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(prepared in accordance with Article 122(2) of the Treaty at the request of CYPRUS)

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European Economy

Convergence Report 2007 on Cyprus – Technical Annex

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Aknowledgements

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Abbreviations and symbols used

Member States

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland

PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EUR13	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, SI, FI)
EU15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU25	European Union, 25 Member States before 1 January 2007
EU27	European Union, 27 Member States

Currencies

EUR	euro
ECU	European currency unit
USD	US dollar
CYP	Cyprus pound

Other abbreviations

CBC	Central Bank of Cyprus
COLA	Cost of Living Allowance
CPI	Consumer price index
CR5	Concentration ratio (defined as the aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ICT	information and communications technology
MTO	medium-term objective
NGCAs	non-government controlled areas
PPS	Purchasing Power Standard
SFAs	stock flow adjustments
SGP	Stability and Growth Pact
ULC	unit labour costs
VAT	value added tax

1. INTRODUCTION

1.1. Role of the report

The euro was introduced on 1 January 1999 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision¹ by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency (from the beginning) had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission² and the European Monetary Institute (EMI), respectively.³ These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare Convergence Reports on such Member States.

Box 1: Article 122(2) of the Treaty

"At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned."

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty⁴ and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision⁵ that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two Convergence Reports made by the Commission⁶ and the ECB⁷, which covered both Greece and Sweden. Greece adopted the single currency with effect from

¹ OJ L 139, 11.5.1998, pp. 30-35.

² Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

³ European Monetary Institute, Convergence Report, March 1998.

⁴ Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

⁵ OJ L 167, 7.7.2000, pp. 19-21.

⁶ European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

⁷ European Central Bank, Convergence Report 2000, May 2000.

1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation".⁸

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.⁹

In 2006, two convergence assessments have been carried out. In May, the Commission and the ECB presented reports on Lithuania and Slovenia, prepared at the request of the national authorities.¹⁰ While Slovenia was deemed to fulfil all the convergence criteria and to be ready to adopt the euro in January 2007, the report on Lithuania suggested that there should be no change in the status of Lithuania as a Member State with the derogation. The remaining nine Member States with a derogation were assessed in regular Convergence Reports issued in December 2006.¹¹ None of the countries assessed was deemed to

meet the necessary conditions for adopting the single currency.

On 13 February 2007, Cyprus submitted a request for a convergence assessment. As a response to this request, the Commission and the ECB prepared Convergence Reports for Cyprus. This report examines only the areas in which the Government of the Republic of Cyprus exercises effective control, as defined in Protocol No 10, annexed to the 2003 Act of Accession, as has been done in all other relevant procedures (e.g. EDP, Lisbon, participation in ERM II).

This Commission services working paper is a technical annex to the Convergence Report 2007 on Cyprus and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in the convergence report and in this technical annex is 26 April 2007.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors (Box 2). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

⁸ European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence report 2002, May 2002.

⁹ European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

¹⁰ European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report, May 2006, May 2006. On the basis of the reports, the Ecofin Council adopted on 11 July 2006 the Decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp 25-27).

¹¹ European Commission, Convergence Report, December 2006, COM(2006) 762 final, 6 December 2006; and European Central Bank, Convergence Report, December 2006, December 2006.

Box 2: Article 121(1) of the Treaty

"1. The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;*
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);*
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;*
- the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long term interest rate levels.*

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a national central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central

bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: *"the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability"*.

Article 1 of the Protocol on the convergence criteria further stipulates that *"the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-*

performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation¹² setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005¹³ provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points (Box 3).

Over the 12 month period covering April 2006-March 2007, the three best-performing Member States in terms of price stability were Finland, (1.3%), Poland (1.5%) and Sweden (1.6%) yielding a reference value of 3.0%.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this technical annex examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation. From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead.¹⁴

¹² Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4).

¹³ Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

¹⁴ According to the Commission Spring 2007 Forecast, the reference value is forecast to stand at 2.8% in December 2007. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

Box 3: Assessment of price stability and the reference value

The numerical part of the price stability criterion implies a comparison between a Member State's average price performance and a reference value.

A Member State's **average rate of inflation** is measured by the percentage change in the unweighted average of the last 12 monthly indices relative to the unweighted average of the 12 monthly indices of the previous period, rounded to one decimal.

