme reaffirms its ambitious Medium-Term Objective of a balanced budget. This represents a cautious approach taking into account the uncertain economic period which we are now entering.

Overall, and irrespective of specific measures which may be taken to address the current slowdown, policies will have to support investment and private sector development, and contribute towards the further enhancement of productivity and competitiveness of the economy. The Government anticipates playing a special role in reducing the administrative burden of laws and regulations, upgrading public infrastructure, promoting R&D and innovation and, at the same time, playing a role in determining wages in the economy, through public sector wage setting.

Furthermore, the Government anticipates playing an important role in promoting energy efficiency and developing alternative energy sources, while promoting, in parallel, measures to upgrade the environment and address the consequences of climate change. Another important priority, following the severe drought of the past 2-3 years, is to enhance water supply and security, while providing incentives for containing water consumption. Moreover, policies will continue to be directed toward strengthening the longer-term performance of the economy, with investments in supporting infrastructure, and ensuring the sustainability of public finances. In this respect some progress is being made in reforming the pension system and in developing a new healthcare system. These priorities are incorporated in the National Reform Programme. Accordingly, the expenditures related to the implementation of the National Reform Programme have been taken into account in the Stability Programme.

This SP also includes a special section devoted to measures taken to address the global recession, which is also affecting Cyprus' economy. Though growth to-date

remains satisfactory, the SP forecasts a slowdown in 2009-10, with the risk to this scenario being on the downside. The European Commission has announced a recovery plan to be initiated at the European level which will comprise of timely, temporary, and targeted concrete measures, aimed at bolstering faltering demand. Cyprus has already announced measures, and these include both short-term and temporary measures, as well as other more permanent structural measures, which should have a significant impact upon introduction in 2009. These are described in detail in the SP.

The central scenario of this Stability Programme is based on the assumption that the current international economic crisis will primarily affect the construction, real estate and tourism sectors, and, to a lesser extent, exports of services other than tourism. Moderate effects due to tight borrowing conditions, gradual deleveraging, possible confidence effects may also affect private consumption. However, given the increased degree of uncertainty, more pronounced effects on construction and tourism, as well as, on private consumption and export of services can not be excluded. Under such scenarios, growth may fall to 1%, with adverse effects on public finances. Nevertheless, even under this pessimistic scenario, the underlying fiscal position is expected to remain sound, as reflected in the public debt-to-GDP ratio remaining below 50% of GDP.

The macroeconomic framework underlying the SP is based on the assumption that oil prices in 2009 will average \$50 per barrel in 2009, and the euro/dollar exchange rate will be 1.36 \$/€. This represents a necessary downward revision for oil prices compared to the assumptions embodied in the Autumn Forecast of the European Commission, as oil prices have fallen substantially below the \$85 level set in November 2008.

The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as feasible and credible. If warranted by adverse developments, the Government stands ready to provide the required stimulus to the economy through further effective, targeted and temporary measures, in line with the European Council agreement of December 11-12, 2008.

The Ministry of Finance will be monitoring closely the timely implementation of the Programme.

## **1. OVERALL POLICY FRAMEWORK AND OBJECTIVES**

The overriding objective of economic policy is to enhance long-term growth and the standard of living of all citizens, in particular of low income groups, to maintain macroeconomic stability, implement structural reforms, which improve the functioning of the market mechanism, and ensure that the government sector provides, adequately and efficiently, services to the public. Within the overall government finance constraints and targets, fiscal policy will focus on growth and social cohesion, through the redirection of resources to growth-enhancing activities and prioritization of expenditure programmes. A more efficient and leaner government, that can tackle effectively these challenges, will be important in this process.

Despite the relatively satisfactory performance of the economy—as exemplified by real convergence and the fulfillment of several key Lisbon targets—efforts to reform further labour, product and financial markets, in line with the country-specific Broad Economic Policy Guidelines' (BEPGs') and Cyprus' National Reform Programme, will be further pursued.

### ***Fiscal Policy***

At a time of intense financial market turbulence, and growth slowdown internationally, fiscal policy must remain flexible to respond as needed to a more marked deterioration in the macroeconomic outlook domestically. Nevertheless, the overall strategy for fiscal policy is to continue consolidating the public finances, with a view to reducing further public debt and thus ensuring the long-term sustainability of public finances. Particular emphasis is placed on the need to curtail current expenditure and restructure public spending, in favour of capital expenditure and research and education, which can boost the economy's growth potential. Emphasis is also attached to targeted social spending. Redirecting resources towards infrastructure is particularly important at this point due to the expected construction of the construction sector.

The overall policy strategy is based on six key pillars:

- The implementation of a Medium-Term Budgetary Framework (MTBF), which will institutionalise expenditure rules and program-based budgeting, give more independence to spending ministries and, at the same time, increase their accountability for achieving programmes and quantifiable targets;
- Strengthening social cohesion, with particular emphasis on raising the standard of living of pensioners. Priority will be attached to households with at least one

pensioner living below relative poverty, as well as, to the reform of the social welfare system in general;

- Implementation of structural reforms as outlined in the National Reform Programme of Cyprus;
- The modernisation of the public sector, which will result in leaner and more productive public services. Such a policy will limit expenditure growth and raise overall productivity. Particular attention will be placed on the wage policy for public sector employees, given its significant impact on overall wage developments;
- Enhance public debt and cash management systems; and
- Improve further tax collection by addressing tax evasion and strengthening tax administration.

In spite of the unfolding economic crisis and prospective slowdown of economic activity in the EU and Euro area—and conscious of the need to safeguard the important achievements so far—this Stability Programme reaffirms its ambitious Medium-Term Objective of a balanced budget. This represents a cautious approach taking into account the uncertain economic period which we are now entering.

### *Monetary and Exchange Rate Policy*

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, mainly through the pegging of the Cyprus pound to an anchor currency, be it a basket of currencies until 1992 or a single currency, the ECU from 1992 to 1998 and the euro in the period 1999-2007. As from 1<sup>st</sup> of January 2008 the euro has been adopted as the official currency

As of 1/1/2008 the setting and implementation of monetary policy has shifted to the ECB. The Central Bank of Cyprus is represented in all relevant bodies and committees of the ECB and ESCB. Interest rate policy is set by the ECB taking into account the conditions prevailing in the euro area as a whole and the banking system has full access to all liquidity facilities provided by the ECB.

### *Structural Reforms*

During this difficult time internationally, and domestically, it is especially important to continue with the vigorous implementation of structural reforms which will raise long-term growth and boost the economy's agility and competitiveness. Cyprus has already submitted an elaborate outline of structural reforms in its National Reform Programme (NRP). The implementation of these measures is an important pillar of this SP, and the funding constitutes an important element of the proposed budget.

- Reforms are being undertaken in the labour market, especially to boost supply of labour among females and address the high gender pay gap, increase employability and labour force adaptability—particularly through lifelong learning—and raise the employment rate. Enhancing physical and human capital is also key in increasing productivity and boosting the economy's potential growth. Development of human capital is especially important in an economy, dominated by the services sector.
- Furthermore, reforms are being carried out, aimed at strengthening competition, especially in the area of professional services, improving the overall business climate and streamlining the regulatory framework and cutting red tape.
- Another important area of the reform agenda is reform of the social security and of the healthcare provision systems. Both are crucial for tackling the long-term sustainability of public finances.
- In addition, as it is widely accepted that R&D and innovation and the wider utilisation of information technology are important in attracting foreign direct investment, boosting productivity and growth, the SP provides for increased expenditure on R&D. The increased expenditure is being accompanied by efforts to coordinate more effectively government-funded academic and private sector research programmes, so as to encourage innovation. EU structural funds will finance a large part of the budget for Research, Technological Development and Innovation, while the institutional framework for R & D and innovation will be further enhanced.
- Implementation of policies aimed at upgrading the physical infrastructure and improving the functioning of network industries will be intensified, taking into account environmental concerns. A number of infrastructure projects will be speeded up in particular as part of the EU-led initiative to boost demand in view of the weakening economic activity especially in the construction sector.

## **2. ECONOMIC OUTLOOK**

### *World Economy*

The uncertainty surrounding the global economic outlook has been exceptionally high, in view of the rapidly unfolding events in the financial markets. The unfolding financial market crisis, strong volatility in oil and commodity prices and ongoing adjustments in housing markets continue to weigh on global economic activity. Ongoing strains in the international financial system and the associated financial turbulence are having profound repercussions on the global economy. On the positive side, inflation has fallen in line with the recent decrease in commodity prices. Oil prices fluctuated sharply in September amid the unwinding of financial positions, first falling towards \$90 per barrel and then recovering—mainly owing to the renewed intensified financial turbulence particularly following the collapse of Lehman Brothers—before declining steeply again to below the \$45 level. Over the medium term, market participants expect oil prices to return to higher levels.

Prospects for the global economy are exceptionally uncertain and markets are likely to remain under heavy strain throughout 2009. The latest IMF and the European Commission projections show the global economy undergoing a major downturn, with growth falling to its lowest level since the 2001-02 recession. A gradual recovery is projected to get under way later in 2009, but global growth is not expected to return to trend until 2010. Important supporting elements for the eventual recovery will be the unwinding of adverse terms-of-trade effects as commodity prices are reduced to more subdued levels, a turnaround in the U.S. housing market, and rising confidence that the liquidity and solvency problems in core financial institutions are being resolved. On an annual basis, global growth is expected to moderate from around 5% in 2007 and 3.7% in 2008 to 2.2% in 2009. Moreover, world trade growth is expected to drop from 7.2% in 2007 and 4.6% in 2008 to 2.1% in 2009.

The high uncertainty surrounding this outlook for global economic growth has resulted in increased downside risks for the European and euro area economic growth, affecting the real economy considerably more adversely than previously foreseen. The European Commission's economic sentiment indicator also reflects the negative outlook, as it continued to fall during the autumn. It is now well below its long-term average for both the EU and the euro area.

In the EU27, GDP stagnated during the second quarter of 2008, compared with the previous quarter and fell by 0.2% in the third quarter. In the euro area GDP fell by 0.2% in both the second and third quarters of 2008. According to the autumn forecasts of the European Commission, albeit now too optimistic, the annual growth for the year 2008 was expected to be 1.4% in the EU27, down from 2% anticipated in the

Spring forecasts. Similarly, for the euro area, the growth forecast for the 2008 has been revised downwards from 1.7% to 1.2%. Among the largest Member States, GDP growth in Germany was expected to reach 1.7%, 1.3% in Spain, 0.9% in France and no growth in Italy. It is important to note the marked downturn of growth in Ireland, which was expected to fall to -1.6% in 2008 from 6.0% in 2007. In 2009, GDP was forecast by the European Commission to expand by 0.2% in the EU27 and around 0.1% in the euro area, thus displaying significant deceleration compared to 2008. Among the largest Member States, GDP was expected to fall in Spain (-0.2%) and Ireland (-0.9%), whereas no growth was projected for France, Germany and Italy. To address the weakening economic activity the ECB has lowered its main policy rate by 225 basis points since October 2008.

Economic activity in the UK, which is by far the most important economic partner of Cyprus, slowed markedly in the first three quarters of 2008. More specifically, in the first quarter growth of real GDP halved to 0.3% compared to the previous quarter, in the second quarter it came to a standstill, and in the third quarter it contracted by 0.5%. For 2008, GDP growth was projected to reach 0.9%. Given these negative prospects, the Bank of England cut interest rates by 350 basis points since October 2008, with a view to alleviate as much as possible the problems faced by the financial system in UK and the adverse repercussions for the real economy. For 2009 the outlook is even more gloomy, as UK is expected to fall into a recession (-1% growth). The fact that UK exhibited a sharply weaker performance—given its greater exposure to the ongoing weakness in both credit and equity markets—contributed to a substantial (around 20%) depreciation of the pound sterling against the euro over the past twelve months. This resulted in a decrease of the number of British tourists visiting Cyprus and to a fall in property demand by UK nationals.

The US economy is already experiencing a significant slowdown, which could prove to be deeper and more persistent than initially anticipated and this could have further considerable side effects on world economic growth. Real GDP expanded at a 2.1% annualised rate in the second quarter of 2008 and fell sharply to 0.7% in the third quarter with the rate of growth projected to reach 1.4% in 2008 and to turn a negative 0.7% in 2009. Financial market strains increased substantially since September, especially since the collapse of Lehman Brothers. The collapse of several financial institutions, owing to mortgage-related losses and intensified pressures in funding markets, have posed risks for the availability of credit and increased uncertainty for the economic outlook. In this context, the US authorities have lowered the basic interest rates to 0–0.25%, in order to restore confidence in the financial system.

Russia, which is seen as an important economic partner of Cyprus, was forecast by the IMF to grow by 6.8% in 2008, reflecting a stronger-than expected performance early in the year and initial substantial terms-of-trade gains. On the other hand, growth was set to weaken appreciably in 2009 (3.5%), reflecting slowing world demand and

tightening financial conditions. Moreover, falling commodity prices, particularly for oil and natural gas, are depressing export earnings and government revenues, putting pressure on the rouble and dampening prospects for growth in 2009.

In Japan, economic activity has declined significantly, reflecting sluggish domestic demand and a slowdown in exports. In the second and third quarters of 2008 real GDP decreased by 0.9% and 0.5% on a quarterly basis, respectively, largely offsetting the fairly strong growth recorded in the first quarter of 2008. For the whole 2008, according to IMF forecasts, growth was expected to expand by 0.5% and turn negative -0.2% in 2009.

Overall, the external economic environment has deteriorated and is expected to worsen at least in the short term. The realization of the severity of the current economic situation, nevertheless, has stimulated significant policy initiatives which should help dampen the depth of the downturn and, hopefully, usher in a recovery by the end of 2009.

### *Cyclical Developments and Current Prospects in Cyprus*

Despite the negative external environment, the economy of Cyprus continued to expand at a much higher pace compared with the EU. According to the preliminary estimates of the Statistical Service of Cyprus, the GDP in constant prices increased by 3.9% in the first nine months of 2008 compared to the corresponding period of the previous year. Growth during this period has been mainly driven by domestic demand, private consumption and gross fixed capital formation, on the back of continued employment and wage growth, low real interest rates and high credit expansion. Gross fixed capital formation continued to support growth, mainly as a result of sustained growth of investment in construction and to a lesser extent machinery and equipment. The growth contribution of the external sector has been negative, as the more unfavourable external environment and the slowdown of Cyprus' main economic partners has had an adverse effect on demand for exports, in particular tourism.

From a sectoral viewpoint, agricultural output is estimated to have contracted considerably in 2008, due to the severe drought of the past few years, which culminated in dramatic shortage of water both for agricultural purposes, but also for household use. The construction sector has not shown noticeable signs of a sizeable slowdown, owing to the considerable carry-over activity in this sector, although prospects appear grim. Sales of cement point to continued buoyant activity in several areas, but building permits have decreased noticeably, thereby implying a future slowdown. The tertiary sector has continued to expand vigorously, driven by strong activity of financial intermediation and other business and related activities. However, the tourism industry, which has been operating below potential for a number of years,

continued to experience intense competition from other near-by destinations, placing pressure both on arrivals and margins. Recent data for the whole of 2008 has shown that the overall number of tourist arrivals in 2008 decreased by 0.5%, compared to 2007.

**Table I: Selected Economic Indicators 2006-2008**

<i>annual % change</i>	<b>2006</b>	<b>2007</b>	<b>2008 (proj)</b>
Real GDP growth rate	4.1	4.4	3.8
Private consumption	4.5	8.2	7.2
GDP deflator	3.0	3.5	4.2
Tourist arrivals (000's)	2,401	2,416	2,404
HICP	2.2	2.2	4.4
Productivity growth	1.4	1.3	1.9
Employment growth	2.7	3.1	1.9
Unemployment rate (Labour Force Survey)	4.5	3.9	4.0
Trade balance of goods (% of GDP)	-27.2	-30.2	-34.2
Trade balance of services (% of GDP)	23.2	23.5	24.3
Current account balance (% of GDP)	-7.0	-11.7	-12.9

From the demand side, continued strong private consumption, mainly driven by consumer credit and strong employment growth, provided the impetus to growth. In the first nine months of 2008, consumption grew by over 8%. As mentioned above, net exports contributed negatively to GDP, as exports grew by 3.6% in and imports by 12% in the first nine months of 2008. As a result the current account deficit widened significantly in the first nine months of 2008 to 15.8% of GDP (see more discussion in Section 3).

Labour market conditions remained tight, with the unemployment rate remaining around 4% of the labour force in 2008; the unemployment rate in the third quarter of 2008 was 3.6% of the labour force. Employment continued to expand strongly, at around 2%, sustained mainly by a continued inward immigration particularly from the EU. The rapid growth of the working age population and employment in several sectors, have been instrumental in supporting strong demand and curbing wage growth. At the same time, these developments have increased, markedly, the de facto flexibility in the labour market.

Inflation, as measured by the Harmonized Index of Consumer Prices (HICP), accelerated significantly since the second half-year period of 2007. Even though HICP remained low at some 2.2% in 2007, it accelerated to 4.4% in 2008 owing mainly to rising energy and commodity prices, and, to a lesser extent, to buoyant credit conditions domestically. The introduction of the euro in January led to a small rounding effect, involving a number of low-value mainly cash-purchased

products/services (e.g., parking places, fast food, hairdressers, dry cleaners etc). According to official estimates, as well as estimates by Eurostat, the total effect due to the euro introduction is estimated at around 0.2-0.3 of 1 percentage point.

At the same time, and despite the ongoing slow down of credit in the US and euro area, bank credit soared reaching very high levels (Section 3). Bank credit to the private sector, and in particular credit for housing loans expanded by 30.7% and 24.3%, respectively, in November 2008 compared with the same month in 2007.

### *Medium-term Scenario 2009-2012*

For the preparation of the underlying macroeconomic framework presented here the following key assumptions have been made for 2009-12:

- It is assumed that the price of crude oil (Brent crude) will average \$50 per barrel in 2009, and will rise to \$53 per barrel in 2010. In subsequent years, crude oil prices are assumed to remain at \$55 per barrel.<sup>1</sup>
- The euro dollar exchange rate will average at around 1.36 in 2009 and 2010.
- Tourist arrivals will decline by 10% in 2009 and remain relatively flat thereafter. On average, over the forecast period, arrivals will decline by 2¼% on an annual basis, and per capita tourist spending will increase by around 1.7% in real terms annually over 2009-12.
- Nominal earnings will rise by about 5% per annum and real earnings by 2.3% during 2009-2012, above prospective productivity gains. Hence, real unit labour costs will rise around 1% per annum over the same period.
- Employment will expand by 1.5% per annum, as a result of the continuing inflow of foreign workers.
- Public sector employment will expand by some 1% annually.

