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EUROPEAN COMMISSION

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Proposal for a

**COUNCIL DECISION**

**on the existence of an excessive deficit in Cyprus**

## EXPLANATORY MEMORANDUM

### **1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION**

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

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

### **2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE**

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

According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

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<sup>1</sup> OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 10 November 2009, available at [http://ec.europa.eu/economy\\_finance/sgp/legal\\_texts/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm).

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

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

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

### **3. THE EXISTENCE OF AN EXCESSIVE DEFICIT**

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

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

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

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

<sup>3</sup> All EDP-related documents for Cyprus can be found at the following website:  
[http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm).

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

The Commission, having taken into account its report under Article 126(3) and the opinion of the Economic and Financial Committee under Article 126(4), is of the opinion that an excessive deficit exists in Cyprus. This opinion, adopted by the Commission on [15 June 2010], is herewith addressed to the Council according to Article 126(5). The Commission proposes that the Council shall decide accordingly, in conformity with Article 126(6). In addition, the Commission is submitting to the Council a recommendation for a Council Recommendation to be addressed to Cyprus with a view to bringing the situation of an excessive deficit to an end according to Article 126(7).

#### **4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION**

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 126(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which “should be completed in the year following its identification unless there are special circumstances”. Article 2(6) of the Regulation implies that the “relevant factors” considered in the Commission report under Article 126(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a “minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation”.

Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Cyprus. In 2009, for the first time in 35 years, economic activity contracted, by 1¾%. The recession reflected the significant fall in domestic demand and an adverse external environment. In particular, high household indebtedness together with tighter lending conditions, a worsening labour market outlook and negative confidence effects led to a decline in private consumption. In parallel, investment recorded a strong correction, amidst a fall in foreign demand for housing, low capacity utilisation and the restructuring of corporate balance sheets. Moreover, export of goods and services, especially tourism, plummeted as a consequence of the financial crisis and the global slowdown, in particular the much lower growth prospects of the main trading partners (Euro Area, United Kingdom, Russia). The deficit in 2009 is a consequence of both the economic downturn and the stimulus measures taken in line with the EERP by the Cypriot authorities.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2012. Recognising that the deterioration of the Cypriot budgetary position in 2009 resulted from measures taken in response to the crisis, amounting to about 1½% of GDP annually in 2009 and in 2010, which was an appropriate response in line with the European Economic Recovery Plan, and the free play of automatic stabilisers, the Cypriot authorities should strengthen the fiscal strategy in 2010 with measures to control current expenditure. In particular, in view of the domestic and external economic imbalances, a credible and sustainable adjustment path would require the Cypriot authorities to ensure an average annual structural adjustment of 1¾ percentage points of GDP over the period 2010-2012. It would also require the Cypriot authorities to specify the

measures that are necessary to achieve the correction of the excessive deficit by 2012, to ensure a swift reduction of the gross debt ratio below the reference value and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. In this context, the timely implementation of a medium-term budgetary framework would be critical for a successful and lasting consolidation of the public finances. Furthermore, given that the long-term budgetary impact of ageing in Cyprus is significantly above the EU average, mainly as a result of a relatively high increase in pension expenditure, measures are needed to improve the long-term sustainability of public finances.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the forthcoming updates of Cyprus' stability programme could usefully be devoted to this issue.

### Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012	2013
Real GDP (% change)	COM spring 2010	5.1	3.6	-1.7	-0.4	1.3	n.a.	n.a.
	SP Apr 2010	5.1	3.6	-1.7	0.5	1.5	3.0	3.2
Output gap <sup>1</sup> (% of potential GDP)	COM spring 2010 <sup>2</sup>	2.4	3.4	-0.7	-2.1	-1.6	n.a.	n.a.
	SP Apr 2010 <sup>3</sup>	1.9	2.9	-1.3	-2.4	-2.5	-1.6	-0.5
General government balance (% of GDP)	COM spring 2010	3.4	0.9	-6.1	-7.1	-7.7	n.a.	n.a.
	SP Apr 2010	3.4	0.9	-6.1	-6.0	-4.5	-3.4	-2.5
Primary balance (% of GDP)	COM spring 2010	6.4	3.7	-3.6	-4.4	-4.8	n.a.	n.a.
	SP Apr 2010	6.4	3.7	-3.6	-3.7	-2.1	-1.0	0.1
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	COM spring 2010	2.5	-0.4	-5.8	-6.3	-7.1	n.a.	n.a.
	SP Apr 2010	2.6	-0.2	-5.6	-5.2	-3.6	-2.9	-2.3
Structural balance <sup>4</sup> (% of GDP)	COM spring 2010	2.5	-0.4	-5.8	-6.3	-7.1	n.a.	n.a.
	SP Apr 2010	2.6	-0.2	-5.6	-5.2	-3.6	-2.9	-2.3
Government gross debt (% of GDP)	COM spring 2010	58.3	48.4	56.2	62.3	67.6	n.a.	n.a.
	SP Apr 2010 <sup>5</sup>	58.3	48.4	56.2	61.0	63.2	63.1	62.3