This measure captures inflation trends over a period of one year as requested by the provisions of the Treaty. Using the commonly used inflation rate – calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year – would not meet the one year requirement. The latter measure may also vary importantly from month to month because of exceptional factors.

The **reference value** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers.

The reference value has been defined in the Maastricht Treaty in a relative way. An absolute reference value could, depending on the overall economic circumstances at the time of the assessment, be considered to be unduly harsh or too loose. Alternatively, using the average of the inflation rates of all Member States as a basis for the reference value would imply that high inflation rates of a few countries could increase the average to undesired levels. These problems are avoided in the Treaty by requiring convergence towards the best performing Member States within a margin of 1.5 percentage points. As the reference value is a relative concept based on the Member States with the lowest rate of inflation, a margin of 1.5 percentage points is added.

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004 and EU-25 for the reports as of 2004.

As a principle, and in line with what was intended by the authors of the Maastricht Treaty, the Commission and ECB reports select as best performers in terms of price stability those Member States which have the lowest average rate of inflation. In the 2004 report, the Commission decided to exclude countries in deflation from the calculation of the reference value because these countries could not be considered to be 'best performers' in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation.

Table 1 lists the reference value as used in the Convergence Reports issued since 1998.

Table 1.

Inflation reference value in previous and current Convergence Reports ¹⁾

Convergence Report adoption date	Cut-off month	Three best performers ²⁾	Reference value	Euro area average inflation rate ²⁾
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 from January 2007 onwards.

2) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

Source: Commission services.

Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as “*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*”.

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact. The existence of an excessive deficit is determined in

relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (for further information on this procedure, see Box 4).¹⁵

¹⁵ The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

Box 4: The excessive deficit procedure¹⁶

The excessive deficit procedure (EDP) is specified in Article 104 of the Treaty, the associated Protocol on the EDP and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP¹⁷, which is the “dissuasive arm” of the Stability and Growth Pact (SGP). Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position, and the steps to be followed to correct a situation of excessive deficit. According to Article 104(2), compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

- “(a) *whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [specified in the Protocol as 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;*
- (b) *whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60%], unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace”.*

According to the Protocol, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October¹⁸. After each reporting date, Eurostat examines whether the data are in conformity with ESA95¹⁹ rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors (considerations related to the medium-term economic and budgetary position of the Member State). These factors should be considered in the steps of the EDP leading to the decision on the existence of an excessive deficit only under the double condition that the deficit is close to the reference value and its excess over it is temporary. Special provisions are foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar (for further details, see Box 1.5 of the December 2006 Convergence Report).

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission then addresses an opinion to the Council (Article 104(5)). On the basis of a Commission recommendation, the Council decides, after an overall assessment, whether an excessive deficit exists (Article 104(6)). Any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

When it decides that an excessive deficit exists, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are

¹⁶ Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/edp_en.htm.

¹⁷ OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

¹⁸ Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

¹⁹ European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve 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.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, on the basis of a Commission recommendation (Article 104(12)).

Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as *“the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”*.

Article 3 of the Protocol on the convergence criteria stipulates: *“The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period”*. Based on the Council Resolution on the establishment of the ERM II²⁰, the European Monetary System has been replaced by the Exchange-Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The

relevant period for assessing exchange rate stability in this technical annex is 27 April 2005 to 26 April 2007.

Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires *“the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels”*. Article 4 of the Protocol on the convergence criteria further stipulates that *“the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”*.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March

²⁰ 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

2007, the reference value, derived from the average interest rate in Finland (3.9%), Poland (5.3%) and Sweden (3.8%), was 6.4%.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards the *integration of financial markets*, the focus is on compliance with the *acquis communautaire* in respect of the financial sector, on main characteristics, structures and trends of the financial sector and on progress in financial integration. *Integration of product markets* is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, the situation and development of *the current account of the balance of payments* is examined to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances.

2. LEGAL COMPATIBILITY

2.1. Legal situation

The Central Bank of Cyprus (CBC) was established by the Central Bank of Cyprus Law in 1963, shortly after the island gained its independence in August 1960. The law was replaced by the Central Bank of Cyprus Law of 2002 (138(I) 2002), as amended by the CBC (amending) Law of 31 October 2003. A Law amending the Central Bank of Cyprus Laws of 2002 and 2003 was adopted by Parliament on 15 March 2007. The law entered into force on the same day, while certain provisions will take effect on the date of the introduction of the euro in Cyprus.