Table II compares long-term trends, which provide a good indication about potential growth in each sector, with the baseline scenario growth rates. The picture is mixed as some sectors are forecast to perform poorly, relative to trend, while others are expected to continue performing satisfactorily. The baseline scenario included in this SP envisages growth significantly below trend in agriculture, construction, hotels and restaurants and to a lesser extent to financial intermediation. A number of rapidly growing sectors, such as other business activities, are assumed to gradually converge to their trend growth levels over the medium term.

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<sup>1</sup> Assumptions are based on the Autumn Economic Forecast, November 2008, of the European Commission.

Based on this scenario real GDP will expand by 2.1% in 2009 and 2.4% in 2010, with the recovery gathering pace in 2011-12.

From the demand side, private consumption growth also is projected to exhibit a considerable correction in 2009 as households attempt to reduce the overall level of indebtedness, slowing to 3.8%, from an estimated 7.2% in 2008. Investment is expected to slow down owing mainly to the slackening of construction activity. Despite a boost by public investment in infrastructure projects overall growth of investment in buildings will contract from 1.2% in 2008 to -6.9% in 2009, with total investment exhibiting a smaller contraction. Similarly, due to the expected slowdown of tourism, the growth of total exports will decline from nearly 6.1% in 2008 to 1.4% in 2009.

**Table II: Sectoral growth rates, comparison with trend growth**

Trend Levels	Long-term average	Deviation from Trend				
		2008 1	2009 1	2010 1	2011 1	2012 1
<b>Agriculture</b>						
<i>Trend</i>	-2.2	-2.2	-2.2	-2.2	-2.2	-2.2
<i>Projection Scenario</i>		-5.0	5.7	-2.2	-2.2	-2.2
<b>Construction</b>						
<i>Trend</i>	2.9	2.9	2.9	2.9	2.9	2.9
<i>Projection Scenario</i>		-0.2	-8.0	-1.1	1.5	1.5
<b>Retail Sector</b>						
<i>Trend</i>	4.5	4.5	4.5	4.5	4.5	4.5
<i>Projection Scenario</i>		9.7	4.5	2.4	2.4	2.4
<b>Hotels and Restaurants</b>						
<i>Trend</i>	1.6	1.6	1.6	1.6	1.6	1.6
<i>Projection Scenario</i>		-3.5	-6.0	-3.0	0.6	1.1
<b>Financial Intermediation</b>						
<i>Trend</i>	7.3	7.3	7.3	7.3	7.3	7.3
<i>Projection Scenario</i>		6.2	4.7	4.7	5.1	6.2
<b>Real Estate</b>						
<i>Trend</i>	5.0	5.0	5.0	5.0	5.0	5.0
<i>Projection Scenario</i>		4.3	3.8	3.6	3.6	3.6
<b>Other Business Activities</b>						
<i>Trend</i>	5.2	5.2	5.2	5.2	5.2	5.2
<i>Projection Scenario</i>		6.8	6.3	5.2	5.2	5.2

Services will continue to be the main engine of growth, given that the comparative advantages of Cyprus favour the development of these types of activities. The share of the services sector as a whole to GDP is anticipated to grow further and reach 81.4% in 2012, as compared with 78.6% in 2006, whereas the share of both the primary and secondary sectors would correspondingly decline from 2.6% and 18.6% in 2007 to 2.2% and 16.4% respectively in 2012. Within services, continuing restructuring and diversification are expected, with an increased shift towards export-oriented private services in the areas of communications, financial intermediation, business services, private education and health. These will continue to benefit from the abolition of all restrictions on direct and portfolio investment, not only for EU residents but also for residents of third countries, implemented as from the last quarter of 2004, the

conditions of enhanced competition in the utilities sectors, the opening up of new universities in Cyprus, and the utilisation of the comparative advantages of Cyprus.

The inflation rate constitutes a major uncertainty given the large swings in the price of oil and other commodities. Based on the harmonised definition, inflation averaged 4.4% in 2008, significantly lower than had been expected earlier in the year, owing to the fall in the price of oil. Based on the external assumptions presented in Table 8, oil prices will average \$50 per barrel in 2009 and \$53 per barrel in 2010. The dollar/euro exchange rate is assumed to be around 1.36 \$/€. Inflation is forecast to ease further to 2 % in 2009 and to stay around 2½% in the medium term.

In the labour market the medium-term scenario envisages further, albeit diminished employment gains compared to recent years, mainly resulting from increased participation of foreign workers, and a gradual increase in the participation rate of female and old-aged workers. However, some small increase in the unemployment rate is forecast as a result of below-potential growth over the programme period. Thus while employment growth will remain robust in some sectors, in other sectors more directly exposed to the external slowdown such as hotels and restaurants and construction, some increase in unemployment will be observed. Overall, the gainfully employed population is forecast to continue increasing strongly at around 1.5% per annum, albeit at significantly slower pace compared to the past five years. The unemployment rate will rise somewhat over 5% in 2010 and reach 5.5% in 2012.

Productivity growth is expected to average 1.3% per annum over the medium term, which is above the performance recorded over the period 2003-2007. Real earnings are forecast to rise broadly in line with productivity growth, and nominal unit labour costs will increase by 3.7% over the same period.

The current account deficit is expected to remain at relatively high levels over the medium term. The deficit is forecast to reach 13% of GDP in 2008 and decline only modestly to around 9.8% by 2012. This implies an overall improvement in the savings-investment balance, with the decline in the domestic saving ratio being less than the fall in the investment rate.

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**Box 1. Risks to medium-term forecasts**

Overall, the risks to the growth outlook tilted heavily to the downside over the medium term. Similarly, upside risks to prices diminished as oil and other commodity prices declined in a spectacular fashion, as a result of the situation of the world economy.

***External Environment***

- Further escalation of the financial sector crisis, resulting in volatility of interest rates and widening of spreads;
- A deeper-than-anticipated real economy correction in the EU, particularly the UK which constitutes a major trading partner to Cyprus;
- A deeper-than-anticipated slowdown in Russia could affect the international business sector in Cyprus, and hence export of services other than tourism;
- A reversal of the current dollar appreciation, owing in large part to the unwinding of cross-currency positions and flight to safety, could unleash a protracted and significant selling of the dollar with repercussions on the external competitiveness in the euro area; and
- More volatility of commodity prices, especially oil.

***Domestic Economy***

- A deeper correction of private consumption and investment in construction, due to more pronounced confidence effects and credit restraint;
- A more significant impact of the world economy on the export affected sectors of the economy; and
- A deeper contraction of the construction sector.

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Notwithstanding significant risks to this scenario, it is forecast that GDP will expand at an average rate of 2.7% during the programme period 2009-12, below the estimated potential growth rate of 3¾%. Growth is expected to decelerate to 2.1% in 2009 and gradually pick up to 2.4% in 2010. With a negative output gap, the unemployment rate will increase somewhat to 5.1% over 2009-12 from 3.9% in 2007. Nevertheless, there are significant risks and uncertainty underlying these both stemming from the evolution of the world economy, including of the price of commodities, and the behaviour of households and corporations domestically.

### **3. KEY ISSUES RELEVANT FOR POLICY**

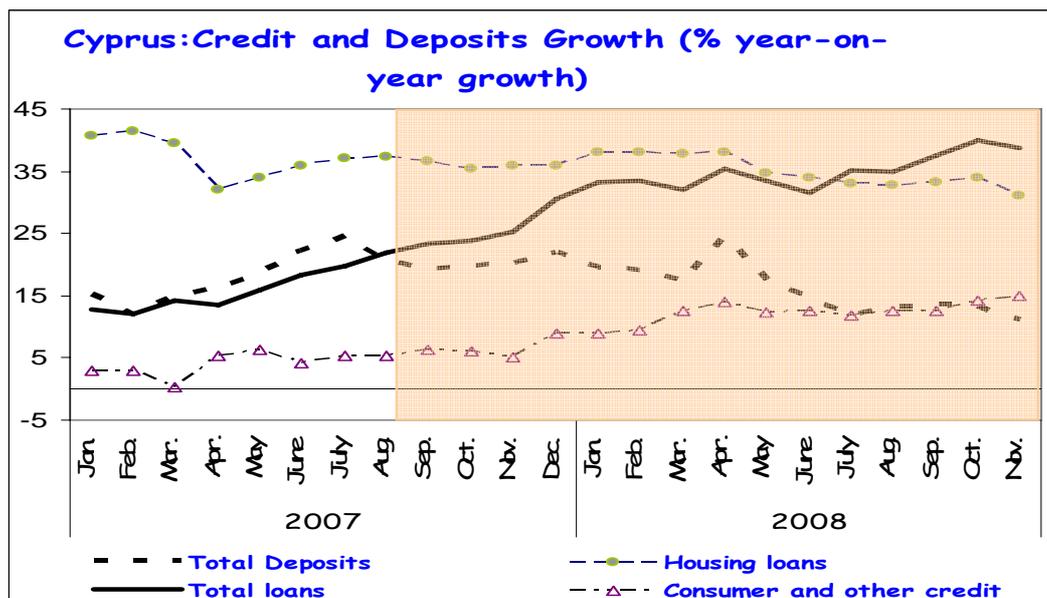
The analysis of the current outlook and medium-term prospects, and the conditions prevailing in the international financial system, raise a number of important issues which are relevant for policy. Among these key issues for discussion, this section focuses on three areas: (i) credit expansion (ii) the current account deficit and its significance and (iii) structural reforms.

#### ***Will the international credit crunch affect Cyprus?***

A key challenge for the authorities is to ensure that, in the face of the international credit crunch, there is sufficient and affordable credit flow to the productive sectors. One major problem faced currently by policy makers at the current juncture is that despite ample liquidity in the banking system worldwide, lending among institutions is seriously impaired, owing to elevated perceived counterparty risk. The market faces a typical asymmetric information problem where participants are uncertain about each other's true financial state—due to possible undeclared holdings of “bad” investments and the difficulty in valuing assets and liabilities of counterparties—and therefore refrain from lending money to one another. This is seen in the massive excess liquidity which is deposited on a regular basis at the ECB (amounting sometimes to €200-300 billion) by banking institutions, and at the same time the extensive liquidity operations which the ECB is undertaking to provide funds to financial institutions.

The first striking signs of a crisis were experienced in August 2007, mainly in the US, and since then several waves of turbulence have shocked the international financial system and the world economy.

The economy of Cyprus has been growing rapidly during this period sustained by continued growth of domestic demand, particularly private consumption, investment in construction as well as and a satisfactory performance of exports, mainly in the area of non-tourist services.



Nevertheless, and despite signs of an emerging crisis as early as August 2007, bank credit growth accelerated during the same period from 21% in August 2007 to 40% growth by November 2008 (Chart). The key driver of this rapid credit expansion has been a continued sustained growth of loans for housing to residents and non-residents, which have been growing at some 35% yearly, and an acceleration of credit extended to other sectors, including consumer loans, from 5½% in August 2007 to 15% in November 2008. The continuing buoyancy of the construction and real estate sectors has been a key driver of the growth of credit. Additionally, credit may have played the role of a shock absorber as the prices of basic goods, including food, fuel and electricity surged during this period, while households maintained their consumption.

It is debatable whether these growth rates can be explained by underlying trends of the economy, and furthermore whether they can these be sustained in particular against the background of the liquidity problems in the euro area money markets.

The simple quantity theory of money identity tells us that  $\Delta m = \Delta p + \Delta y - \Delta v$ , or that money growth in the long run must be determined by long-run inflation (p), real GDP growth (y) and trend velocity (v). Assuming that inflation in the long run is 2½–3%, real growth 3¾–4% and a velocity negative trend of around -2–4% (compared with -½–1% for the euro area), one can, roughly, assert that money supply must be expanding at around 8-10% yearly. Indeed, as it can be seen in the Chart deposits have expanded at around 15-17% which does not seem to be unreasonable also taking into account the above-trend growth of income and prices, and of course the increased inflows of capital from abroad. In addition, as we know from various studies both the level and growth of GDP is underestimated by official national account data, and the demand for credit and money is influenced as well by the volume and prices of wealth transactions.

Growth rates above these levels are sustained not by domestic sources, but instead by other borrowing by banks either through their parent companies, through bond markets or the interbank markets. It is, therefore, inevitable that the growth of credit will decelerate both as a result of the slowdown of the economy, but also due to the possible international credit crunch which will make it difficult for banks to secure funds from the euro interbank market. It is also rather interesting that banks in Cyprus, chose to maintain lending at high levels, probably in the face of intense competition for market shares. To secure their cash flow and liquidity banks engaged in intense competition for deposits, which pushed up market interest rates even as euribor and base rates were declining.

What is the likely outcome of an emerging normalisation of conditions in the credit markets? Inevitably banks will have to limit the growth of credit and to direct it, primarily, to the most productive sectors of the economy. This is a challenge as enhanced credit risk standards will have to be applied so that lending is channeled to where it is needed most, but also to where it provides a higher and safer return to banks. Finally, banks will have to restructure on the side of their expenditures, otherwise profits will be squeezed.

#### ***Current Account Developments and Policy Implications***

In Cyprus, the current account deficit widened markedly from below 4% in 2000 to 11.7% in 2007 and it is expected to remain at relatively high levels in the medium term. Similar trends in the external balance have been observed in a number of countries, including in the European Union.

**Table III: Balance of Payments**

<i>in percent of GDP</i>	<b>2000</b>	<b>2007</b>
<b><i>Current Account (% of GDP)</i></b>		
Current Account	-5.3	-11.7%
Export of goods	10.2	6.9
Import of goods	-38.3	-37.1
Export of services	43.8	41.1
Import of services	-17.1	-18.0
Export of travel	20.9	12.5
Import of travel	-4.4	-6.9
Export of other business services	8.2	9.1
Import of other business services	-0.9	-1.7
<b><i>Financial Account (% of GDP)</i></b>		
FDI (in Cyprus)	9.2	9.7
FDI (abroad)	-1.9	-5.0
Portfolio investment (liabilities)	1.8	4.5
Portfolio investment (assets)	-4.9	-1.8
Other investment (inflows)	15.2	69.8
Other investment (outflows)	-13.8	-70.3

As demonstrated in a seminal paper by Blanchard and Giavazzi (2002) current account deficits have been associated with the level of output per capita of a country.<sup>2</sup> This correlation, according to this study, has been particularly visible within the European Union, and stronger still within the euro area. According to Blanchard and Giavazzi (2002) this is, in general, due to a decrease in savings rather than through an increase in investment. In Cyprus, between 2000-2007 GDP increased by 9½%, private consumption by 16% and investment 28%, all in per capita terms. Thus, while consumption has increased faster than income, investment also expanded rapidly, though, to a great extent, due to the rapid expansion of investment in construction.

One of the channels facilitating this dynamic is financial liberalisation in the EU countries and the process of financial integration which has intensified in recent years. Financial integration has allowed a decrease in saving to show up as an increase in the current account deficit. Euro adoption has been instrumental in this process as the elimination of exchange rate risk associated with the euro has led to additional low-cost borrowing.

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<sup>2</sup> Blanchard, Olivier J. and Giavazzi, Francesco, Current Account Deficits in the Euro Area. The End of the Feldstein Horioka Puzzle? (September 17, 2002). MIT Department of Economics Working Paper No. 03-05. Available at SSRN: <http://ssrn.com/abstract=372880> or DOI: 10.2139/ssrn.372880.

There are currently two key questions that need to be addressed:

*1. Why is the current account deficit of Cyprus so high?*

The deterioration of the current account during the last few years seems to be, to a large extent, the result of the deterioration of the goods and services balance.<sup>3</sup> The widened trade deficit is mainly attributed to high consumption and investment demand and also to worsening terms of trade notably due to the increase of price of oil and other raw materials and commodities. The oil component, especially, constitutes a relatively large part of total imports and hence any fluctuations in oil prices have had major repercussions on the trade deficit. In 2008 for example imports of oils and lubricants soared to an estimated 7½% of GDP, an increase of around 40% from 2007.

It is important to note that during this period while tourism revenues have stagnated, due to intense competition from neighbouring destinations, the overall balance has deteriorated much faster as a result of a strong upward trend in overseas holiday travel by Cypriots. The positive balance of travel services has declined from 36.8% of GDP in 2000 to 5.7% of GDP in 2007.

Another factor behind the enlarged current account deficit is the increased profitability of foreign firms which are recorded through the current account as income outflows and at the same time registered as FDI inflows in the financial account. These amounted to 8.6% in 2007.

With regards to competitiveness issues the example of the travel balance of the current account, the substitution by Cypriots for foreign travel, as well as of foreigners to other destinations reveals that in the area of tourism Cyprus faces a competitiveness problem. Accordingly, this can be corrected not only through relative price adjustments but also through the relative upgrading of the product. In other areas, however, notably other services, the gaining of market shares suggest that the country enjoys a competitiveness edge internationally. This may, to a large extent, be due to non-price competitiveness factors which have contributed to maintain the solid export performance in this area.

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<sup>3</sup> The balance of services presented only a small increase despite the strong performance by the financial sector and this is attributed to the fact that the income from tourism did not increase considerably during the last years, while the expenses of Cypriot tourists abroad showed a major rise as more and more Cypriots travel abroad. This has resulted in a substantial decrease in the net revenue from tourism.

*2. Does the size of the CA deficit really matter, especially within a monetary union?*

From an inter-temporal maximisation viewpoint, large current account deficits today require offsetting trade surpluses in the future, and thus would imply pressure on relative prices for domestic goods and services. In this case, the legacy of high current deficits is their adverse effect on future terms of trade. The potential output costs of adjusting relative prices (sacrifice ratio) can be high, unless prices drop due to full flexibility of real wages or improvements in productivity.

Furthermore, according to theory, as countries move up the development ladder, they may experience higher deficits, due to the changing composition of consumption towards imported goods and higher spending for capital investment. Under these circumstances, a large deficit should not signal any risks, unless it leads to a significant increase in gross debt and pressure on the exchange rate. In a monetary union, of course, this is only important to the extent that it requires a demanding real adjustment eventually.

If the deficit has its origin in large fiscal deficits (low public savings), then issues of intergenerational distribution would obviously arise. Higher government debt would mean higher taxes in the future, and thus a higher burden on future generations. However, this is not the case in Cyprus, since the deficit has its origin in private saving and not on low public savings. Quite the contrary, Cyprus has recently managed to consolidate its public finances, even achieving surpluses.