**Notes:**

<sup>1</sup> Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>2</sup> Based on estimated potential growth of 2.0%, 2.8%, 2.8%, 2.8% and 2.8% respectively in the period 2009-2013.

<sup>3</sup> Based on estimated potential growth of 2.5%, 1.6%, 1.6%, 2.0% and 2.2% respectively in the period 2009-2013.

<sup>4</sup> Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% in years 2010, 2011 and 2012 (all deficit reducing) according to the most recent programme. There are no one-off and other temporary measures in the Commission services' spring 2010 forecast.

<sup>5</sup> For 2010, Cyprus notified a planned debt of 62% of GDP, thus exceeding 60% of GDP Treaty reference value. The April 2010 stability programme plans a slightly lower figure (61%) and foresees a further increase to 63.2% of GDP in 2011.

**Source:**

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

Proposal for a

## COUNCIL DECISION

### on the existence of an excessive deficit in Cyprus

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(6) thereof,

Having regard to the proposal from the European Commission,

Having regard to the observations made by Cyprus,

Whereas:

- (1) According to Article 126 of the Treaty on the Functioning of the European Union Member States shall avoid excessive government deficits.
- (2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.
- (3) The excessive deficit procedure (EDP) under Article 126 of the Treaty, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure<sup>4</sup> (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 479/2009<sup>5</sup> lays down detailed rules and definitions for the application of the provision of the said Protocol.
- (4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.
- (5) Article 126(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 126(3)

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<sup>4</sup> OJ L 209, 2.8.1997, p. 6.

<sup>5</sup> OJ L 145, 10.6.2009, p. 1.

and having regard to the opinion of the Economic and Financial Committee in accordance with Article 126(4), the Commission concluded that an excessive deficit exists in Cyprus. The Commission therefore addressed such an opinion to the Council in respect of Cyprus on 15 June 2010<sup>6</sup>.

- (6) Article 126(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Cyprus, this overall assessment leads to the following conclusions.
- (7) According to data notified by the Cypriot authorities in April 2010, the general government deficit in Cyprus reached 6.1% of GDP in 2009, thus exceeding the 3% of GDP reference value. The deficit was not close to the 3% of GDP reference value, but the excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' 2010 spring forecast, real GDP in Cyprus is projected to shrink further, although to a lesser extent, by almost ½% in 2010 compared with 1¾% in 2009. However, the planned excess over the reference value cannot be considered temporary. According to the Commission services' spring 2010 forecast, the budgetary deficit would reach about 7¾% of GDP in 2011 on a no-policy change basis. The deficit criterion in the Treaty is not fulfilled.
- (8) According to data notified by the Cypriot authorities in April 2010, the general government gross debt remains below the 60% of GDP reference value and stood at 56.2% of GDP in 2009. For 2010, Cyprus notified a planned debt of 62% of GDP, thus exceeding 60% of GDP Treaty reference value. The Commission services' spring 2010 forecast projects debt to rise further to 62.3% of GDP in 2010 and 67.6% in 2011 on the back of a deteriorated primary balance. In view of these trends, the debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.
- (9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 126(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Cyprus, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

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<sup>6</sup> All EDP-related documents for Cyprus can be found at the following website:  
[http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm).



HAS ADOPTED THIS DECISION:

*Article 1*

From an overall assessment it follows that an excessive deficit exists in Cyprus.

*Article 2*

This decision is addressed to the Republic of Cyprus.

Done at Brussels,

*For the Council  
The President*