The CBC is a corporate entity with its capital fully paid up by the government. As from the date of the introduction of the euro in Cyprus, the decision-making bodies of the CBC will be the Board of Directors, the Governor and the Deputy Governor. The governor shall seat, *ex officio*, as an independent personality, in the General Council and the Governing Council of the ECB and shall have the exclusive competence to carry out the tasks and exercise the powers conferred upon the Bank by or in accordance with the provisions of the ESCB Statute.

Objectives

The primary objective of the CBC is to ensure price stability. The secondary objective of the CBC (Article 5) refers to the general economic policy of the State. It moreover makes reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

According to Article 108 of the Treaty neither a national central bank nor any member of its decision-making bodies shall, when exercising the powers and carrying out the tasks and duties conferred upon them by the EC Treaty and the ESCB Statute, seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Inversely, the Community institutions and

bodies and the governments of the Member States have to respect this principle and may not seek to influence the members of the decision-making bodies of the national central banks in the performance of their tasks. The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.²¹ In particular concerning personal independence, the ESCB Statute contains specific provisions, for example, on the term of office of the governor of a national central bank and the grounds for his dismissal (Article 14.2 ESCB Statute).

The 2006 Convergence Report concluded that the CBC Law was compatible with the Treaty as regards independence. The amendment to Article 13(3) enacted since then has further strengthened the personal independence of the members of the CBC's Board other than the Governor and the Deputy Governor: in case of an unexpected vacancy a new Board member shall systematically be appointed for a term of office of 5 years, as opposed to the remainder of the term of office of the outgoing Board member.

Integration in the ESCB

The incompatibilities raised in the 2006 Convergence Report have been removed. The Law on the amendments to the Central Bank of Cyprus Laws of 2002 and 2003 notably repeals Articles 10, 27(2), 37, 40, and 44. Moreover, a series of articles have been amended so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and the EC Council. This concerns in particular Article 6(2)a on monetary policy, Article 6(2)b on the conduct of foreign exchange operations, Articles 29, 30 and 31(2) on the issue of banknotes and the volume of coins, Articles 27 and 28 on the definition of the monetary unit, as well as Articles 39(2), 41, 42, 46(2) and (3) and 65 on the monetary functions, operations and instruments of the ESCB.

²¹ See European Commission, Convergence Report 2004, p. 10-11.

Prohibition of monetary financing

In line with the prohibition of monetary financing (Article 101(1) of the Treaty), overdraft facilities or any type of credit facility with the CBC in favour of Community institutions or bodies, the government, regional, local or other public authorities, public corporations or public undertakings are prohibited. Moreover, the CBC may not directly purchase debt instruments of such entities (Article 49(1)).

Pursuant to Article 46(3) the CBC may grant advances against collateral to commercial banks. A specific safeguard clause has been inserted in this Article as regards the role of the CBC as lender of last resort, so as to strengthen compliance with Article 101 of the Treaty and to avoid that the CBC might eventually end up bearing financial costs which are in principle to be borne by the state.

2.2 Assessment of compatibility

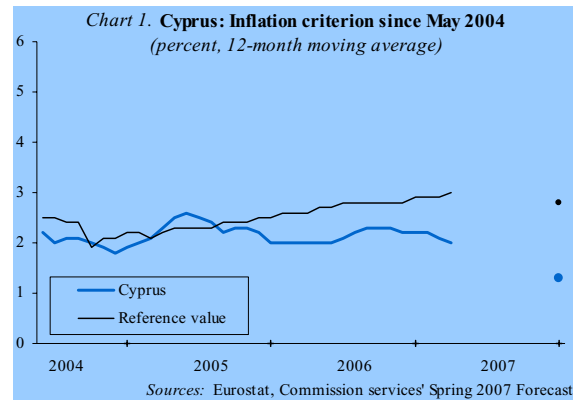
Legislation in Cyprus is compatible with the requirements of the EC Treaty and the ESCB Statute.