Moreover, policymakers must be aware of the fact that a persistent deficit can lead to accumulation of substantial foreign debt that could become problematic, especially if interest rates increase in the future. Indeed, it is noted that European bond spreads are widening, with countries with higher fiscal and current account deficits now facing substantially higher borrowing costs. At the moment, Cyprus does not face such a threat but increased vigilance will be needed.

In conclusion, while a high current account deficit can be the natural result of increased spending through higher growth, facilitated by the better access to borrowing given financial integration, at the same time policymakers should look ahead and consider the risks involved. Policies should therefore aim at preventing the emergence of imbalances either at the household, public or enterprise level. Such imbalances will require painful adjustment later with significant costs in terms of output and financing.

### *3. Is the source of financing of current accounts relevant?*

Since 2000, and of course due to its lower level, FDI flows as well as other capital flows have covered a fair share of the deficit. This has meant that outflows of foreign currency were counterbalanced by inflows from these sources, thereby also proving the adequacy of foreign reserves in the central bank. After 2006, however, and with the current account widening appreciably, the level of financing from FDI as a share of the total deficit has declined considerably. Indeed, the largest share of financing comes in the form of other investment which in the case of Cyprus are foreign deposits and foreign borrowing. Does this matter at all?

In a monetary union the issue of level of financing becomes less relevant. The country has to close a saving-investment gap, but the origin of the capital is less important, compared to, say, its maturity. Obviously to the extent that its maturity (e.g., if FDI) is more long term, than say other types of capital which can easily be reversed (deposits or other form of foreign borrowing by banks), the financing terms matter.

### *4. What does it all mean?*

In a monetary union given that the financial system operates in a larger and more open market compared to the past, the risks are shifted to the banking and financial institutions themselves. The cushion provided by the Central Bank plays a less significant role than in the past and banks are therefore more directly exposed to the risks emanating from the wider single market.

Hence, banking supervision as well as financial stability must be strengthened so as to allow authorities to foresee early risks to financial institutions. Of course, financial institutions themselves must also adopt in this new environment through lending practices and further upgrade their risk management systems introducing this new element into their assessments of risks.

Furthermore, real adjustment has to come about from structural reforms which boost productivity and keep unit labour costs under control.

### *Structural Reform Challenges*

The revised National Reform Programme (NRP) of Cyprus was submitted to the European Commission in October 2008. It has been revised to meet key policy challenges for action on structural reforms in the four priority areas of the Lisbon Strategy (people, business, infrastructure and energy, research and innovation) some of which were delineated for Cyprus by the European Council under the Commission's Country Specific Recommendations (CSR) and Points to Watch

(PTW). Moreover, the unfolding of the international financial crisis and its adverse impact on the real economy has highlighted the need to align economic measures to stimulate the economy with the best policies for the longer-term performance of the Cyprus economy, namely structural reforms in key priority areas. Indeed, the timely implementation of structural reforms will enable the Cyprus economy to cope better with external shocks, including those arising from the ongoing international financial crisis and to raise its long run growth potential.

***(a) People***

On people the NRP identifies the major employment challenges as investing in people, modernizing labour markets and enhancing the conditions for social cohesion. In this respect, the unfolding international financial crisis has brought to the forefront the need for the implementation of integrated flexicurity policies, focus on life-long learning, re-training and skills upgrading as essential to promote employability. Also, policies to improve employment and training opportunities for younger persons by appropriate vocational training and apprenticeship schemes are required as well.

Within this context under the Commission CSR Cyprus was recommended to “enhance life-long learning, and increase employment and training opportunities for young people by implementing the reforms of the vocational, education, training and apprenticeship system”.

Over the last 18 months Cyprus has made progress in developing strategies, schemes and institutional infrastructure to facilitate life-long learning and to train younger persons with the introduction of a modern apprenticeship scheme and the setting up of vocational training courses in secondary schools.

***(b) Business***

In the NRP the unlocking of business potential is identified as a major microeconomic challenge. To meet this challenge reforms are being carried out aimed at enhancing competition and improving the business environment. With the current international financial crisis unfolding, there is a greater need for businesses to have sufficient and affordable access to finance to underpin investment.

Furthermore, to support businesses and entrepreneurship Cyprus, along with other EU members, recognizes the need to take steps to substantially reduce administrative burdens, in particular, for small and medium-sized enterprises.

The Spring European Council specifies for “improving competition in the area of professional services” as a point to watch for Cyprus in its assessment of the NRP with the Commission referring to insufficient competition in the professions of

pharmacists, lawyers, architects and engineers. Accordingly, policies to enhance market efficiency put particular focus on instituting reforms in the sector of professional services. In this regard, the Competition Protection Commission has been strengthened, and arrangements for the setting up of enterprises expedited with the operation of an One Stop Shop.

On improving the regulatory environment for business a national target for a reduction in the administrative burden on business enterprise by 20% by 2012 has been legislated.

*(c) Energy and infrastructure*

In line with the EU target of transforming the European economy into a low carbon and energy efficient one Cyprus has set the promotion of the utilization of renewable energy sources (RES) and energy conservation as major policy priorities, with ambitious targets for RES as a proportion of total energy consumption and of total electrical generation agreed.

Financial incentives promoting the use of RES and for energy conservation are provided and funded by a levy of 0,22 eurocent/KWh on consumption of electricity based on imported oil. New support schemes for RES promotion and energy conservation provided support to encourage small scale photovoltaic systems, geothermal heat pumps and solar thermal installations for heat/cooling purposes and generation of electricity from large scale wind and photovoltaic systems have been put before the Council of Ministers for approval. Also, a decree regulating minimum energy efficiency requirements for new buildings was passed in 2006.

While Cyprus does not have direct connections with the trans-European energy network and other infrastructure systems, the Council of Ministers have agreed to accelerate the implementation of major infrastructure projects to contribute to stimulating the real European economy. This acceleration could involve the speeding up of work on the construction of the Vasilikos Energy Centre, which will include a terminal for the importation/storage/vaporization of environmentally friendly liquefied natural gas, thus helping diversify Cyprus energy supply away from its current overwhelming reliance on imported oil.

These initiatives in the area of energy involving energy conservation and efficiency, shifts to more environmentally energy sources, and the construction of supporting infrastructure, will contribute to a significant reduction in greenhouse gas emissions, helping to mitigate climate change, and create a more sustainable environment.

In adapting to climate change in Cyprus, which is currently being reflected in prolonged drought and water shortages, the Government is bringing forward the

construction of infrastructure relating to alleviating the water problem, in particular, water desalination plants.

***(d) Research and Innovation***

A major policy priority for Cyprus is to allocate more resources for investments in education and R&D. While the financial crisis will inevitably squeeze financial resources, the Government remains determined to meet its targets for raising R&D through the development and expansion of publicly funded institutions and programmes. The budgetary allocation for the Research and Promotion Foundation's Framework Programme for Research, Innovation and Technological Development for the three years from 2008 to 2010 will be €120 million compared with just €10 million in 2006. Furthermore, in its projections under the medium-term budgetary framework, which gears budgetary allocations to government priorities, appropriations for spending on education and on R&D rise significantly as proportions of GDP.

It is noted that in the last assessment of the National Reform Programme the need to "further stimulate private sector R&D" was included by the Commission as a point to watch. In the Cyprus context this is a contentious point as most private sector enterprises in Cyprus are very small (90% have less than four employees) and have little scope to raise R&D, especially during the current financial crisis.

On the promotion of innovation the government is, continuing to support the development of business incubators and fosters an innovation culture such as through the awarding of innovation prizes to businesses.

***(e) Other Structural Reforms***

Structural reforms related to pensions and the health care systems and which constituted a specific country recommendation of the Commission are discussed in the chapter on the long-term sustainability of the public finances.

#### **4. GENERAL GOVERNMENT BALANCE AND DEBT 2008-2012**

##### *Policy Strategy*

The general government nominal budget surplus exhibited a decline in 2008 and is currently estimated to have recorded a surplus of around 1% of GDP, compared with a surplus of 3.4% in 2007. The decline of the budget surplus is primarily attributed to the deteriorating external environment and the resulting marked slowdown in the activity of the real estate sector. Expenditure developments were also unfavourable, mainly due to higher social transfers, as well as, the severe drought conditions that prevailed on the Island, which led to extraordinary expenditures for maintaining water supply. According to the central scenario of this Programme, the structural budget balance is projected to gradually converge to a balanced position by 2012. There are significant downside risks to this central scenario.

At a time of intense financial market turbulence and a growth slowdown internationally, fiscal policy must remain flexible to respond, if needed, to a more marked deterioration in the macroeconomic outlook. Notwithstanding the challenging external environment, the overall strategy for fiscal policy is to maintain a sound budgetary position, with a view to reducing further public debt and, thus, addressing the long-term sustainability of public finances. Particular emphasis is placed on the need to curtail current public consumption expenditure and restructure public spending, in favour of capital expenditure, research and education, which can boost the economy's growth potential. Emphasis is also attached to targeted social spending. Redirecting resources towards infrastructure is particularly important at this point due to the expected weakness of the construction sector.

Overall policy strategy is based on six key pillars:

- The implementation of a Medium-Term Budgetary Framework (MTBF), which will institutionalise expenditure and programme-based rules, give more independence to spending ministries and, at the same time, increase their accountability for achieving programmes and quantifiable targets;
- Strengthening social cohesion, with particular emphasis on raising the standard of living of pensioners. Priority will be attached to households with at least one pensioner living below the relative poverty measure, as well as, to the reform of the social welfare system in general;
- Implementation of structural reforms as outlined in the National Reform Programme of Cyprus;
- The modernisation of the public sector, which will result in leaner and more productive public services. Such a policy will limit expenditure growth and raise overall productivity. Particular attention will be placed on the wage policy

for public sector employees, given its significant impact on overall wage developments;

- Enhancement of public debt and cash management systems; and
- Further improvement of tax collection by addressing tax evasion and strengthening tax administration.

In spite of the unfolding economic crisis and prospective slowdown of economic activity in the EU and Euro area—and conscious of the need to safeguard the important achievements thus far—this Stability Programme reaffirms its ambitious Medium-Term Objective of a balanced budget. This represents a cautious approach taking into account the uncertain economic period, which we are now facing.

The achievement of the MTO target set in 2007, implies a sufficient safety margin against the reference value, allows scope for the automatic stabilizers to operate, thus helping to dampen cyclical fluctuations. The prudent fiscal policies followed, during “good times”, when cyclical conditions were favourable and unemployment low, provide the fiscal room necessary for manoeuvre, especially given the external environment anticipating a severe global downturn.

In view of the challenging economic environment, the implementation of sound macroeconomic policies, especially in the area of public finances and incomes policies, becomes even more important. The responsibility of Cyprus as a euro area member state is to make the right strategic choices and take advantage of the merits of monetary union. The impressive results in the area of public finances, in recent years, has placed Cyprus in a better position to adjust to the rapidly deteriorating external environment and achieving progress with institutional and structural reforms.

This SP includes a special section devoted to measures taken to address the global recession, which is also affecting Cyprus’ economy. Though growth to-date remains satisfactory, the SP forecasts a slowdown in 2009-10, with the risk to this scenario being clearly on the downside. The European Commission has announced a recovery plan to be initiated at the European level, which will comprise of timely, temporary, and targeted measures aimed at tackling the faltering demand. Cyprus has already announced measures, and these include both short-term and temporary measures, as well as other more permanent structural measures, which should have a significant impact upon introduction in 2009.

### *Medium-Term Objective*

The country-specific MTO, that is, the cyclically-adjusted balance net of one-off and other temporary measures, of a balanced budget, is expected to be respected throughout the programming period. The final outturn for 2007 indicates that the country-specific MTO has been achieved during that year, following a structural

improvement of the order of 4.4 percent points of GDP, with the structural balance reaching a surplus of 3.8% of GDP in 2007, compared with a deficit of 0.5% the year before.

In line with the spirit of the revised Stability and Growth Pact, pro-cyclical fiscal policies were avoided. The structural position in 2008 is expected to moderate and is currently estimated that it has exhibited a surplus of the order of 1.2% of GDP, mainly due to a slowdown in the activity of the real estate sector.

According to the central scenario of this Programme, the structural budgetary position is projected to gradually deteriorate, from a projected marginal surplus of 0.1 percent of GDP in 2009 to a balanced structural position in 2010, subsequently projected to turn into deficit of 0.3 percent in 2011 and finishing with a deficit of 0.4 percent by the end of the programming period. The projected trend of the fiscal balance is adversely affected by the assumed lower tax elasticities during the period of a widening output gap, as well as by rising pension expenditures of the Social Security Funds, due to the gradual impact of population ageing. A more marked turnaround of public finances cannot be excluded at this juncture.

**Table IV: Components of Fiscal Adjustment and the Medium-term Objective**

<i>in percent of GDP</i>	2006	2007	2008	2009	2010	2011	2012	Total Adjustment 2009-2012
<i>Expenditure developments</i> <sup>4</sup>	-0.2	-0.7	1.4	0.3	0.9	0.8	0.8	2.8
<i>Revenue developments</i> <sup>5</sup>	1.1	4.0	-1.1	-1.5	0.2	0.3	0.4	-0.6
<b>General Government Balance</b>	<b>-1.2</b>	<b>3.4</b>	<b>1.0</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-2.2</b>	<b>-1.4</b>
<i>Cyclically Budgetary Component</i>	-0.7	-0.3	-0.2	-0.8	-1.4	-1.7	-1.9	
<b>Cyclically Adjusted Balance</b>	<b>-0.5</b>	<b>3.8</b>	<b>1.2</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.5</b>
<i>One-off revenue measures</i>	-	-	-	-	-	-	-	
<b>Cyclically Adjusted Structural Balance</b>	<b>-0.5</b>	<b>3.8</b>	<b>1.2</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.5</b>

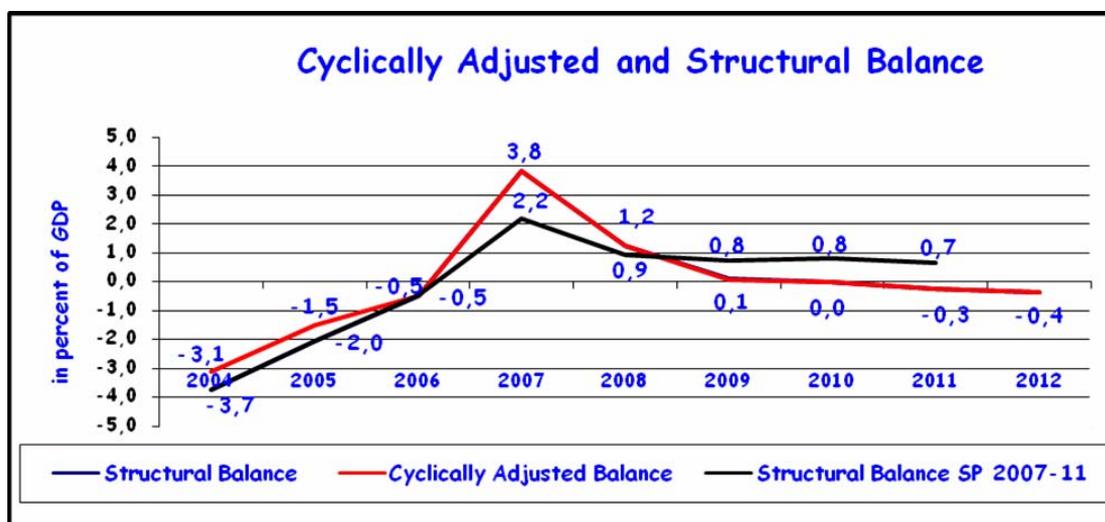
Note: The figures may not add up to the total due to rounding effects.

<sup>4</sup> The figures represent the difference from one year to the next as a percentage to GDP.

<sup>5</sup> The figures represent the difference from one year to the next as a percentage to GDP.

Over the programming period 2009-2012 expenditure is forecast to increase by 2.8 percent points of GDP. This is due to increased expenditures in a number of key areas, including on basic infrastructure and R&D, health and education and other social transfers in line with the priorities of the new Government<sup>6</sup>, as well as, rising pension outlays. The reforms are outlined in the National Reform Programme of the Republic of Cyprus.

Following an estimated decline of revenues by 1.1 percent points of GDP in 2008, owing to a decline in current taxes on income and wealth (mainly lower revenues related to the real estate sector), revenue will fall by a further 1.5 percent of GDP in 2009 and then gain on average approximately 0.3 percent of GDP annually over the period 2010-2012.



Note: The structural balance and cyclically adjusted balance lines coincide

### *Actual Balances in 2008*

The considerable improvement in public finances of 2007 has been followed by a partial turnaround in 2008, especially during the second half of the year. During the first eleven months of the year, the general government balance remained in surplus amounting to some 3% of GDP compared with 4.2% in the corresponding period of 2007. For the year as a whole, it is estimated that the budget balance will recede to a surplus of 1.0% of GDP, from a surplus of 3.4% in 2007 and a deficit of 1.2% in 2006.

On account of a primary surplus for a fourth consecutive year and the use of accumulated financial assets to repay maturing debt, the general government gross

<sup>6</sup> Following the gradual increase of the retirement age of civil servants, introduced in 2005, pension outlays declined significantly during this period of adjustment and are set to increase again over the programming period as the adjustment is completed.

debt is estimated to have declined to 49.3% of GDP by end of 2008, compared with 59.4% in 2007.

The fiscal performance in 2008 reflects significant changes in both expenditures and revenues. Total expenditure is forecast to increase by 1.4 percent points, to 44.3% of GDP, while revenue is expected to contract by 1.1 percent points, to 45.3% of GDP.

On the expenditure side, the severe drought conditions that prevailed on the Island, led to the introduction of a compensation scheme for farmers as well as to the import of potable water from Greece at a total cost of some 0.7% of GDP. Concurrently, social transfers are anticipated to rise by around ½% of GDP, owing to implementation of social measures introduced in late 2007, as well as, the gradual impact of population ageing.

**Table V: General Government Consolidated Accounts**

<i>in percent of GDP</i>	<b>2007</b>	<b>2008 est.</b>	<b>2009 proj.</b>	<b>2010 proj.</b>	<b>2011 proj.</b>	<b>2012 proj.</b>
Current Revenue	46.4	45.3	43.8	44.0	44.4	44.8
Current Expenditure	40.0	41.3	41.6	42.5	43.3	44.0
<i>Interest Payments</i>	<i>3.1</i>	<i>2.9</i>	<i>2.4</i>	<i>2.2</i>	<i>2.1</i>	<i>2.1</i>
Current Balance	6.3	4.0	2.2	1.5	1.1	0.8
Capital Expenditure	2.9	2.9	3.0	3.0	3.0	3.1
<b>General Government Balance</b>	<b>3.4</b>	<b>1.0</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-2.2</b>
Primary Balance	6.5	3.9	1.5	0.8	0.2	-0.2
<b>Government Gross Debt</b>	<b>59.4</b>	<b>49.3</b>	<b>46.8</b>	<b>45.4</b>	<b>44.2</b>	<b>44.2</b>

The negative performance on the revenue side is, mainly, attributed to a decline in the activity of the real estate sector and the contained growth of corporate profits in the financial sector, following the exceptionally buoyant activity of 2007. In particular, depressed real estate activity is expected to lead to significantly lower receipts from capital gains taxes and land and survey fees estimated to amount to 2.1% of GDP (see Box 2 for details).

In contrast, taxes on production and imports remained buoyant during the first three quarters of 2008, owing to strong private consumption and high commodity prices. During the last quarter of the year, taxes on production and imports exhibited a marked deceleration.

## *Revenue*

Overall, for 2008 total revenue is expected to increase by 5.8% declining to 45.3% of GDP compared with 46.4% the year before.

More analytically, total taxes are estimated to decelerate and increase at a rate of 4.5%, reducing their share to 32.6% of GDP as compared with 33.7% in 2007.

Taxes on production and imports are anticipated to level off at 19.7% of GDP, exhibiting an increase of the order of 8.1%. The decelerated rate of growth, compared to the previous two years, is attributed to the application of a reduced VAT rate on specific goods and services introduced at the beginning of the year, the anticipated slowdown in consumption and import growth, the fall in commodity prices as well as to the dissipating effects from the application of a 15% VAT rate on the sale of new buildings, constructed with building permits issued post EU accession.

Furthermore, excise duty receipts declined significantly in 2008, following a buoyant performance in 2007 owing to a tax reform on motor vehicles, which reduced the tax burden and boosted car sales, markedly, during 2007. More specifically, registration of motor vehicles grew at a rate of 6.4% during the first ten months of 2008, considerably lower than the 33% growth exhibited during the corresponding period of the year before. Excise duty receipts were also affected by the abolition of the excise duty levied on refreshments and the application of the minimum excise duty, prescribed by the *acquis*, on heating oil of €0.02 cent per litre.

The surge in the activity in the real estate sector, during the period 2006-2007, has led to a significant re-pricing of the value of the assets contributing to an exceptional rate of growth of land and survey fees over the two year period. As the activity in real estate, during 2008, began to show signs of decline, land and survey fees are estimated to have fallen to 1.7% of GDP in 2008 compared with 2.6% the previous year.

Taxes on income and wealth are anticipated to have exhibited a small decrease of 0.3% for the year and declined to 12.9% of GDP compared with 14% in 2007. The fall of 1.1 percent points of GDP, is attributed to lower revenues derived from the taxation of profits from the sale of immovable property and a fall in land and survey fees, as a result of a declining activity in the real estate sector.

More specifically, capital gains tax receipts in 2008 are estimated to have fallen as a percent to GDP to 1.8% compared to 3% in 2007. Indeed, capital gains tax receipts fell by 30% in the first eleven months of 2008. In contrast to the above, corporate tax receipts are estimated to have exhibited an increase in line with nominal GDP, thus remaining at 4.8% of GDP. This is mainly attributed to the expiration on 31.12.2007

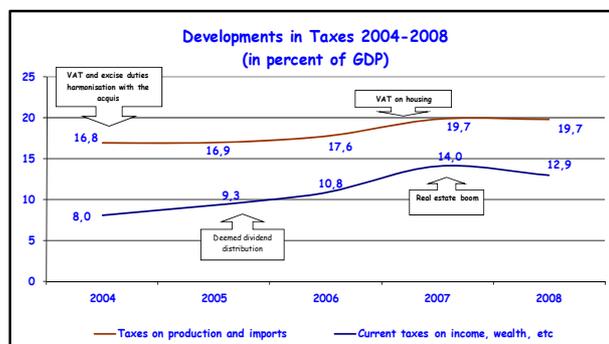
of the grace period for the application of a reduced corporate tax rate of 4.25% on international businesses and the application of a 10% corporate tax rate as from 1.1.2008.

Following, the raising of the tax-free income for individuals and aligning the tax brackets, retroactively, as from 1.1.2007, income tax receipts from physical persons are estimated to have exhibited a deceleration and increase marginally falling as a percentage to GDP to 2.8% in 2008 compared with 3% the year before.

Property income is estimated to have shown a marginal increase reaching 0.9% of GDP in 2008 compared with 0.7% the year before. The rise in property income is attributed to a rise in dividend income from semi-governmental organisations.

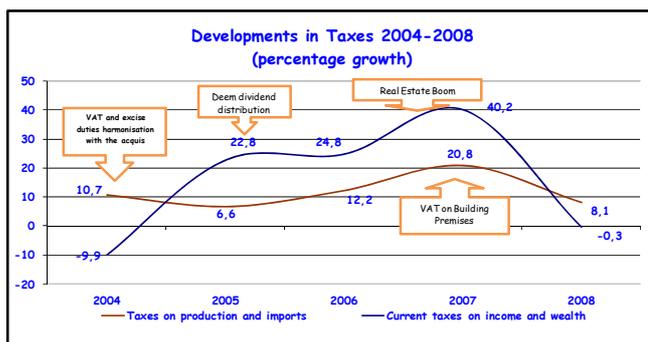
### **Box 2: Analysis of Revenue Developments**

The buoyant performance of government revenues in 2007 was followed by a less favourable performance of revenues in 2008. Total government revenues are estimated to have exhibited an increase of 5.8% falling by 1.1 percent point of GDP compared to 2007. This is can be ascribed to declining receipts from current taxes on income and wealth as well as a deceleration in the rate of growth of taxes on production and imports.



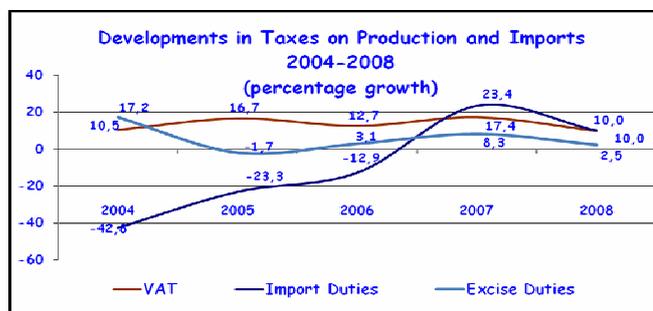
During the period of 2004-2008, taxes on production and imports have been exhibiting a steady increase reaching 19.7% of GDP in 2008 compared with 16.8% of GDP in 2004. This development is, mainly, attributed to the gradual application over a two year period, prior to the accession of Cyprus to the EU, of the minimum excise duty

rates prescribed by the acquis on petroleum products, tobacco and alcohol. Furthermore, the minimum VAT rate and the widening of the VAT base, as prescribed by the acquis, was gradually introduced over the said two-year period, raising the rate from 8% in 2002 to 15% in late 2003. In addition, the VAT rate on hotel and restaurant services was increased from 5% to 8%, as from the beginning of 2006. The widening of the tax base brought by the application of a 15% VAT rate, as from 1.5.2004, on the sale of premises built with a permit issued post EU accession had an impact from 2007 onwards. This is due to the fact that buildings generally require two years to be completed and then sold. In addition to the above changes in tax bases, the accelerated rate of growth of private consumption, as well as, the substantial increases in commodity and asset prices boosted further taxes on production and imports in 2007.



On 1<sup>st</sup> January, 2008 the excise duty on refreshments and bio-fuels was abolished and a reduced VAT rate of 5% was introduced on specific<sup>7</sup> goods and services. These reforms were estimated to have a small cumulative annual fiscal impact of the order of 0.2% of GDP.

In accordance with the above changes in tax bases, taxes on production and imports exhibited relative modest growth during the period 2004-2006 averaging 9.8%, which was followed by an accelerated growth of 20.8% in 2007. During 2008 the growth of revenues from taxes on production and imports are estimated to have decelerated to 8.1%. More analytically, VAT receipts exhibited an increase of the order of 16.7% in 2005, attributed to a widening of the tax base introduced prior to accession in May 2004. Subsequently, VAT receipts continued to exhibit satisfactory growth reaching 12.7% in 2006, due to a favourable composition of growth, which continued throughout 2007 as VAT receipts grew at a rate of 17.4% reinforced by the sharp increase in commodity and asset prices and the lagged impact of the application of VAT on the sale of building premises. During 2008, especially in the second half of the year, VAT receipts registered a deceleration growing at an annual rate of 10% as base effects started to dissipate and consumption growth showed signs of gradual deceleration.



The trend recorded by taxes on income and wealth, as a percentage to GDP, is broadly similar with that of taxes on production and imports, with the end of the period under review being an exception, as they are estimated to exhibit a small decline.

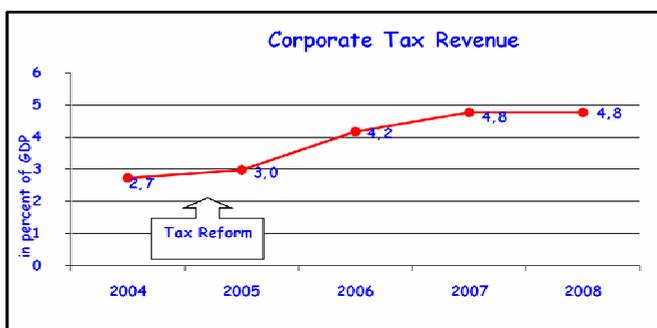
Over this period, receipts from taxes on income and wealth recorded a steady increase, as a percentage to GDP, rising from 8% in 2004 to 14% in 2007 and subsequently estimated to have declined to 12.9% in 2008. The trend exhibited by this category of taxes is attributed to the impact of the application of a deemed dividend distribution, a 15% tax on 70% of profits not distributed within two years, which was introduced in 2002, having an impact on revenues for the first time in 2006. Additional factors included the improved profitability of the corporate sector, especially of financial institutions, and the increased revenues arising from the boom in the real estate. Consequently, capital gains taxes and land and survey fees have grown at very high rates and reached 3% and 2.6% of GDP in 2007 compared with 0.7% and 0.9% in 2004. In 2008, especially in the second half, activity in the real estate sector was beginning to dissipate, impacting on the revenue collections of capital gains taxes and land

<sup>7</sup> A reduced VAT rate of 5% was introduced as from January 1<sup>st</sup>, 2008 on private housing renovations, hair salon services, cultural events and exhibitions including sport events, entrance to museums, concerts and cinemas, certain categories of foodstuffs including confectionery products, bottled water, fruit juices and animal feed.



and survey fees, indicating the temporary nature of most of revenue increases of 2007. Building permits issued, during the first nine months of the year, were down by 2.7% in value terms, indicating a fall in transactions, but an increase in prices. In 2008, capital gains taxes and land and survey fees are estimated to have declined, as a percentage to GDP to 1.8% and 1.7% respectively, below the 2007 level, but still above the levels recorded in previous years.

Similarly, corporate tax revenues, as a percentage to GDP, recorded strong gains following the major tax reform, which reduced the corporate tax rates considerably, introducing a common rate for both domestic and international companies. Corporate tax revenues, as a percentage to GDP, rose to 3.0% in 2004 compared with 2.7% the year before. In 2006, corporate tax revenues increased sharply jumping to 4.2% of GDP and subsequently to 4.8% of GDP in 2007 due to a buoyant profitability of business services corporations. During 2008, despite a deteriorating business environment and profits of financial corporations on decline<sup>8</sup>, corporate tax receipts are estimated to have remained at last year's level, as a percentage to GDP, at 4.8%. The fall in corporate tax receipts was compensated by the expiration on 31.12.2007 of the derogation allowing for the application of a reduced corporate tax rate of 4.25% on international business.

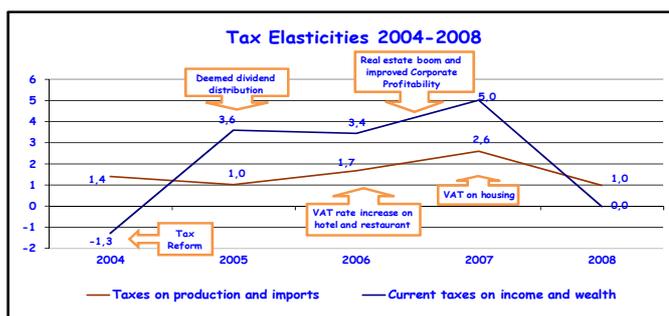


environment and profits of financial corporations on decline<sup>8</sup>, corporate tax receipts are estimated to have remained at last year's level, as a percentage to GDP, at 4.8%. The fall in corporate tax receipts was compensated by the expiration on 31.12.2007 of the derogation allowing for the application of a reduced corporate tax rate of 4.25% on international business.

During the period under review, elasticities of taxes on income and wealth rose from -1.3 in 2004 to around 3.6 in 2005 and 3.4 in 2006. The elasticity of this tax category is estimated to have peaked in 2007 reaching 5 and subsequently has declined to zero. The substantial rise in elasticities during the period 2004-2007, as already mentioned, is, mainly, attributed to the revenues derived from the application of a deemed dividend distribution on undistributed profits, the effects of a real estate boom and an improved profitability of the corporate sector. The zero elasticity for 2008 is the result mainly of declining revenues associated with the real estate sector.

Elasticities of taxes on production and import fell to 1.0 in 2005 compared with 1.4 in 2004, owing to the application of the Common Customs Tariff upon accession to the EU that led to

<sup>8</sup> During the first three quarters of the year, one of the two major financial corporations of the island, namely Marfin Popular Bank, has recorded a fall in operating profits of around 33%, while the Bank of Cyprus, has recorded a stagnation in the level of profits compared with the corresponding period of 2007.



a decrease in the level of import duties collected and to the reform of the excise duty regime on motor vehicles. In 2006, the elasticity increased again to 1.7, slightly above historical levels, and further to 2.6 in 2007. The increased elasticity of taxes on production and imports in the last two years

can be ascribed, mainly, to a widening of the VAT base due to an increase in the VAT rate applied to hotels and restaurant services from 5% to 8% as from 1.1.2006 and the lagged impact from the application of a 15% VAT rate on building premises, that was introduced upon accession to the EU. In 2008, the elasticity of this tax category is estimated to have reverted to unity, slightly below historical levels.

As far as, the programming period is concerned, elasticity of taxes on production and imports is assumed at unity, while elasticity of current taxes on income and wealth is assumed to turn negative during the first year of the programming period falling to -0.7 and then return to historical levels of close to 1.2.

### *Expenditure*

Total public expenditure is expected to have increased at a rate of 11.8% in 2008 reaching 44.3% of GDP compared with 42.9% the year before. The increase in total expenditure in 2008 can be attributed, mainly, to increased subsidies for compensation to farmers for adverse effects of the protracted drought, as well as higher than targeted social payments.

Social payments are expected to have risen as a percentage to GDP to 12.1% compared with 11.7% the year before, due to an increased emphasis on social cohesion, in line with the objectives of the National Reform Programme. Specifically, social security payments is estimated to have exhibited an increase of the order of 12% due to a gradual population ageing and rise as a percentage to GDP to 6.3% in 2008 compared with 6.1% in 2007.

Social cohesion was enhanced through the introduction, in late 2007, of a set of social measures targeted towards low income pensioners and recipients of welfare support. In effect an increased supplementary allowance was provided to pensioners, with a monthly income of less than €533, in order to reduce the percentage of households,

with at least one pensioner, living in relative poverty<sup>9</sup>. Additionally, a monthly subsistence allowance was provided to persons with disabilities living on the welfare, the level of which was determined in accordance to their disability. The fiscal impact of the said measures was estimated to be of the order of 0.3 percent points of GDP.

Furthermore, in mid-2008 the Government approved an increase of the order of 12% on monetary allowances provided to persons on the welfare, as well as, a reform of the housing policy addressed to low income families, estimated to have an annual impact of 0.2 and 0.3 percent points of GDP, respectively.

The rate of growth of compensation of employees and intermediate consumption expenditure has accelerated in 2008 and is estimated to have risen by 8.9%, marginally increasing as a percentage to GDP to 19.7%. This accelerated growth is attributed on the one hand to a higher inflation rate that feeds in through the automatic indexation mechanism, also known as the Cost of Living Allowance, and on the other to the provision of higher contractual salary increases of 2%, as well as to the costs of ensuring adequate water supply in the face of drought conditions.

Owing to a falling stock of debt, as well as to the lower cost of borrowing, interest expenditure is anticipated to have been reduced to 2.9% of GDP, falling by 0.2 percent points, compared to last year.

Gross fixed capital formation is expected to have stabilised at around 2.9% of GDP in 2008.

### *Features of the 2009 Budget*

The Budget for 2009 was prepared based on a three year forecasting period taking into consideration the Medium Term Budgetary Framework of 2009-2011, which predicated on the linkage of medium-term fiscal targets to the annual budgetary process. The main characteristics of the forthcoming budget are the implementation of social measures introduced in the second half of 2008, in conjunction with the reallocation of government expenditures towards growth-enhancing activities and other policy priorities, established in the National Reform Programme for Cyprus.

The Budget for 2009, which was prepared during the summer of 2008 and approved by the Council of Ministers on the 17<sup>th</sup> of September 2008, was based on a more optimistic macroeconomic scenario than the current one presented in this SP. GDP was assumed to expand at around 3¾% in 2009, and inflation to average 3% for the

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<sup>9</sup> Very few pensioners live in absolute poverty in Cyprus, but the risk of elderly people having incomes below 60% of the relatively high median income in Cyprus is high by EU standards; in 2005 relative poverty for elderly persons was estimated at 52%.

year. Since then, and owing to dramatic developments in the international financial system and the world economy, growth rates have been marked down both in the EU and Cyprus. The current macroeconomic central scenario envisages growth of 2.1% in 2009 and inflation to average around 2.0% for the year. The revenue side of the budget has been revised accordingly, while the expenditure side has not been amended.

The growth of total revenues is forecast to decelerate to 1.3%, that is, below nominal GDP growth, and thus falling as a percentage to GDP to 43.8% compared with 45.3% the year before. The decelerated rate of growth is mainly attributed to a continuation of a subdued rate of growth of tax revenues brought about by a decline in current taxes on income and wealth. More specifically, land and survey fees and capital gains taxes are forecast to continue to exhibit a negative growth, having a cumulative loss of the order of 0.8 percent points of GDP.

Additionally, revenue developments for 2009 are forecast to be negatively affected by the fact that no dividend income from semi-governmental organisations was taken into account, having a negative impact on property income of the order of 0.5 percent points of GDP in the said year.