3. PRICE STABILITY

3.1. Respect of the reference value

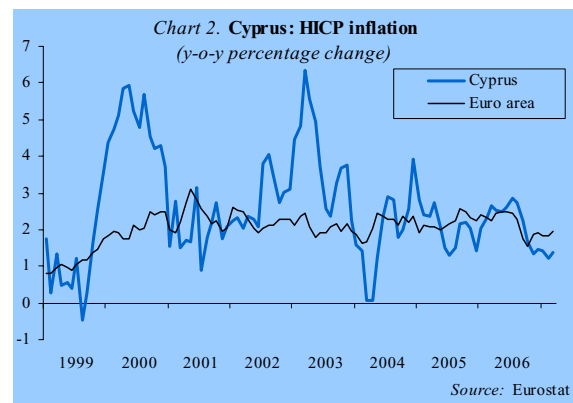
The 12-month average inflation rate, which is used for the convergence assessment, hovered around the reference value from spring 2004 to late 2005. From December 2005 onwards, average annual inflation has been below the reference value by half a percentage point or more. In March 2007, the reference value was 3.0%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Finland, Poland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Cyprus was 2.0%, 1 percentage point below the reference value.

increases for food and by a drop in the prices for telecommunications and pharmaceutical products.



3.2. Recent inflation developments

Cyprus has traditionally enjoyed relatively low, albeit at times volatile, inflation, reflecting the high sensitivity of the small and open economy to external price shocks and exchange rate fluctuations. Between January 1997 and March 2007, year-on-year HICP inflation²² averaged 2.6%, despite the two peaks of around 6% recorded in the spring of 2000 and again in the winter of 2003, in the first case largely owing to higher energy and food prices and in the latter case primarily due to accession-related increases in VAT rates and excises.



Inflation fell in the course of 2005, from a peak of 3.9% in December 2004 to a low of 1.4% in December 2005, prompted notably by lower price

External factors, such as low import prices of specific goods, notably clothing and footwear, further contributed to subdued consumer price inflation.

From January 2006 onwards, headline inflation picked up again and peaked at 2.8% in July 2006, buoyed by higher energy prices. In the following months inflation declined, to 1.4% in March 2007, largely mirroring the fall in oil prices. Inflation developments in 2006 and early 2007 were also characterized by a marked upturn in food prices due to weather conditions. Reductions in the prices of imported clothing and footwear continued to exert downward pressure on inflation.

²² In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Cyprus against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat concluded that, in general, the methods used for producing the Cypriot HICP are of good standard. The methodological basis for compiling the Cypriot HICP conforms to HICP requirements and should be considered comparable to the HICPs of other EU countries. The compliance report published in November 2006 is available at http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP_DS_HICP.

Table 2.

Cyprus: Components of inflation¹⁾
(percentage change)

	2001	2002	2003	2004	2005	2006	Mar-07	weights in total 2007
HICP	2.0	2.8	4.0	1.9	2.0	2.2	2.0	1000
Non-energy industrial goods	-1.3	-0.9	-0.7	-3.0	-1.1	-1.8	-1.8	296
Energy	1.9	6.9	12.3	11.3	12.9	8.9	4.4	114
Unprocessed food	5.7	4.2	4.5	2.8	2.7	8.0	9.0	85
Processed food	3.0	7.5	9.1	5.7	1.6	2.8	2.7	128
Services	4.0	2.9	4.5	2.5	2.1	1.9	2.3	377
HICP excl. energy and unproc. food	1.6	2.1	3.1	0.8	0.8	0.8	0.9	801

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

As regards the evolution of the price of services in 2006, relatively high increases were notably recorded in transport, education and health, with the latter two categories continuing to show high increases in early 2007. In addition, the fall observed over the previous five years in the price of telecommunications services, due to intensified competition, moderated in the course of 2006. By contrast, falling prices for accommodation services, as a result of increased competition and an ongoing shift in the tourism sector towards more permanent tourists who purchase holiday houses in Cyprus, exerted a significant downward effect on inflation. Due to the importance of tourism, accommodation services have a relatively high expenditure share in private consumption on the domestic territory.

3.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Real GDP growth was quite strong in the period 2004-2006, with annual growth at slightly below 4% on average. Although for Cyprus estimates of potential growth have to be treated with caution, economic growth is expected to remain around potential in the coming years. Exchange rate stability and a credible monetary policy have contributed to keep inflation at relatively low levels, in a context of tightening labour market conditions. The increased supply of foreign workers has helped to address labour shortages in a number of key sectors and to curb wage growth. The unemployment rate fell to 4.8% in 2006 and is expected to further decline to about 4½% in the coming years.