Furthermore, the Government has decided to reduce the corporate tax rate for semi-governmental organisations from 25% to 10%, bringing it in line with corporate tax rate applied to non-governmental corporations. The new tax rate for semi-governmental organisations is envisaged to come into effect as from 1.1.2009. The measure is projected to have a limited fiscal impact.

Furthermore, the Government has also decided to proceed with the reduction of the withholding tax on interest earned by the Social Security Funds. More specifically the withholding tax on interest will be reduced from 10% to 3%, bringing it in line with the tax levied on other pension funds. Due to consolidation reasons, this measure has no fiscal impact.

It is noted that, the increase of the excise duty on petrol, originally envisaged to be introduced in the course of 2008 due to the expiration of the transitional period granted upon EU accession, is envisaged to be introduced at the beginning of 2009. The fiscal impact of this measure is estimated at 0.15% of GDP. Simultaneously, the Government intends to introduce compensating measures offsetting the impact of the increase on the excise duty on petrol. The net fiscal impact is projected to be zero. The application of the minimum VAT rate on building land also envisaged to be introduced in the course of 2008, due to the expiration of the said derogations, has not been taken into account in the estimation of revenue forecast for 2009 as the estimated impact will be marginal.

It should also be noted that a Bill incorporating the agreement reached between the social partners for the introduction of parametric reforms in the Social Security Scheme has been tabled before the House of Representatives. The proposed parametric reforms include an increase in the contribution rates by 1.3 percent points, as well as, stricter eligibility criteria for pension entitlements. The increase in contribution rates is allocated between employees, employers and the government. More specifically contribution rates for the employees and the employers are forecast to increase by 0.5 percentage points, while government's contribution rate is forecast to increase by 0.3 percentage points. The application of the increased contribution rates to the Social Security Funds, estimated to have, on an annual basis, a fiscal impact of 0.7 percent of GDP has not been taken into account in the estimation of revenue forecast for the programming period.

Total government expenditure is projected to increase by 5.5%, slightly above nominal GDP growth, and increase marginally, as percentage to GDP, to 44.6% compared with 44.3% the year before. This rise is partly mitigated by an anticipated fall, in absolute terms and as a percentage to GDP, in interest payments and costs associated with the importation of potable water and subsidies.

Subsidies are projected to fall considerably as a recurrence of the compensating scheme associated with the drought conditions prevailing on the island is not anticipated. These are projected to decline to 0.5% of GDP in 2009 compared with 1% the year before.

Similar to the above, interest payments are projected to continue their downward trend and exhibit a decline, falling to 2.4% of GDP in 2009 compared with 2.9% the year before. The steady decline of interest payments results from a declining stock of debt, arising from primary surpluses, the running down of sinking fund deposits and comparatively lower interest rates reflecting, inter alia, entry to the euro area.

The above are offset by developments in compensation of employees and intermediate consumption and social transfers. In particular compensation of employees and intermediate consumption is projected to rise at a rate of 7.2%, reaching 20.2% of GDP compared with 19.7% the year before. This is mainly attributable on the one hand to the contractual salary increase of 1.5% that will be provided to employees of the public sector as from 1.1.2009, and on the other to the purchase of desalinated water to maintain water supply.

Particularly, in view of the severe drought conditions that prevailed on the Island, the Government has decided to take action to raise the supply of desalinated water. This will be provided via the construction of three new desalination plants, which will be

built through Public Private Partnership agreements. The costs associated with, the purchase of the desalinated water is estimated to reach 0.3 percent of GDP in 2009.

Concurrently, social transfers are projected to increase by 9%, reaching 12.6% of GDP compared with 12.1% the year before. This increase is attributable to the full year application of the social measures introduced in mid-2008, as well as, to the dissipated effects from the extension of the retirement age, from 60 years of age to 63 years, which was introduced for the public sector in 2005.

The general government balance is projected to turn into deficit of 0.8% of GDP in 2009 compared with an estimated surplus of 1% in 2008. The projected budgetary position provides a sufficient safety margin against the risk of breaching the 3% of GDP reference value as the minimum benchmark for Cyprus is currently estimated at a deficit of 1.8% of GDP. It also provides room for allowing automatic stabilisers to operate freely.

The measures included in the Stability Programme reveal a high degree of continuity with the measures incorporated in the last Programme; Box 3 lists the main changes to fiscal projections compared to last year's Stability Programme.

### **Box 3: Main Changes to Fiscal Projections**

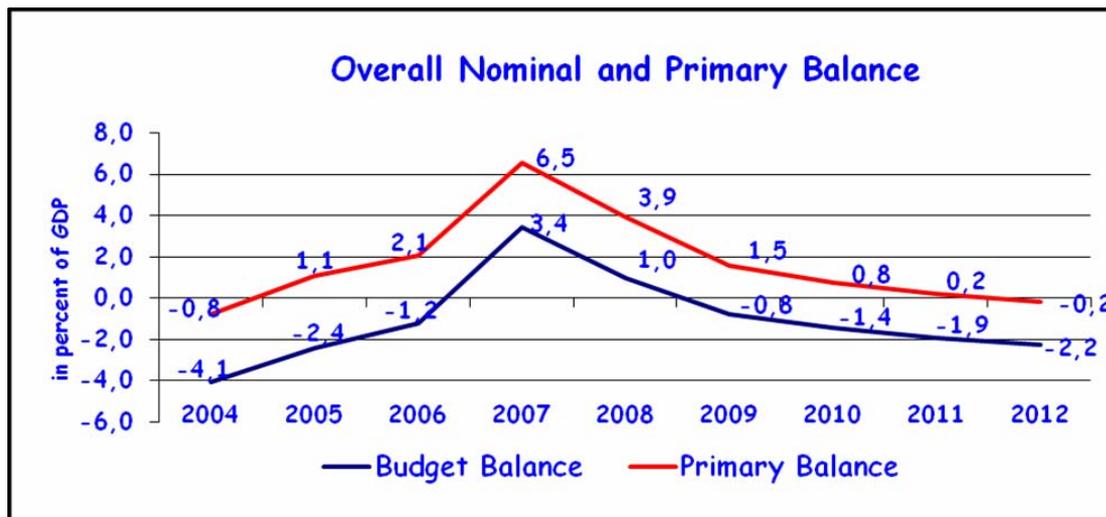
The main features of the fiscal projections are:

- A deteriorating macroeconomic environment.
- A turnaround in public finances in 2008, and thereafter due to base effects.
- Negative rates of growth of revenue arising from capital gains taxes and land and survey fees.
- The carry over effect of 2008 also led to an accelerated decrease of public debt-to-GDP ratio having an impact on the profile of interest payments.
- Costs associated with drought conditions prevailing on the Island.
- Costs arising from the application of social measures introduced in mid-2008.

The Government is committed to further adhere to the provisions of the revised Stability and Growth Pact and implement the policies necessary for the successful participation in the Economic and Monetary Union. The objective is to maintain sound public finances and address the issue of long-term fiscal sustainability. The achievement of the country-specific medium-term objective in 2007 and the estimated surpluses for 2008 enables broadly the respect of the MTO throughout the programming period and the sustaining of primary surpluses. Maintaining these will

ensure that the debt-to-GDP ratio continues its distinct downward path, leading to a rapid decline of the debt to 44.2% of GDP by the end of 2012.

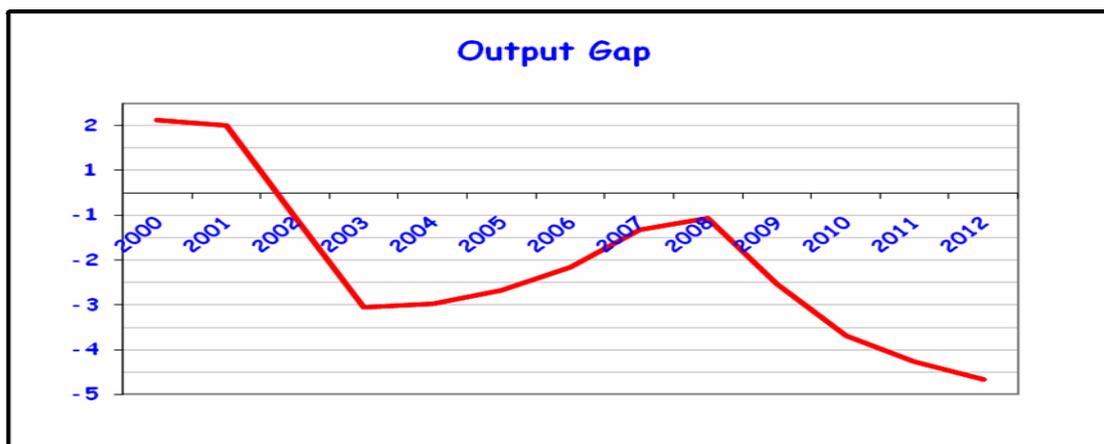
As already emphasised, there are significant downside risks to this central scenario, which are analysed in Chapter 4 of this Stability Programme. However, even under more pessimistic assumptions the underlying fiscal position will remain sound as reflected in the declining and relatively low public debt to GDP ratio.



### *Structural Balance and Fiscal Stance*

While the economy recovered considerably following the economic slowdown in 2002-03, economic activity still remains below potential, and is expected, according to the estimates presented in the SP, to remain below potential over the medium term. Specifically, the output gap which widened to around -2½% in 2003 narrowed in subsequent years to below 1%, but is expected to deteriorate somewhat in view of the expected slowdown in 2009-2010. In 2009 the output gap, as a percent of potential, is forecast to widen from -0.6% 2008 to -2% in 2009 widening further over the programming period rising to -4.2% by 2012.

Based on this analysis of the cyclical position of the economy, and to provide a clear picture of the underlying fiscal position, the following analysis disentangles trend, cyclical, and one-off fiscal effects.



### *One-off measures*

The substantial improvement in the fiscal position of Cyprus economy in nominal terms during 2006-2007 occurred in absence of any one-off measures, in contrast to the situation in 2002-2005<sup>10</sup>, where one-off operations played a significant role. During 2008, the effects of the exceptional revenue brought by the extraordinary boom in the real estate sector in 2007, started to wear off, as capital gains tax receipts and land and survey fees exhibited sharp declines. The loss of revenue attributed to a slowdown in the real estate sector is estimated to amount to 2.1 percent of GDP in 2008.

The Stability Programme does not rely on the implementation of any temporary or one-off measures over the programming period. Budgetary projections are based on the current macroeconomic scenario, with tax elasticities falling to 0.2 in 2009, well below historical levels, subsequently slightly picking up from a low level, reaching an average of 1.1 over the remainder of the programming period, slightly below historical levels.

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<sup>10</sup> One-off revenue measures as a percentage to GDP amounted to 0.3%, 1.7%, 1.1% and 0.9% for 2002, 2003, 2004 and 2005, respectively.

**Table VI: Cyclical Developments and one-off measures**

<i>as a percent of GDP</i>	2007	2008 est.	2009 proj.	2010 proj.	2011 proj.	2012 proj.
GDP growth at constant prices	4.4	3.8	2.1	2.4	3.0	3.2
<b>General Government Balance</b>	<b>3.4</b>	<b>1.0</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-2.2</b>
Net Interest payments	3.1	2.9	2.4	2.2	2.1	2.1
Potential GDP growth, % change	3.7	3.7	3.7	3.7	3.7	3.7
GDP output gap <sup>11</sup>	-0.8	-0.6	-2.0	-3.2	-3.8	-4.2
Cyclical budgetary component	-0.3	-0.2	-0.8	-1.4	-1.7	-1.9
<b>Cyclically-adjusted balance</b>	<b>3.8</b>	<b>1.2</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.4</b>
Cyclically-adjusted primary balance	6.8	4.1	2.4	2.2	1.9	1.7
One-off revenue measures	-	-	-	-	-	-
<b>Cyclically-adjusted balance net of one-off and other temporary measures</b>	<b>3.8</b>	<b>1.2</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.4</b>
Structural Change	4.3	-2.6	-1.1	-0.1	-0.3	-0.1
Cyclically-adjusted primary balance net of one-off and other temporary measures	6.8	4.1	2.4	2.2	1.9	1.7

*The cyclically-adjusted balance and structural balance*

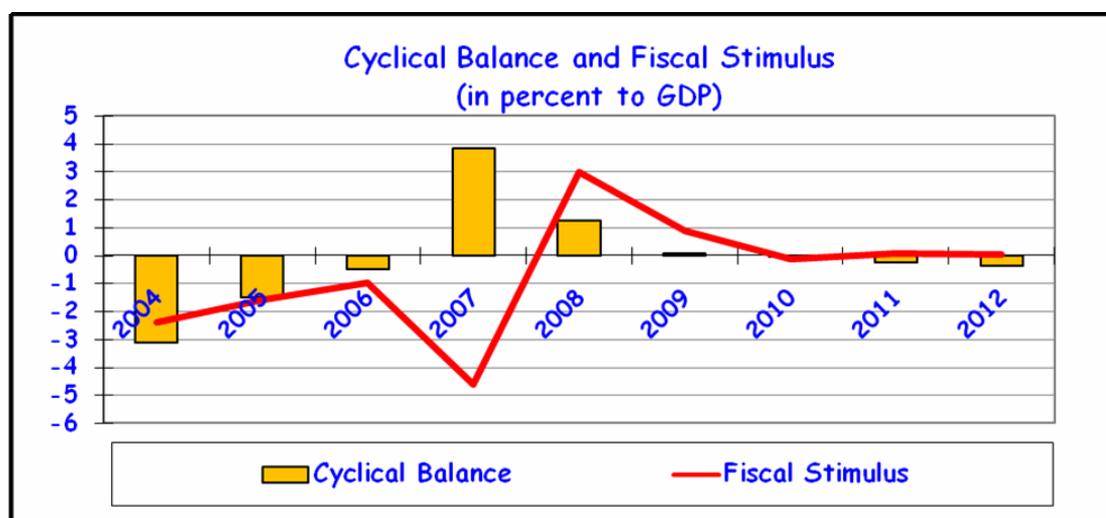
Similarly to last year's Stability Programme, indicators of cyclically-adjusted budget balances have been incorporated in the compilation of the Stability Programme 2008-2012, in order to take into account cyclical variations. The cyclically adjusted budget balance is estimated to decline from a surplus of 3.8% of GDP in 2007 to a surplus of 1.2% in 2008, and is projected to decline further to a marginal surplus of 0.1% percent of GDP in 2009 and exhibit a downward path, reaching a deficit of 0.4% by 2012 (Table VI), implying a positive annual fiscal stance averaging 0.2% of GDP over the programming period 2009-2012.

Fiscal stimulus is estimated to have turned positive in 2008 reaching 3% of GDP, following the negative levels exhibited over the period 2004-2007 peaking at -4.6 percent of GDP in 2007. In 2009, fiscal stimulus is projected to reach approximately 1 percent of GDP. More analytically, although the stimulus packages introduced at the beginning of 2009 are estimated to reach 1.55%<sup>12</sup> of GDP due to savings attributed, as well as, to lower interest payments and subsidies, the overall fiscal stimulus for the said year falls close to 1%. This is considered appropriate given the deteriorating

<sup>11</sup>In percent of potential GDP.

<sup>12</sup> See analysis in the European Economic Recovery Plan on page 48.

macroeconomic conditions. During the remainder of the programming period fiscal stimulus is projected to approach zero.



A similar picture is also presented for the cyclically-adjusted balance net of one-off measures (Table VI). The cyclically-adjusted balance net of one-off measures, as a percent of GDP, improved remarkably in 2007 reaching a surplus of 3.8% of GDP, exhibiting 4.3 percent points of GDP improvement, compared to the previous year. The exceptional revenue, attributed to the real estate boom, being of a temporary nature, began to dissipate in 2008, leading to deterioration of the structural position by 2.6 percent points resulting in an estimated structural surplus, net of one-off measures of, around 1.2% of GDP in 2008. The structural balance in 2009 is projected to deteriorate with the surplus falling to 0.1% of GDP. The structural adjustment effort is slightly negative over the programming period, as the cyclically adjusted balance, net of one-off measures, is forecast to decline gradually to a balanced position in 2010 and by the end of the programming period to a deficit of 0.4 percent of GDP.

## ***Debt Management***

### ***Debt Levels and Developments***

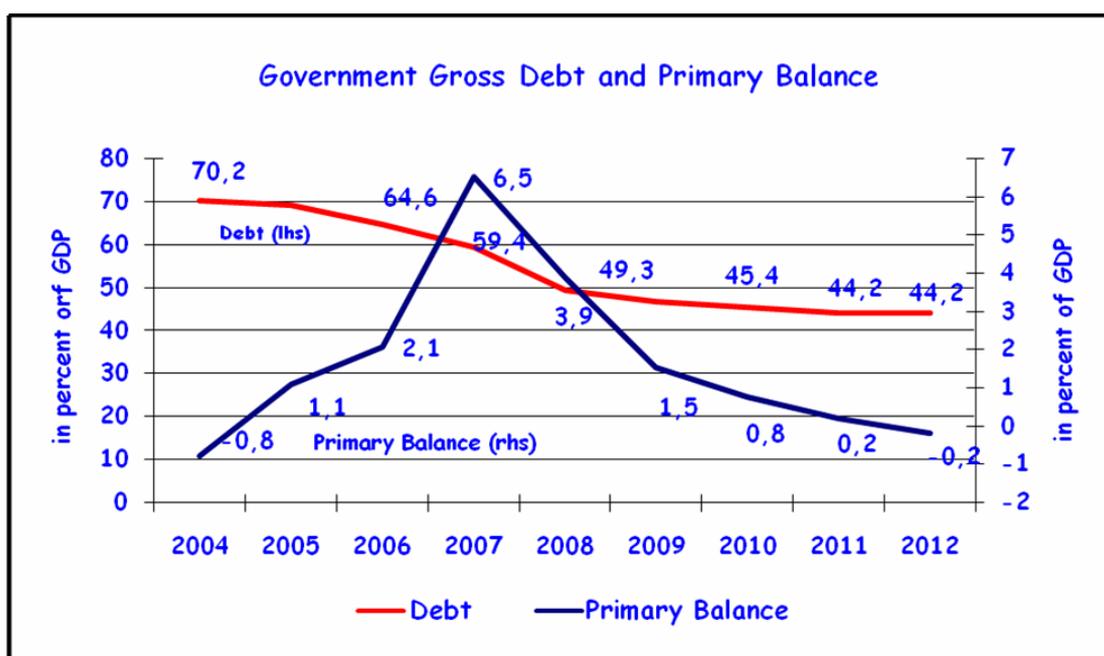
The revised Stability and Growth Pact (SGP) specifies that, in light of the increased economic and budgetary diversity in the EU, “*the medium-term budgetary objectives (MTOs) should be differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as the diversity of risks to the sustainability of public finances*”.