Cyprus has shown a mixed record on fiscal consolidation in the past years. In 2002 and 2003

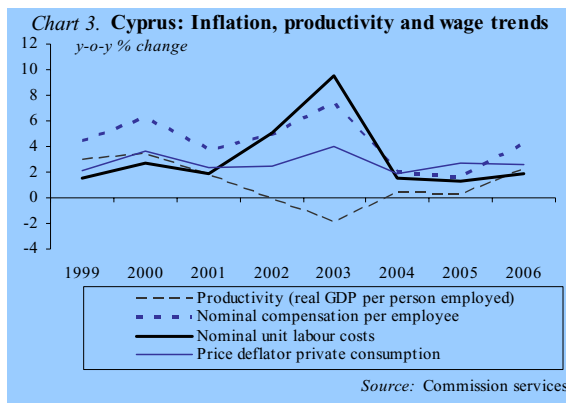
fiscal policy was expansionary and deficit outturns were well above the official targets. However, since 2004, the fiscal stance has been tightened substantially, leading to a strong reduction of the government deficit. Following sharp decreases in 2005 and 2006, the cyclically-adjusted primary balance is expected to remain unchanged in 2007, which corresponds to a broadly neutral fiscal stance.

Wages and labour costs

Cyprus registered relatively moderate wage increases in the late 1990s, and this trend mostly continued in subsequent years, with the notable exception of 2002-2003. In these two years, unit labour costs surged in response to a strong pick-up in wage growth and weak labour productivity, putting upward pressure on consumer prices.

Cyprus has a backward-looking system of wage setting based on a Cost of Living Allowance (COLA). The system has not fundamentally changed in the past decade. Under COLA, wages are adjusted twice a year to inflation in the preceding six months. Although the system is a potentially complicating factor in the wage setting process, wage pressures in recent years, including those due to tax harmonisation in the run-up to EU membership, were mitigated by a relatively flexible labour market, an increasing share of foreign workers in the labour force and the exclusion of excise duties from the calculation of the cost of living index.²³

²³ Indirect taxes such as VAT are however included in the cost of living index.



During the last five years, wage setting in the public sector has acted as a guide for private sector wage negotiations. In 2004 and 2005, the government reached an agreement with public sector unions not to give any contractual salary increases, as an important element of the fiscal consolidation strategy. The example of the government was followed by the banking sector and had a moderating impact on wage settlements in the private sector at large. Moderate overall wage gains contributed to a sharp deceleration in unit labour costs from 9.5% in 2003 to about 1½% on average in 2004 and 2005, helped by a progressive cyclical pick-up in labour productivity growth. For 2006 and 2007, contractual wage increases in the public sector have been agreed, amounting to 2 and 1% respectively. In line with the increase in contractual wages in the public sector, nominal compensation per employee in the whole economy

seems to have picked-up in 2006, leading to an increase of almost 2% in nominal unit labour costs, despite a strong acceleration of labour productivity.

Import prices

As a small and very open economy, inflation in Cyprus has been substantially affected by changes in import prices, in particular energy. Since 2002, Cyprus has been confronted with swings both in energy inflation and its contribution to the HICP that were larger than in most Member States, although the uptrend in the nominal effective exchange rate in 2001 to 2005 helped to dampen the impact. Energy prices strongly increased between mid-2002 and mid-2003 reflecting the rises of crude oil price.

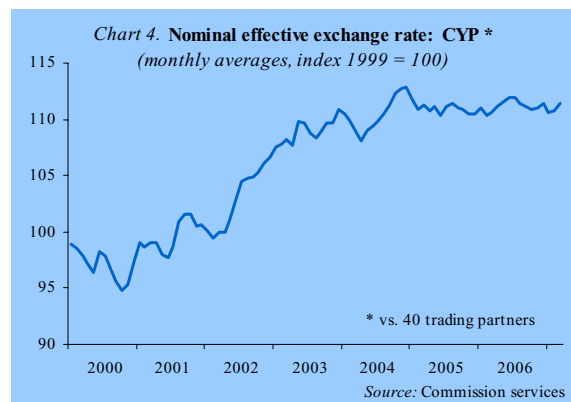


Table 3.