The European Council on the 20<sup>th</sup> of March, 2005 indicated that “*the long-term sustainability of public finances would be supported by the convergence of debt ratios towards prudent values*”. The 'Code of Conduct' also stresses “*the need to ensure the*

*convergence of debt ratios towards prudent levels taking into account the economic and budgetary impact of ageing populations".*

In light of the above, the evolution of public debt has been brought to the forefront of fiscal surveillance. Countries with higher-than-average debt levels are subject to stricter consolidation requirements, while low public debt countries are allowed to sustain small scale fiscal deficits and set relatively less ambitious MTOs.

General government debt, as a percentage to GDP, is estimated to exhibit a substantial reduction in 2008 and contract to 49.3% of GDP compared to 59.4% in 2007, decreasing by about 10 percent points of GDP. The considerable decrease of debt-to-GDP ratio is attributed to the achievement of high primary surpluses and the running down of financial assets, including sinking fund deposits. The debt-to-GDP ratio in 2009 is projected to continue its downward path and fall to around 46.8% of GDP exhibiting a further decrease of approximately 2½ percent points of GDP.



Based on the central scenario, primary balances, as a percentage to GDP, over the remainder of the programming period are projected to continue to be broadly in surplus and are estimated to decline from 1.5% in 2009 to 0.8% in 2010 and gradually falling to a marginal deficit of around 0.2% by 2012.

In accordance, the distinct downward path of debt-to-GDP ratio is projected to continue throughout the programming period and decline from 45.4% in 2010 to 44.2% by 2012, due to the maintenance of primary surpluses. Even under a more

pessimistic scenario, which is included in this Stability Programme, the debt-to-GDP ratio is expected to continue exhibiting a downward trend, albeit at a more moderate pace.

#### *Stock-Flow Adjustment*

The factor contributing to changes in government debt, other than government deficits/surpluses, is the Stock-Flow Adjustment (SFA). The main operations refer to the accumulation or decumulation of financial assets. The accumulation of government assets in 2007, equivalent to 2.8% of GDP, reflect the high surplus recorded in public finances in the said year. This is followed in 2008 by a decumulation of government assets, equivalent to 4.7% of GDP, reflecting the use of sinking fund assets, as well as, of other accumulated financial assets to repay maturing debt.

Overall, the SFA in 2008 is anticipated to have turned negative reaching 4.7% of GDP following a positive SFA of the order of 2.6% of GDP in 2007. The negative SFA of 2008 contributed to the substantial reduction of government debt in the said year; this includes privatisation proceeds from the sale of the Cyprus Development Bank amounting to 0.3% of GDP. The SFA is projected to be zero in 2009. The contribution of SFA is projected to turn slightly positive again in 2010, reaching 0.2% of GDP and subsequently, in 2011, is projected to turn negative reaching 0.2% of GDP. By the end of the programming period the SFA is projected to be negative rising to 2.3% of GDP.

Table VII below presents the gross debt level, according to the central scenario, and the contribution to change in gross debt for the period of 2007-2008, and projections covering the period 2009-2012.

**Table VII: General Government – Debt Developments**

<i>as a percent of GDP</i>	2007	2008 est.	2009 proj.	2010 proj.	2011 proj.	2012 proj.
Gross Debt Level	59.4	49.3	46.8	45.4	44.2	44.2
Change in Gross Debt	-5.3	-10.0	-2.6	-1.4	-1.2	0.0
<i>Contributions to Change in Gross Debt</i>						
Primary Balance	6.5	3.9	1.5	0.8	0.2	-0.2
Interest Payments	3.1	2.9	2.4	2.2	2.1	2.1
Nominal GDP Growth	8.0	8.2	4.8	4.5	5.2	5.4
Stock-flow adjustment	2.6	-4.7	0.0	0.2	-0.2	-2.3
Net Financial debt	52.7	47.4	44.8	43.3	42.3	44.5
Implicit interest rate	4.8	4.9	4.8	4.7	4.7	4.7

### *Debt Management*

Against the background of the unfolding international financial crisis, conditions in the capital markets for the Government in 2008 were made difficult. However, the reduced financing requirements of the Government, combined with the accumulated financial assets at the end of 2007 brought forward, allowed the Government to finance its borrowing requirements for the first half of the year, without resorting to additional borrowing.

In particular, a better management of liquid assets led to additional revenues for the Government. More specifically, available cash surpluses were invested in short term bank deposits, yielding returns averaging around 5%.

During the second part of the year the Government financed its borrowing requirements through the issue of European Commercial Paper (ECP). The turmoil in the markets had led to an increase of borrowing cost during the third quarter, but that trend was partly offset by the reduction of interest rates in the fourth quarter as euribor rates exhibited a decline.

During 2008, due to the extensive use of the ECP programme, short-term debt increased as a percentage to total debt to a still moderate 4% from approximately 2% in 2007. This increased reliance on short term debt reflected the extraordinary conditions prevailing in 2008 and it is projected to be reversed over the programming period.

With the introduction of the euro on January 1<sup>st</sup>, 2008 foreign currency debt has virtually been eliminated, as debt issued in other than the euro currency amounted to less than 1% of total debt.

The introduction of the euro has provided new opportunities for the reduction of financing costs and risks and has led to the reconsideration of established practices in debt management and a complete review of debt management strategies and structures is underway.

The present debt management system is being reformed, so as to be able to adapt better to changing market conditions, including the introduction of the euro. The reforms underway include:

- Setting up a Primary Dealers System (PDS) for the Government bond market, with the use of an electronic trading platform.
- Putting in place procedures and tools that will help in tackling unforeseen contingencies. The options available to the Government are now under consideration.

- Increasing the technical competence of staff in the area of debt management, especially with respect to risk management techniques.
- Improving decision-making mechanisms and the monitoring of the structure and terms of debt so as to better respond to the changing market conditions.

The Government intends to finance its borrowing requirements in 2009, initially, by resorting to the domestic market, thus exploiting the favourable conditions for issuing Government debt. A major issue, covering the financing needs in the first three quarters of 2009, took place in early January of 2008. Subsequently and depending on developments in financial markets, the Government is considering, entry into international markets, mainly for benchmarking and refinancing purposes, as well as, safeguarding a more balanced structure of public debt.

### *Balance by Sub-Sector of General Government*

The General Government sector in Cyprus comprises of the central government, the local authorities and the social security funds. The central government accounts for the bulk of the general government deficit, with the local authorities responsible for a marginal deficit of 0.1% of GDP as a substantial part of their operations and investment programmes are financed by transfers from the central government (Table VIII).

The Central Government balance is estimated to turn from a surplus of the order of 0.4% of GDP in 2007 into a deficit amounting to 1.7% of GDP in 2008. In contrast to the above, the Social Security Funds, which is based on a pay-as-you-go system, recorded a surplus<sup>13</sup> of 2.8% of GDP in 2008 following surplus of 3.1% the year before, thus contributing to the improvement in the overall budget balance.

During 2009, it is projected that the Central Government budget balance will deteriorate with the deficit rising to around 3.2% of GDP compared to a deficit of 1.7% the year before. The surplus of the Social Security Funds is projected in 2009 to decline to 2.5% of GDP, bringing the overall balance of the General Government to a deficit of around 0.8% of GDP.

The sizeable surplus of the Social Security Funds is attributed to the fact that the system has not fully matured yet, as well as to the still favourable demographics. With the system maturing over the next decade and the expected demographic changes, due to population ageing, the Social Security Funds financial position is projected to deteriorate and exhibit a downward trend over the programming period 2010-2012.

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<sup>13</sup> The Government as an employer and as a contributory party to the whole scheme contributes annually approximately 3 percent of GDP.

Specifically, the surplus of the social security funds is projected to decline from a forecast of 2.5% of GDP in 2009 gradually to 1.6% by 2012. The steady decline in the surpluses of the Social Security Funds would be partly offset by the possible approval of the relevant Bill pending at the House of Representatives, which specifies a set of parametric reforms, including increased contribution rates to the Social Security Funds.

**Table VIII: General Government Budgetary Developments by Sub-Sector**

<i>in percent of GDP</i>	2007	2008 est.	2009 proj.	2010 proj.	2011 proj.	2012 proj.
<i>Net lending by sub-sectors</i>						
<b>General Government</b>	<b>3.4</b>	<b>1.0</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-2.2</b>
Central Government	0.4	-1.7	-3.2	-3.6	-3.8	-3.8
Local Government	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Social Security Funds	3.1	2.8	2.5	2.2	1.9	1.6

*Budgetary implications of “major structural reforms”*

The projects and measures promoted within the framework of the implementation of the Lisbon Programme are financed through:

- National resources;
- EU funds; and
- Public Private Partnerships.

The necessary budgetary appropriations for the actions included in the microeconomic and employment section have been provided in the Budgets of 2007 and 2008. The net budgetary expenditure of the microeconomic and employment actions is estimated at 2% of GDP in 2007; this estimation rises to 2.7% in 2008 and 2009.

Furthermore, a number of infrastructure projects in the area of transport and the environment will be co-financed by the Cohesion Fund, whereas a number of measures and actions aiming at enhancing and utilising the production potential of disadvantaged areas and increasing the employability possibilities for targeted groups will be co-financed from the EU Structural Funds under the current EU programming period. In the next programming period of the EU (2007-2013), it will be the objective to co-finance a number of infrastructural projects mainly in the areas of maritime transport and the environment as well as measures and actions in other areas via the various instruments of the EU Cohesion Policy. Moreover, it is noted that important infrastructural projects, such as airports, marinas, storage depots for

petroleum products and a terminal for importation, storage and vaporisation of liquefied natural gas will be undertaken through public private partnerships.

### ***European Economic Recovery Plan***

As already mentioned, economic activity in Cyprus over the short-term is expected to exhibit a deceleration. The global financial crisis will have an adverse effect on Cyprus economy, with the slowdown being more evident in the tourist and construction sectors of the economy.

Therefore, the Government of the Republic of Cyprus, on 19<sup>th</sup> of December, 2008, has approved a fiscal stimulus plan targeting the tourism and construction sectors of the economy. The first fiscal stimulus package which was temporary, timely and targeted was estimated at 0.3 percent of GDP. The first package included provisions for an increase of the government grant provided to the Cyprus Tourism Organisation and for speeding up the implementation of infrastructural and other projects, already incorporated in the Budget for 2009.

More specifically, the Government has decided to increase the Budget for the Cyprus Tourism Organisation (CTO) by €12 million equivalent to 0.07% of GDP, aimed at boosting the advertising campaign locally and abroad, in order to help alleviate the anticipated decline in tourist arrivals and its impact on the demand for hotel and restaurant services. Additionally, the CTO intends to introduce a plan for raising the demand for hotel and restaurant services during the low season, where the capacity is substantially underutilised.

An additionally €40 million equivalent to approximately 0.2% of GDP were provided for speeding up the implementation of infrastructural and other projects, in order to support aggregate demand and employment in the construction sector.

The issue of speeding up infrastructural and other projects was handled by a task force, which was established and presided over by the Permanent Secretary of the Ministry of Finance. This task force has completed its work and identified a set of infrastructural measures to be expedited that will raise the implementation rate of the development programme budgeted for 2009 by approximately ten percent points having an impact of 0.8% of GDP. Additionally, the task force also identified a specific set of infrastructural projects, that additional funds will be provided for, which include the construction of school buildings (€17.5 million), the construction of road networks (€15.3 million) and government offices (€1.6 million), the extension of irrigation systems (€20 million), the implementation of projects for the protection of the environment (€9.5 million) and the reconstruction of government dwellings for low income families (€0.4 million). In addition, increased funds will be granted, over and above the funds included in the Budget, to Local Authorities for the promotion of

small infrastructural projects at the local level. The above measures are estimated to have a total impact of 1.2% of GDP in 2009.

Furthermore, on February 3<sup>rd</sup>, 2009, taking into account the deteriorating external environment, the Government of the Republic of Cyprus has decided to introduce a set of additional temporary measures, in the course of 2009, for tourism and construction sectors. Taking into consideration the deteriorating external environment, the aim is to improve the competitive position of Cyprus via the reduction of costs, thus allowing businesses to price their products and services more competitively and partly offsetting the faltering demand in the construction sector thus alleviating the effects on labour.

These measures include the reduction of the VAT rate applied on hotel accommodation from 8% to 5% (from 1.5.2009 to 30.4.2010), the lowering of landing fees levied on airline companies, the introduction of a scheme promoting local tourism through grants for low income families and the cancelation of overnight stay fees levied by local authorities on hotels. The fiscal impact of the said measures for 2009 is estimated at 0.3% of GDP.

In addition to the above, the Government has decided to introduce a scheme for the provision of loans, at favourable terms, for low income families with an annual household income less than €40.000 for the acquisition of their primary residence. The total amount approved for this scheme was set at €200 million for the period 2009-2013, equivalent to 1.1% of GDP. The scheme's impact on public finances is limited to an equivalent impact on general government gross debt and a neutral impact on the budget balance.

The recovery plan measures outlined above are estimated to have an impact on the budget balance totaling 1.52% of GDP in 2009, of which 0.32% refers to measures for the tourism sector and 1.2% refers to measures for the construction sector and in general to support development.

In the event of a more protracted slowdown, the Government has the necessary room to manoeuvre, given the underlying sound fiscal position and stands ready to implement additional measures, if required.

**Table IX: Short-term fiscal measures with direct budgetary impact**

Measure	Planned date of adoption	Description of the measure	Direct budgetary impact (in % of GDP)				
			2008	2009	2010	...	Final prog. year
<i>Tourism Sector</i>							
Increasing the Budget of Cyprus Tourism Organisation - announced	2009	Boosting the campaign for the promotion of the Cyprus tourism product. The measure is planned to be implemented during the course of 2009. At this stage, the measure is not planned to be repeated in 2010. Its purpose is to support aggregate demand.	-	0.07	-	-	2009
Improve the competitive position of Cyprus's tourism product - announced	2009	Application of the reduced VAT rate on hotel accommodation of 5% instead of 8% for the period 1.5.2009-30.04.2010	-	0.07	0.03	-	2009
	2009	Reduction of landing fees at airports levied on airline companies for the period 1.4.2009-31.12.2009	-	0.06	-	-	2009
	2009	Cancellation of overnight stay fees levied by local authorities on hoteliers for the period 1.4.2009-31.12.2009	-	0.06	-	-	2009
Promotion of local tourism - announced	2009	Increasing the available budget provided to low income families for subsidising vacations at local destinations during the summer period of 2009.	-	0.06	-	-	2009
<i>Total Impact on the Tourism Sector</i>			-	0.32	0.03	-	

Measure	Planned date of adoption	Description of the measure	Direct budgetary impact (in % of GDP)				
			2008	2009	2010	...	Final prog. year
<i>Construction Sector</i>							
Increase of public infrastructure investments - announced	2009	The raising of the implementation rate of the development programme of the Government. The measures are planned to commence in the course of 2009. At this stage, the measure is not planned to be repeated in 2010. Its purpose is to support aggregate demand and employment in the sector.	-	0.80	-	-	2009
	2009	Speeding up of the procurement of infrastructural projects such as building of schools, extension of irrigation systems and road networks, erection of government buildings and environmental projects. The measures are planned to commence in the course of 2009. At this stage, the measure is not planned to be repeated in 2010. Its purpose is to support aggregate demand and employment in the sector.	-	0.40	-	-	2009
Introduction of a loan scheme for the acquisition of primary residence – announced	2009	The Government announced the introduction of a loan scheme targeted to low income families for the acquisition of their primary residence. The annual	-	-	-	-	2009

Measure	Planned date of adoption	Description of the measure	Direct budgetary impact (in % of GDP)				
			2008	2009	2010	...	Final prog. year
		family income of eligible families must not exceed €40.000. The total area of the residence acquired should be less than 200 square meters. The terms of the loans provided will be favourable as the interest charged will be zero during the first two years and subsequently close to the market rates prevailing. The measure is planned to commence in the course of 2009 and implemented over the period 2009-2013. Its purpose is to support aggregate demand and employment in the sector.					
<i>Total Impact on the Construction Sector</i>			-	1.20	-	-	
<b>Total Impact</b>			-	1.52	0.03	-	

**Table X: Medium-term measures improving the quality of public finances and the long-term sustainability**

Measure	Planned date of adoption	Description of the measure
Medium Term Budgetary Framework - announced	2008-..	Improve budgetary frameworks
Parametric Reforms to the Social Security Schemes - announced	2009	Ensure long-term sustainability of public finances

## **5. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT**

### *Alternative Scenarios and Risks*

The baseline scenario included in this SP envisages growth significantly below potential in 2009-2010 and a gradual recovery thereafter. In this baseline scenario the economy is expected to operate below potential in agriculture, construction and real estate, renting and other business activities, financial intermediation, hotels and restaurants. A number of booming sectors, such as other business activities, are assumed to gradually converge to their trend growth levels over the medium term.

Furthermore, in the central scenario, it is assumed that the international turmoil will primarily affect investment in construction, as well as, export of goods and services, especially tourism. The impact on private consumption, primarily arising from adverse confidence effects and borrowing conditions is expected to be relatively moderate. A limited impact is also expected on exports of services, other than tourism.

Nevertheless, as was indicated earlier there are significant downside risks to these central projections, mainly emanating from the following factors:

#### ***External Environment***

- Further escalation of the financial sector crisis, resulting in volatility of interest rates and widening of spreads;
- A deeper-than-anticipated real economy correction in the EU, particularly the UK which constitutes a major trading partner to Cyprus;
- A deeper-than-anticipated slowdown in Russia could affect the international business sector in Cyprus, and hence export of services other than tourism;
- A reversal of the current dollar appreciation, owing in large part to the unwinding of cross-currency positions and flight to safety, could unleash a protracted and significant selling of the dollar with repercussions on the external competitiveness in the euro area; and
- More volatility of commodity prices, especially oil.

***Domestic Economy***

- A deeper correction of private consumption and investment in construction, due to more pronounced confidence effects and credit restraint;
- A more significant impact of the world economy on the export affected sectors of the economy; and
- A deeper contraction of the construction sector.

***Sensitivity of Budgetary Projections to Different Scenarios and Assumptions***

To assess the sensitivity of the projected general government balance and debt ratios, alternative assumptions for real GDP growth rates and interest rates have been incorporated in three distinct scenarios. All simulations assume that, while automatic stabilisers would be allowed to operate fully, expenditure targets will not be altered with the exception of the impact on interest payments due to an assumed different interest rate forecast. To conduct the sensitivity analysis, the shocks included in Chapter 2, Box 1 are also analysed here in terms of their budgetary implications.