**Cyprus: Other inflation and cost indicators
(annual percentage change)**

	2001	2002	2003	2004	2005	2006 ¹⁾	2007 ²⁾
Private consumption deflator							
Cyprus	2.4	2.4	4.0	1.9	2.7	2.6	1.9
Euro area	2.3	1.8	2.1	2.0	2.0	2.0	1.8
Nominal compensation per employee							
Cyprus	3.7	4.9	7.4	2.0	1.6	4.2	3.5
Euro area	2.7	2.7	2.8	2.5	1.9	2.2	2.6
Labour productivity							
Cyprus	1.8	-0.1	-1.9	0.4	0.3	2.3	2.3
Euro area	0.5	0.4	0.8	1.6	0.9	1.4	1.4
Nominal unit labour costs							
Cyprus	1.9	5.1	9.5	1.6	1.3	1.9	1.2
Euro area	2.2	2.4	2.0	0.9	1.0	0.9	1.2
Imports of goods deflator							
Cyprus	0.2	0.3	-0.9	4.0	6.4	3.8	1.2
Euro area	0.2	-2.9	-2.2	1.5	4.0	4.7	0.7

1) Nominal compensation per employee, labour productivity and nominal unit labour costs are estimates.

2) Commission services' Spring 2007 Forecast.

Source: Commission services.

A temporary easing of energy price increases was then followed by a further uptrend in 2004 and 2005, in response to the pick-up in crude oil prices. The contribution of energy to headline HICP inflation peaked in January 2006 at 2 percentage points and gradually eased thereafter. It dropped to close to zero by September and has thereafter been slightly negative.

The prices for imported unprocessed food have been largely affected by weather conditions, with a net upward impact in the course of 2006 and early 2007. By contrast, changes in import prices for manufactured goods have exerted downward pressure on inflation in the last three years, notably due to decreases in the prices of clothes, footwear and motor vehicles.

Administered prices and taxes

Price regulations apply mainly to government services, public transport, and energy prices. The weight of administered prices in the Cypriot HICP is relatively low compared to other new Member States. Nevertheless, a rise in gas and electricity prices had an upward impact on HICP inflation estimated at around 0.3 percentage point in 2005 and around 0.4

percentage point in 2006. In addition, increases in VAT rates in the run-up to EU accession, required to bring them in line with the *acquis*, had a large upward impact on consumer prices, estimated at about 0.7 percentage point in 2002 and 1.7 percentage points in 2003. However, in these two episodes, consumer prices did not increase by the full amount of VAT increases and the impact on inflation was only temporary, with year-on-year inflation reverting to its long-term trend after about a year.

By contrast, substantial decreases in excises on cars lowered headline inflation by an average 0.7% between 2002 and 2004. The further decrease in excises on cars enacted in October 2006 is estimated to have an annual downward impact of about 0.4 percentage point. Multiple increases in minimum excises duties on diesel and unleaded petrol between 2002 and 2004 have only had a minor impact on inflation, as are likely to have the additional increases scheduled for 2008 and 2010.

Medium-term prospects

Consumer prices in Cyprus have already converged relatively closely to the EU average, broadly in line with Cyprus' relatively high income level (Cyprus'

GDP per capita (PPS) was 83% of the EU25 average in 2005). Due to the substantial impact of energy inflation on HICP, the inflation performance in the medium term will to a large extent depend on the development of energy prices.

Broad money and credit growth have gathered pace, partly in response to relatively strong capital inflows. Further interest rate convergence to the euro area and further reduction in reserve requirements from the current ratio of 5% to the euro area reserve requirement of 2% will provide a monetary stimulus, which, in a context of strong growth, could feed into inflation.

Changes in administered prices are not expected to add substantially to inflation, but further increases in VAT rates that are related to fulfilling EU requirements are expected to have a notable upward effect on inflation. With a view to completing tax harmonisation, Cyprus must abolish zero and reduced VAT rates for foodstuffs, pharmaceuticals and restaurants, as current derogations expire at the end of 2007. The resulting total cumulated increase in HICP inflation is estimated at around one percentage point. By the time of the adoption of this report, the authorities have not yet adopted any legislative measures to harmonize VAT rates. While the impact of VAT increases would be expected to be temporary, there is some risk of second-round effects, particularly through their inclusion in the cost of living index and in the context of strong cyclical conditions.

According to the Commission Spring 2007 Forecasts, overall HICP inflation is expected to moderate to 1.3% in 2007, due to favourable oil price base effect and the reduction on excises on cars. It is expected to increase to 2.0% in 2008. These forecasts however do not include the effects of VAT adjustments, as their precise timing and implementation modalities are not yet known.

Maintaining sustainable low inflation in the medium term depends on the success of efforts to contain a potentially inflationary impact of further interest rate and reserve requirements convergence, to mitigate credit growth and to avoid second-round effects from increases in indirect taxes. A prudent fiscal stance, in particular aiming at avoiding the build-up of excessive demand pressures, and wage developments in line with productivity gains would be required.

4. GOVERNMENT BUDGETARY POSITION

4.1. The excessive deficit procedure for Cyprus²⁴

In July 2004, the Council decided that Cyprus was in excessive deficit, based on a deficit of 6.3% of GDP in 2003 and a rising debt ratio, which stood at 72.2% of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Cyprus was recommended to bring the deficit below 3% of GDP by 2005 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. The Council endorsed the intermediate targets for the general government deficit of 5.2% of GDP in 2004 and 2.9% in 2005. Cyprus was also recommended to bring the rise in the debt ratio to a halt in 2004.

In July 2006 the Council found that the excessive deficit had been corrected and decided to abrogate its July 2004 Decision on the existence of an excessive government deficit in Cyprus.

4.2. Developments until 2006

The general government deficit in 2000 was 2.3% of GDP. It peaked at 6.3% of GDP in 2003 before subsiding back to 2.3% by 2005. This was the result of the implementation of a strong fiscal adjustment in 2004 and 2005. For 2006, the December 2006 update of the Convergence Programme estimated the government deficit at just below 2% of GDP. However, according the EDP notification of April 2007, the final outcome for the government deficit in 2006 is estimated at 1.5% of GDP. This is 0.4 percentage points of GDP lower than initially projected, in particular on the back of higher-than-expected tax revenues, which largely reflect the buoyant performance of the construction and real

estate sector as well as efficiency improvements in the Land and Survey Department.

With interest expenditure broadly stable at 3.3% of GDP, the primary balance was in a range between 1% of GDP in 2000 and around -3% in 2003, before turning positive again in 2005 (to around 1% of GDP). Between 2000 and 2006, total revenues increased by 7.7 percentage points of GDP, mainly due to a mix of structural (alignment of VAT tax rates with the *acquis* in May 2004 and measures to discourage tax evasion) and one-off measures (exceptional dividend on past profits of the semi-governmental organisations and a tax amnesty). In parallel, total expenditures increased by 6.9 percentage points of GDP between 2000 and 2006. Current primary expenditures increased by 6.0 percentage points of GDP, mainly due to increases of wages and salaries and social transfers. From 2005 onwards, the implementation of a ceiling on the nominal growth rates of current primary expenditures (containment of current transfers and subsidies in line with inflation and an increase in the retirement age of public sector employees) and capital expenditure helped curbing expenditure growth.

The cyclically-adjusted deficit increased from 3% of GDP in 2000 to just above 6% in 2003 but declined to 1.9% of GDP in 2005. One-off and other temporary measures amounted to 1.8% of GDP in 2003 and to about 1% both in 2004 and 2005. The structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) rose from 3% of GDP in 2000 to around 8% of GDP in 2003, but declined to 2.8% of GDP in 2005, a reduction of some 5 percentage points. For 2006, the structural deficit is estimated to have declined further to around 1.2% of GDP.

During 2004-2006, fiscal consolidation gained momentum, taking advantage of the relatively strong economic growth (3.9% per year on average, although the output gap remained negative). The high tax content of growth, which has been almost fully based

²⁴ All documents related to the excessive deficit procedure for Cyprus can be found at:
http://ec.europa.eu/economy_finance/about/activities/sfp/procedures_en.htm.

on domestic consumption and accompanied by sustained employment growth and a buoyant construction and real estate sector, has been helpful in this respect.

General government debt followed an upward trend until 2004, rising to 70.3% of GDP (from 58.8% of GDP in 2000). In 2005, the debt ratio fell to 69.2% of GDP and a further decrease to 65.3% of GDP was recorded in 2006. Cyprus' stock-flow adjustments (SFAs), of a debt-increasing nature, have been among the highest in the EU and the highest among the EU-10 Member States, averaging about 2.5% of GDP during 2000-2004. These SFAs were mainly associated with the accumulation of financial assets by the government in the form of deposits in sinking funds with the Central Bank.²⁵ Deposits in sinking funds, which have been used for the repayment of long-term loans, according to the most recent update of the convergence programme amounted to some 7% of GDP by the end of 2005. As of 2003, the policy of sinking funds was abolished²⁶ and their decumulation, which is planned to be completed by 2009, is projected to contribute by about 6 percentage points to a reduction in the gross debt-to-GDP ratio.