***Assumption 1:*** A deeper demand shock could lower growth to some 1% from 2.1% in 2009 in the central scenario. Other things being equal, the budget balance is projected to deteriorate by some 0.4 percent of GDP at the beginning of the programming period to a deficit of 1.2 percent of GDP in 2009; the resulting deficit path follows an upward trend reaching 3.8% of GDP by the end of the programming period. The public debt-to-GDP ratio is projected to remain on a downward path during the period 2009-2011, albeit less pronounced, falling to 45.4% by 2011 and then a reversal of the trend is projected with the debt-to-GDP rising to 45.8% by the end of the programming period, 4 percent points of GDP higher compared with the baseline or central scenario.

**Table XI: Three Scenarios for Public Finances**

<i>in percent of GDP</i>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2009-2012 4– year Average</b>
<b><i>Central Scenario</i></b>					
GDP	2.1	2.4	3.0	3.2	2.7
General Government Balance	-0.8	-1.4	-1.9	-2.2	
General Government Debt	46.8	45.4	44.2	44.2	
<b><i>More negative demand shock</i></b>					
GDP	1.0	1.4	2.0	2.2	1.6
General Government Balance	-1.2	-2.2	-3.1	-3.8	
General Government Debt	47.2	46.2	45.4	45.8	

*Assumption 2: Interest rates remain some 100 basis points above baseline each year during 2008-2011. In this case, the government deficit would be some 0.5 percent of GDP higher during the programming period, and the government debt-to-GDP ratio would be higher by 2.0 percent points of GDP by the end of the programming period.*<sup>14</sup>

**Table XII: Scenario with Higher Interest Rates Cumulative Differential**

<i>in percentage points of GDP with respect to the reference scenario</i>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
General Government Net Borrowing	0.55	0.51	0.49	0.47
General Government Gross Debt	0.55	1.06	1.55	2.02

The sensitivity analysis presented here confirms the importance of growth assumptions in affecting the outcome of the general government deficit and debt figures. Accordingly, the envisaged path for the government finances is highly dependent on the realisation of the projected growth rates of real GDP. Also, higher than anticipated borrowing costs can have a considerable cumulative impact on debt over the medium term.

#### *Comparison with Previous Update*

Compared with the forecast presented in the first Stability Programme 2007-2011, and mainly as a consequence of deteriorating macroeconomic conditions, a continued unfavourable external environment and confidence effects from a slowdown in the real estate and tourist sectors, GDP growth has been revised downwards over the programming period. Similarly, the general government budget balance as a percent of GDP and the government debt-to-GDP ratio forecasts, are projected to exhibit a deterioration relative to the last Stability Programme's projections. The deterioration in the projections for public finances is relatively smaller than the revision of GDP growth projections mostly due to the substantially better than anticipated budgetary outcome for 2007 and its base effects.

The general government balance as a percentage of GDP is estimated to have reached a surplus of 1% in 2008, exhibiting a divergence from last year's estimate of around 0.5 percent points of GDP. This divergence is mainly attributed to the base effects from the extraordinary revenue of 2007, mainly emanating from the buoyant activity of the real estate and financial sector, partly offset by the higher expenditures associated with the severe drought conditions prevailing on the island. The general government balance is projected to exhibit a deficit in 2009, amounting to around

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<sup>14</sup> In this scenario real GDP growth is assumed to remain unchanged even though higher interest rates could be expected to have a negative effect on real economic growth.

0.8% of GDP, exhibiting a reversal compared to last year's forecast of a surplus of 0.5% of GDP; the deficit is projected to gradually widen and deviate from last year's forecast by approximately 2½ percent points of GDP by 2011. The general government debt-to-GDP ratio is predicted to have declined in 2008 to around 49.3% and to 46.8% in 2009, as a result of primary surpluses. The estimate for 2008 and the forecast for 2009 are higher compared to last year's projection of 48.5% and 45.3% of GDP, respectively, which were reported in the Stability Programme of 2007-2011. The deviations are attributed to larger primary surpluses projected during the beginning of the programming period following the exceptional outcome for 2007 and its carry over effects, in conjunction with a revised set of projections for GDP levels. Public debt-to-GDP ratio forecast remains above last year's forecast at the beginning of the programming period being higher by 1.5% of GDP by 2009 and then rising to 3.7% by 2011, resulting in a gross debt level of 44.2% of GDP in the year 2012.

**Table XIII: Divergence from Previous Update**

<i>as a percentage of GDP</i>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
<b><i>GDP Growth</i></b>						
Previous Update	4.2	4.1	4.0	4.0	4.0	n/a
Latest Update	4.4	3.8	2.1	2.4	3.0	3.2
Difference	0.2	-0.3	-1.9	-1.6	-1.0	
<b><i>General Government Balance</i></b>						
Previous Update	1.5	0.5	0.5	0.7	0.7	n/a
Latest Update	3.4	1.0	-0.8	-1.4	-1.9	-2.2
Difference	1.9	0.5	-1.3	-2.1	-2.6	
<b><i>Debt-to-GDP Ratio</i></b>						
Previous Update	60.0	48.5	45.3	43.8	40.5	n/a
Latest Update	59.4	49.3	46.8	45.4	44.2	44.2
Difference	-0.6	0.9	1.4	1.6	3.7	

## **6. QUALITY OF PUBLIC FINANCES**

### *Policy Strategy*

Improvement in the quality of public finances is an important element of fiscal policy for realizing the growth potential and, at the same time, countering the spending pressures that arise from an ageing population, as well as ensuring of long-term sustainability of public finances. Considerable attention is been paid to the quality aspects of public expenditure to ensure that growth enhancing budgetary items are not squeezed out by uncontrolled expenditure costs or by growth in inefficient expenditure categories.

The spending priorities include infrastructural investment, IT-development, research, education and health. On the revenue side, Government policies aim at preserving the current system, characterized by low marginal tax rates and a wide tax base. These are important elements of the Lisbon strategy for promoting growth and jobs, while simultaneously meeting the objectives of the Stability and Growth Pact.

### *Policy Framework and Structural Reforms*

A number of structural reforms will assist in the development of strong and flexible public finances, in order to resist any external shocks. The phased introduction of a Medium Term Budgetary Framework (MTBF), which commenced in 2006, has helped in containing expenditures by line ministries and, at the same time, promoted the reallocation of expenditure in favour of growth - enhancing activities, consistent with the priorities set by the National Reform Programme.

More specifically, budgetary reforms require that ministries and other government spending agencies redesign and prepare their annual budgets, using new Medium-Term Budgetary Framework (MTBF) and Programme and Performance Budgeting (PPB) methods.

These new methods have been introduced progressively from 2007, with all spending agencies being required to prepare three-year budgets for the period 2008-2010. The first steps for introducing the new PPB framework were taken during 2007, with the implementation of pilot projects, covering three ministries. In 2008, the number of ministries and spending agencies, adopting this approach, increased and it is expected that all agencies by 2009 will prepare their FY 2010 budgets according to both the traditional (input-based) budget method and the new PPB/MTBF format. This will enable all spending agencies to have at least two “trial” years (FY 2010 and FY 2011), in which the new methods can be developed, tested and refined.

During this trial period, the Treasury Department of the Ministry of Finance has been upgrading the accounting software Financial Management Accounting System (FIMAS) to a newer version that is capable of supporting the new budgetary methods and classifications. The new MTBF/PPB approach will become the official (and only) budget method from FY 2012 onwards.

Overall, the MTBF budgeting should enable managers to plan activities more effectively, by incorporating the amount of financing required to sustain a particular government policy, budget activity or expenditure project over several years.

It is noted that, the budgetary process for 2009, required line ministries to provide forecasts of their expenditure needs for 2010 and 2011. These forecasts were split between current obligations and future needs. The additional available resources were allocated to the high priority areas, such as research and technology, education and health all in line with the objective of redirecting public expenditure to growth-enhancing categories. The areas with marginal or no growth are those of agriculture, security and defence and road transportation.

The policy for reallocation of government expenditure evidently leads to the decline, as a percent to GDP, of expenditures functions such as Defence, Public Order and Safety and Economic Affairs, while high priority functions such as Education, Housing and Community Amenities exhibit a rising trend. The decline in the expenditure function Social Protection recorded in 2007 is attributed to the gradual extension of the retirement age of civil servants from 60 to 63 years of age introduced in mid-2005.

**Table XIV: Functional Classification of Expenditure**

<i>in percent of GDP</i>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
1. General public services	9.6	10.1	9.9	10.2
2. Defence	1.8	1.9	2.0	1.8
3. Public order and safety	2.2	2.1	2.2	2.1
4. Economic affairs	5.1	4.8	4.7	4.3
5. Environmental protection	0.3	0.3	0.3	0.3
6. Housing and community amenities	2.4	2.2	2.5	2.5
7. Health	3.1	3.0	3.1	2.9
8. Recreation, culture and religion	1.1	1.2	1.2	1.3
9. Education	7.1	7.2	7.2	7.4
10. Social protection	10.0	10.7	10.4	9.9
<b>11. Total expenditure</b>	<b>42.8</b>	<b>43.6</b>	<b>43.4</b>	<b>42.9</b>

### **High priority areas**

Total expenditure for *infrastructure*, in the Budget for 2009 and in projects financed through Private Public Partnership agreements, exceed 3% of GDP. Considerable progress has been achieved in the expanding and upgrading of basic infrastructure including the completion of important projects in the area of transport. Also a number of actions included in the Strategic Action Plan for Road Safety have been implemented, resulting in a considerable reduction in the number of road deaths. Newer priorities in the area of transportation and infrastructure are reflected in the Council of Ministers approving a programme of action for the enhancement of public transport on the Island, and in the signing of the final Concession Agreement between the Government and Hermes Airports Ltd, launching the redevelopment of the two airports in Cyprus, using the BOT method.

Total expenditure on *research and technology* is budgeted to increase by approximately 15% compared to 2008, due mainly to the special focus on the development of needed infrastructures, including the creation of a technological park which aims at attracting high – tech businesses and the creation of a research centre on energy environment and water, in cooperation with the Massachusetts Institute of Technology. The implementation of the actions concerning the promotion of R&D, which were included in the National Reform Programme, over the period October 2006 – September 2007, progressed satisfactorily in all priorities. The Government has approved a substantial increase in the funds allocated via the Framework Programme of the Research Promotion Foundation (RPF) 2007-2010, reaching 0.6 percent of GDP compared with 0.1 percent in 2006.

Total expenditure on *education* is budgeted to increase by approximately 12% in 2009 compared to 2008, reaching 8% of GDP. Expenditure on education is focused mainly on the continuation of computerisation of all primary and secondary schools, the construction and extension of school buildings, the creation and upgrading of new research and academic institutions (Cyprus University of Technology, Open University, Cyprus Institute). Progress in improving the quality and extension of education in these areas in 2008 was considered satisfactory.

Total expenditure on *health* is budgeted to increase by approximately 17% in 2009 compared to 2008, reaching 3.3% of GDP. The Budget for 2009, allocates considerable funds for the operation of two new general hospitals, for financing arrangements between Harvard University and the Republic of Cyprus on Public Health and the Environment, and for the promotion of the National Health Scheme. The improvement of the quality of the health care system and the effective tackling of the anticipated increases in public health expenditure constitutes a significant challenge. This will be accomplished through the restructuring of public hospitals into autonomous establishments under the wider public sector and the implementation of

the National Health Insurance System (NHIS). The main goal of the reform of the health care system is to improve effectiveness via regulated competition and to contain costs. The implementation strategy of the NHIS in Cyprus was submitted to the Health Insurance Organisation (HIO) in November, 2006 and measures have been taken that will enable the National Health Insurance System to begin operations towards the end of 2008.

As in the annual Budget for 2008, the Budget for 2009, shows negligible increases or even decreases in certain cases in the areas of agriculture, security and defence and public administration.

### *Revenue Side*

Improving the quality of public finances from the revenue side has represented an important challenge to the Cyprus authorities covering different aspects. As levels of government revenue and tax structures have macroeconomic and microeconomic consequences, their impact will shape many aspects of the Cyprus economy.

Firstly, the macroeconomic consequences of taxation are materialized by its stabilization, redistribution and (dis)incentive effects. Tax systems must contribute to ensuring budgetary discipline. With the entry of Cyprus to the EMU and the loss of the monetary policy instrument a better functioning product, labour and capital markets, as well as, the enhanced automatic stabilization potential of fiscal policy have been required. Moreover, with tax policy impacting on both, the authorities are closely monitoring the macroeconomic effects of the tax system.

Secondly, taxes are the main source of financing desirable policies and expenditure priorities. Over the medium-term the Government will require a level of revenue to adequately fund its spending priorities. The tax structure must not only produce such a level of revenue, but in the Cyprus context the introduction of the MTBF places a greater premium on improving the accuracy and sensitivity of revenue forecasts over the medium-term so as to provide a more realistic resource envelope for formulating medium-term expenditure plans. Given the volatility of tax elasticities in recent years, the Ministry of Finance makes cautious estimates of tax bases and tax elasticities, taking account of the impact of asset price changes and the composition of GDP growth in their government revenue projections for the medium term.

Thirdly, taxes – by altering relative prices – distort economic choices. In this connection, the Cyprus authorities are constantly monitoring the tax/benefit system to ensure that “work pays”, without jeopardizing needed support to vulnerable groups in society, in the process enhancing the flexicurity system in this direction. Also, in view of the challenge of globalization consideration is also being given to the equitable

taxation of immobile tax bases, such as property, while limiting taxation of mobile tax bases within the confines of the EU acquis and tax directives.

## **7. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES**

The situation concerning the long-term sustainability of public finances has changed significantly in two important ways since the last Stability Programme was submitted to the European Commission in December 2007. Firstly, the general government position improved substantially in 2007, with the surplus amounting to some 3.4% of GDP in 2007. Despite the fact that part of the accrued revenue was one-off, as it was illustrated in last year's SP, the extent of the improvement raised the level of revenue significantly also for 2008. At the same time the Government repaid a considerable part of its debt using financial assets (sinking funds). All in all therefore the public finances improved significantly again allowing an even greater primary balance. Secondly, the Government reached an agreement with the Social Partners on a reform package for addressing the sustainability of the social security fund. The package has been submitted to Parliament for approval.

This chapter illustrates the situation concerning the sustainability of public finances, looking in more depth at the projections on the evolution of the Social Security Fund with and without reforms, based on a new set of demographic assumptions agreed in common by the Economic Policy Committee.

### ***Revised Projections for the evolution of pension expenditure***

The present pension projections for Cyprus are produced directly from the actuarial pension model of the Social Insurance Services of the Ministry of Labour and Social Insurance, using the commonly agreed assumptions of the AWG (EUROPOP 2008).

Table 7 (Appendix I) shows the aggregate results of the projections for social security pensions only. The pension expenditure is expressed in percentage of GDP. The results indicate a significant increase in pension spending over the next 50 years, with the most dramatic deterioration occurring from 2030 onwards. It is clear from the results that both old-age and early pension and other pension (which include invalidity and survivor's pension benefits) increases during the period. Specifically, old-age and early pension expenditure is projected, under the unreformed scenario, to increase from 3.4% of GDP in 2007 to 11.8% of GDP in 2060, while other pension expenditure will increase from 1.3% to 2.8% of GDP over the same period. In addition the pension expenditure of the government employees pension schemes is projected to increase from 1.7% to GDP in 2007 to 2.7% in 2060.<sup>15</sup>

The aforementioned significant increase in pension expenditure in Cyprus over the period 2007-60 is explained almost exclusively by the deterioration of the dependency

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<sup>15</sup> All these numbers are in current prices calculated as share of nominal GDP. The results are therefore different from the Aging Working Group Projections which are presented in constant prices over the entire horizon.

ratio during this period, and to a much lesser extent by the increased coverage ratio. The latter is due to the expected increase in the percentage of female insured persons who meet the qualifying conditions for receiving an old-age pension at the age of 63. This is as a result of the expected increase in the female labour force participation rates and longer contribution periods. Offsetting this positive contribution is a negative contribution stemming from a small increase in the employment rate as a result of the high expected employment growth, particularly for females, in the first decade; and a marginal decrease in the benefit ratio, primarily due to the price indexation on benefits in the longer-term – in the first couple of decades as the supplementary part of the social insurance scheme matures, the average level of new pensions is expected to increase at a rate higher than that of productivity.

In total, all age-related expenditure including spending on healthcare and education are projected to rise from 16.9% of GDP in 2007 to 25.3% in 2060. As a result total general government expenditure will increase from 42.9% of GDP in 2007 to 52.9% in 2060.

On the revenue side, the assets of the reserve of the Social Security Fund provide income to the government<sup>16</sup>. The size of this fund in 2007 was of the order of 36.8% of GDP. In line with the projected increase of pension expenditure, and projected revenues, it is shown that the reserve will hold assets until 2033. Thereafter it will accumulate net debt obligations which would amount to some 182% of GDP by 2060. Consequently the income stemming from these assets is projected also to become negative and the total revenue of the general government to decline from 46.4% of GDP in 2007 to 41.8% of GDP by 2060. The result, of course, will be a substantial increase of the public debt-to-GDP ratio over the period.

### *Planned Parametric Reforms*

Discussion of parametric reforms of the social security system has intensified throughout 2007-08 and a final agreement has been reached with social partners. The proposed new reform package is pending for approval at the House of Representatives. These reforms include:

1. Gradual increases in contribution rates – seven increases by 1.3% every five years – first increase in January 2009 and last increase in January 2039;
2. Stricter eligibility conditions to old-age pension - increase of the minimum contribution requirement to 10 years of paid contributions (currently the minimum requirement is 3 years);
3. Maximum limit of 6 years on credits granted to an insured person in the lower

- band for any period of full time education or approved training after the age of 16 (under the existing legislation there is no maximum limit imposed);
4. Stricter eligibility conditions for the payment of old-age lump sum at age 68, for those who are eligible for old-age pension at 65 - 6 years of paid contributions (currently the minimum requirement is for 3 years).

**Table XV: Current Baseline and reform scenario, % GDP**

<i>in percent of GDP</i>	2007	2020	2030	2040	2050	2060
Social security pensions under reform	4.7	6.3	7.9	9.3	11.6	13.6
Social security pensions under no reform	4.7	6.8	8.7	10.4	12.7	14.7
Contributions under reform	4.2	5.5	6.4	7.4	7.5	7.6
Contributions under no reform	4.2	4.3	4.4	4.5	4.5	4.6
Assets of the SSF (% GDP) before reform	36.8	30.9	9.9	-27.2	-88.0	-182.1
Assets of the SSF (% GDP) after reform	36.8	45.0	51.1	59.0	57.3	33.4

The reforms include expenditure and revenue measures, most important of which is the proposed gradual increase of the social security contribution rate. Table XV shows the estimated impact of the reforms on both expenditure and revenue.

On the expenditure side, the proposed reform measures imply a correction of some 1 percent of GDP annually by 2060. At the same time revenues also increase substantially in line with the phased increased of the social security contribution rates: under the reform scenario total annual contributions will increase by 3 percent points of GDP. Therefore, the financial position of the social security fund improves considerably. Consequently, by 2060 under the current reform scenario the Fund will hold still assets amounting to over 33% of GDP, compared with liabilities of 182% of GDP under the current no reform scenario. The improvement in the financial position of the Fund, and therefore of the general government is noteworthy.

**APPENDIX I**

**Table 1a: Macroeconomic prospects**

	ESA Code	Year 2007	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
		€ million	rate of change					
<b>1. Real GDP</b>	B1*g	12598.3	4.4	3.8	2.1	2.4	3.0	3.2
<b>2. Nominal GDP</b>	B1*g	15596.3	8.0	8.2	4.8	4.5	5.2	5.4
<i>Components of real GDP</i>								
<b>3. Private consumption expenditure</b>	P.3	8637.9	8.2	7.2	3.8	3.3	3.3	3.3
<b>4. Government consumption expenditure</b>	P.3	2088.3	0.1	4.0	5.6	4.9	4.9	4.7
<b>5. Gross fixed capital formation</b>	P.51	2588	7.6	2.8	-2.8	2.1	3.9	3.9
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	107.8	0.9	0.8	0.8	0.7	0.7	0.6
<b>7. Exports of goods and services</b>	P.6	6719.3	7.2	6.1	1.4	1.4	3.1	3.7
<b>8. Imports of goods and services</b>	P.7	7543	12.5	9.6	2.4	3.1	4.1	4.1
<i>Contributions to real GDP growth</i>								
<b>9. Final domestic demand</b>		13314.2	6.7	5.8	2.8	3.3	3.7	3.6
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	107.8	0.7	-0.07	-0.03	-0.04	-0.04	-0.04
<b>11. External balance of goods and services</b>	B.11	-823.7	-3.1	-2.4	-0.7	-1.2	-0.9	-0.7

**Table 1b: Price developments**

	ESA Code	Year 2007	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
		Level	rate of change					
<b>1. GDP deflator</b>		123.8	3.5	4.2	2.7	2.1	2.1	2.1
<b>2. Private consumption deflator</b>		119.6	2.7	5.0	2.3	2.0	2.0	2.0
<b>3. HICP<sup>1</sup></b>		104.5	2.2	4.4	2.0	2.5	2.5	2.5
4. Public consumption deflator		132.4	2.9	4.7	2.3	2.0	2.0	2.0
5. Investment deflator		129.2	4.5	4.3	-5.6	-1.4	0.5	0.5
<b>6. Export price deflator (goods and services)</b>		113.3	2.5	3.0	3.0	3.0	2.9	2.5
<b>7. Import price deflator (goods and services)</b>		114.0	2.3	4.8	-1.9	2.4	1.8	1.8

<sup>1</sup> Optional for stability programmes.

**Table 1c: Labour market developments**

	ESA Code	Year 2007	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
		Level	rate of change					
1. Employment, persons <sup>1</sup> (000's)		370	3.1	1.9	1.1	1.3	1.8	1.9
2. Employment, hours worked <sup>2</sup> (thousands)		715.103	2.9	1.9	1.1	1.3	1.8	1.9
3. Unemployment rate (%) <sup>3</sup>		3.9	3.9	4.0	4.5	5.0	5.3	5.5
4. Labour productivity, persons <sup>4</sup> (€, 2000 prices)		34049.4	1.3	1.9	1.0	1.1	1.2	1.3
5. Labour productivity, hours worked <sup>5</sup> (€, 2000 prices)		17.617	1.5	1.9	1.0	1.1	1.2	1.3
<b>6. Compensation of employees (€ million)</b>	D.1	6924.1	7.4	9.0	6.5	6.1	6.7	6.8
7. Compensation per employee (€)		18713.8	4.2	7.0	5.3	4.8	4.8	4.8

<sup>1</sup>Persons with occupation, domestic concept, national accounts definition.

<sup>2</sup>National accounts definition.

<sup>3</sup>Harmonised definition, Eurostat; levels.

<sup>4</sup>Real GDP per person employed.

<sup>5</sup>Real GDP per hour worked.

**Table 1d: Sectoral balances**

<i>% of GDP</i>	ESA Code	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-11.7	-12.4	-12.1	-11.5	-10.9	-10.2
<i>of which:</i>							
- Balance on goods and services		-6.7	-9.4	-9.1	-8.5	-8.0	-7.5
- Balance of primary incomes and transfers							
<b>2. Net lending/borrowing of the private sector</b>	B.9	-15.1	-13.4	-12.5	-11.5	-10.4	-9.3
<b>3. Net lending/borrowing of general government</b>	EDP B.9	3.4	1.0	0.4	0	-0.5	-0.9
<b>4. Statistical discrepancy</b>		0	-0.2	0	0.1	0.1	0.2

**Table 2: General government budgetary prospects**

	ESA Code	Year 2007	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
		Level	% of GDP					
<i>Net lending (EDP B.9) by sub-sector</i>								
<b>1. General government</b>	S.13	537,4	3.4	1.0	-0.8	-1.4	-1.9	-2.2
<b>2. Central government</b>	S.1311	69,2	0.4	-1.7	-3.2	-3.6	-3.8	-3.8
<b>3. State government</b>	S.1312	M	M	M	M	M	M	M
<b>4. Local government</b>	S.1313	-9,1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
<b>5. Social security funds</b>	S.1314	477,3	3.1	2.8	2.5	2.2	1.9	1.6
<i>General government (S13)</i>								
<b>6. Total revenue</b>	TR	7.231,0	46.4	45.3	43.8	44.0	44.4	44.8
<b>7. Total expenditure</b>	TE <sup>1</sup>	6.693,6	42.9	44.3	44.6	45.5	46.3	47.1
<b>8. Net lending/borrowing</b>	EDP B.9	537,4	3.4	1.0	-0.8	-1.4	-1.9	-2.2
<b>9. Interest expenditure</b>	EDP D.41	479,7	3.1	2.9	2.4	2.2	2.1	2.1
<b>10. Primary balance<sup>2</sup></b>		1.017,1	6.5	3.9	1.5	0.8	0.2	-0.2
<b>11. One-off and other temporary measures<sup>3</sup></b>		0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Selected components of revenue</i>								
<b>12. Total taxes (12=12a+12b+12c)</b>		5.260,4	33.7	32.6	31.4	31.6	31.8	32.2
<b>12a. Taxes on production and imports</b>	D.2	3.076,3	19.7	19.7	19.6	19.5	19.6	19.8
<b>12b. Current taxes on income, wealth, etc</b>	D.5	2.180,7	14.0	12.9	11.9	12.0	12.2	12.4
<b>12c. Capital taxes</b>	D.91	3,4	0.0	0.0	0.0	0.0	0.0	0.0
<b>13. Social contributions</b>	D.61	1.194,7	7.7	7.9	8.0	8.1	8.2	8.2
<b>14. Property income</b>	D.4	110,6	0.7	0.9	0.4	0.4	0.4	0.4
<b>15. Other<sup>4</sup></b>		665,3	4.3	3.9	3.9	3.9	4.0	4.1
<b>16=6. Total revenue</b>	TR	7.231,0	46.4	45.3	43.8	44.0	44.4	44.8
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>5</sup></b>		6.451,7	41.4	40.5	39.5	39.7	40.0	40.4
<i>Selected components of expenditure</i>								
<b>17. Compensation of employees + intermediate consumption</b>	D.1+P.2	3.058,6	19.6	19.7	20.2	20.5	20.7	20.9
17a. Compensation of employees	D.1	2.258,8	14.5	14.6	14.9	15.1	15.2	15.3
17b. Intermediate consumption	P.2	799,8	5.1	5.2	5.3	5.4	5.5	5.6
<b>18. Social payments (18=18a+18b)</b>		1.827,0	11.7	12.1	12.6	13.1	13.6	14.1
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	22,0	0.1	0.2	0.2	0.2	0.2	0.2

18b. Social transfers other than in kind	D.62	1.805,0	11.6	12.0	12.5	12.9	13.4	13.9
<b>19=9. Interest expenditure</b>	EDP D.41	479,7	3.1	2.9	2.4	2.2	2.1	2.1
<b>20. Subsidies</b>	D.3	65,4	0.4	1.0	0.5	0.4	0.4	0.4
<b>21. Gross fixed capital formation</b>	P.51	451,9	2.9	2.9	3.0	3.0	3.0	3.1
<b>22. Other<sup>6</sup></b>		811,0	5.2	5.6	6.0	6.2	6.4	6.6
<b>23=7. Total expenditure</b>	TE <sup>1</sup>	6.693,6	42.9	44.3	44.6	45.5	46.3	47.1
p.m.: Government consumption (nominal)	P.3	2.764,5	17.7	17.8	18.3	18.6	18.7	18.9

<sup>1</sup>Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>2</sup>The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

<sup>3</sup>A plus sign means deficit-reducing one-off measures.

<sup>4</sup>P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

<sup>5</sup>Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>6</sup>D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

**Table 3: General government expenditure by function**

<i>% of GDP</i>	COFOG Code	<b>Year 2006</b>	<b>Year 2011</b>
1. General public services	1	9.9	9.7
2. Defence	2	2.3	1.8
3. Public order and safety	3	2.2	2.2
4. Economic affairs	4	4.4	4.6
5. Environmental protection	5	0.3	0.4
6. Housing and community amenities	6	2.5	3.5
7. Health	7	3.1	3.3
8. Recreation, culture and religion	8	1.2	1.3
9. Education	9	7.2	7.8
10. Social protection	10	10.5	11.7
<b>11. Total expenditure (=item 7=23 in Table 2)</b>	<b>TE</b>	<b>43.6</b>	<b>46.3</b>

**Table 4: General government debt developments**

<i>% of GDP</i>	ESA Code	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>1. Gross debt<sup>1</sup></b>		59.4	49.3	46.8	45.4	44.2	44.2
<b>2. Change in gross debt ratio</b>		-5.3	-10.0	-2.6	-1.4	-1.2	0.0
<i>Contributions to changes in gross debt</i>							
<b>3. Primary balance<sup>2</sup></b>		6.5	3.9	1.5	0.8	0.2	-0.2
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	3.1	2.9	2.4	2.2	2.1	2.1
<b>5. Stock-flow adjustment</b>		2.6	-4.7	0.0	0.2	-0.2	-2.3
<i>of which:</i>							
- Differences between cash and accruals <sup>4</sup>		-0.3	0	0	0	0	0
- Net accumulation of financial assets <sup>5</sup>		2.8	-4.7	0.0	0.2	-0.2	-2.3
<i>of which:</i>							
- privatisation proceeds		-	0.3	-	-	-	-
- Valuation effects and other <sup>6</sup>		0.1	0	0	0	0	0
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		4.8	4.9	4.8	4.7	4.7	4.7
<i>Other relevant variables</i>							
<b>6. Liquid financial assets<sup>8</sup></b>		6.7	2.0	2.0	2.1	1.9	0.0
<b>7. Net financial debt (7=1-6)</b>		52.7	47.4	44.8	43.3	42.3	44.5

<sup>1</sup>As defined in Regulation 3605/93 (not an ESA concept).

<sup>2</sup>Cf. item 10 in Table 2.

<sup>3</sup>Cf. item 9 in Table 2.

<sup>4</sup>The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>5</sup>Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>6</sup>Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>7</sup>Proxied by interest expenditure divided by the debt level of the previous year.

<sup>8</sup>AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5: Cyclical developments**

<i>% of GDP</i>	ESA Code	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>1. Real GDP growth (%)</b>		4.4	3.8	2.1	2.4	3.0	3.2
<b>2. Net lending/borrowing of general government</b>	EDP B.9	3.4	1.0	-0.8	-1.4	-1.9	-2.2
<b>3. Interest expenditure</b>	EDP D.41	3.1	2.9	2.4	2.2	2.1	2.1
<b>4. One-off and other temporary measures<sup>1</sup></b>		1.5	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.7	3.7	3.7	3.7	3.7	3.7
contributions:							
- labour		0.7	0.7	0.7	0.7	0.7	0.7
- capital		1.6	1.6	1.6	1.6	1.6	1.6
- total factor productivity		1.4	1.4	1.4	1.4	1.4	1.4
6. Output gap		-0.8	-0.6	-2.0	-3.2	-3.8	-4.2
7. Cyclical budgetary component		-0.3	-0.2	-0.8	-1.4	-1.7	-1.9
8. Cyclically-adjusted balance (2 - 7)		3.8	1.2	0.1	0.0	-0.3	-0.4
9. Cyclically-adjusted primary balance (8 + 3)		6.8	4.1	2.4	2.2	1.9	1.7
10. Structural balance (8 - 4)		2.3	1.2	0.1	0.0	-0.3	-0.4

<sup>1</sup> A plus sign means deficit-reducing one-off measures.

**Table 6: Divergence from previous update**

	ESA Code	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Real GDP growth (%)</b>							
<b>Previous update</b>		4.2	4.1	4.0	4.0	4.0	n/a
<b>Current update</b>		4.4	3.8	2.1	2.4	3.0	3.2
<b>Difference</b>		0.2	-0.3	-1.9	-1.6	-1.0	
<b>General government net lending (% of GDP) EDP B.9</b>							
<b>Previous update</b>		1.5	0.5	0.5	0.7	0.7	n/a
<b>Current update</b>		3.4	1.0	-0.8	-1.4	-1.9	-2.2
<b>Difference</b>		1.9	0.5	-1.3	-2.1	-2.6	
<b>General government gross debt (% of GDP)</b>							
<b>Previous update</b>		60.0	48.5	45.3	43.8	40.5	n/a
<b>Current update</b>		59.4	49.3	46.8	45.4	44.2	44.2
<b>Difference</b>		-0.6	0.9	1.4	1.6	3.7	

**Table 7: Long-term sustainability of public finances (baseline scenario)**

<i>% of GDP</i>	<b>2007</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>	<b>2060</b>
Total expenditure	<b>42.9</b>	<b>44.8</b>	<b>46.5</b>	<b>49.7</b>	<b>54.8</b>	<b>61.3</b>
<i>Of which: age-related expenditures</i>	<b>17.0</b>	<b>19.2</b>	<b>20.9</b>	<b>22.9</b>	<b>25.0</b>	<b>27.0</b>
Pension expenditure	6.8	8.9	10.8	13.0	15.1	17.1
Social security pension (1)	4.7	6.8	8.7	10.4	12.7	14.7
Old-age and early pensions (A)	3.4	5.0	6.6	8.0	10.1	11.8
Other pensions (disability survivors) (B)	1.3	1.7	2.1	2.3	2.6	2.8
Occupational pensions (if in general government) (2)	2.1	2.1	2.1	2.6	2.4	2.4
Health care (3) <sup>1</sup>	2.7	3.9	3.1	3.2	3.4	3.6
Long-term care (4)( <i>this was earlier included in the health care</i> ) <sup>2</sup>	0.006	0.006	0.007	0.008	0.009	0.010
Education expenditure (5)	6.7	6.5	6.1	5.7	5.5	5.3
Other age-related expenditures (6)	0.8	0.9	0.9	1.0	1.0	1.0
Interest expenditure	3.1	2.1	2.1	3.4	6.3	10.8
Total revenue	<b>46.4</b>	<b>46.2</b>	<b>46.6</b>	<b>46.6</b>	<b>46.7</b>	<b>46.8</b>
<i>Of which: property income</i>	<i>0.7</i>	<i>0.4</i>	<i>0.4</i>	<i>-1.4</i>	<i>-4.4</i>	<i>-9.1</i>
<i>Of which: from pensions contributions (or social contributions if appropriate)</i>	<i>5.7</i>	<i>5.8</i>	<i>5.9</i>	<i>6.0</i>	<i>6.1</i>	<i>6.1</i>
Pension reserve fund assets	<b>36.8</b>	<b>30.9</b>	<b>9.9</b>	<b>-27.2</b>	<b>-88.0</b>	<b>-182.1</b>
<i>Of which: consolidated public pension fund assets (assets other than government liabilities)</i>	-	-	-	-	-	-
<b>Assumptions</b>						
Labour productivity growth	1.7	2.8	1.8	1.7	1.7	1.7
Real GDP growth	3.6	3.9	2.6	2.3	1.8	1.8
Participation rate males (aged 15-64)	81.2	84.1	83.3	82.8	82.8	82.7
Participation rates females (aged 15-64)	64.7	72.9	73.4	73.1	73	73.2
Total participation rates (aged 15-64)	72.9	78.5	78.4	78	78	78
Unemployment rate	4.4	3.4	3.4	3.4	3.4	3.4
Population aged 65+ over total population	12.5	15	17.9	20	23.2	26.2

<sup>1</sup> Ageing Working Group calculations

<sup>2</sup> Ageing Working Group calculations

<sup>3</sup> Education Expenditure

**Table 8: Basic assumptions**

	<b>Year 2007</b>	<b>Year 2008</b>	<b>Year 2009</b>	<b>Year 2010</b>	<b>Year 2011</b>	<b>Year 2012</b>
<b>Short-term interest rate (annual average)</b>	3.6	4.6	3.5	4.1	4.2	4.2
<b>Long-term interest rate (annual average)</b>	4.5	4.1	4	4.1	4.3	4.5
<b>USD/€ exchange rate (annual average)</b>	1.37	1.48	1.36	1.36	1.36	1.36
<b>Nominal effective exchange rate</b>	0.7	4.3	-2.5	0.0	0.0	0.0
<b>World excluding EU. GDP growth (in PPP terms)</b>	5.5	4.3	2.9	3.8	4.2	4.5
<b>EU GDP growth</b>	2.9	1.4	0.2	1.1	1.6	2.0
<b>Growth of relevant foreign markets</b>	6.9	5.7	3.0	4.3	4.8	5.0
<b>World import volumes. excluding EU</b>	7.2	6.0	3.1	4.7	5.3	5.7
<b>Oil prices (Brent. USD/barrel)</b>	72.44	96.9	50.0	53.0	55.0	55.0