4.3. Medium-term prospects

The Budget for 2007 was approved by the Parliament on 21 December 2006. It targeted a general government deficit of 1.6% of GDP. The Commission services project an almost unchanged deficit (1.4% of GDP), despite the lower-than-anticipated outturn for the 2006 deficit, to account for the announcement of a package of social transfers amounting to almost ¼% of GDP. Compared to 2006, total revenues would increase by some ¼ percentage points of GDP, on the back of tax-rich buoyant GDP growth but without

resorting to one-offs. The main measures are improved tax administration and collection by the Land and Survey Department, which, coupled with the buoyant activity of the construction sector, would increase the amount of collected taxes. Total expenditures would remain unchanged as a percentage of GDP, as savings from lower interest expenditure and from the implementation of ceilings on nominal growth of government final consumption are offset by an increase in social transfers. The main measures include the maintenance of a ceiling on the rate of growth of both current and capital expenditure, the continuation of the restrictive recruitment and wage policy in the general government sector, the limitation of the rate of growth of current transfers (pensions, monetary allowances and other benefits) to the rate of inflation, a more targeted social policy, and the reduction of net interest payments by running down the stock of debt using the sinking fund deposits.

Net of one-offs, the fiscal adjustment in 2007 would be marginal, which corresponds to a broadly neutral fiscal stance. This would reflect the deterioration of Cyprus' net position vis-à-vis the EU budget induced by the termination in 2006 of the provision of temporary compensating grants through the EU budget for the period 2004-2006. These temporary grants, associated with Cyprus' accession to the EU, are only partially compensated in the 2007 budget.

The December 2006 update of the Convergence Programme covers the period 2006 to 2010.²⁷ After the correction of the excessive deficit in 2005 and the abrogation of the excessive deficit procedure in July 2006, the programme aims at further consolidating public finances. The general government balance is projected to improve from a deficit of 1.9% of GDP in 2006 to a balanced position in 2010 entirely due to expenditure retrenchment. The revenue ratio is expected to remain constant over the programme period, without any reliance on one-offs. The medium-term objective (MTO) for the budgetary position is a deficit of 0.5% of GDP in structural terms, which the Convergence Programme aims to achieve by 2008.

According to the Commission services' Spring 2007 Forecast, the debt ratio would continue to decline in 2007, reaching 61.5% of GDP. The December 2006

²⁵ According to the provisions of the Development Loans Law the Cypriot Government was obliged to contribute annually, for every government stock issued, to a so-called 'sinking fund' held in the national central bank. The purpose of these contributions was to accumulate by the maturity of every stock issued the amount that was to be repaid. The contributions to the sinking funds were financed by borrowing, thus leading to an increase of gross government debt. Repayments of debt using the sinking funds contribute to the reduction of gross government debt.

²⁶ The relevant Law was amended in July 2003 removing the obligation of the Government to contribute annually to sinking funds. Nonetheless, annual contributions continued to be made for government stocks issued prior to 2003.

²⁷ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

Convergence Programme envisages the debt ratio to decline more rapidly to 60.5% of GDP in 2007 and plummet further thereafter, to just above 46% of GDP by the end of the programme period.

The Council, in its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme of Cyprus, considered that after the correction of the excessive deficit in 2005, Cyprus was making good progress towards the MTO over the programme period, owing to expenditure restraint and in a context of strong growth prospects. The Council

noted that, given that risks to the budgetary projections in the programme seemed broadly balanced, the budgetary strategy in the programme seemed sufficient to ensure that the MTO is achieved by 2008. The Council invited Cyprus to control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances and to implement the fiscal consolidation path as foreseen in the programme.

Table 4.

**Cyprus: Budgetary developments and projections
(as percentage of GDP unless otherwise indicated)**

Outturn and forecast ⁽¹⁾	2000	2001	2002	2003	2004	2005	2006	2007			
General government balance	-2.3	-2.2	-4.4	-6.3	-4.1	-2.3	-1.5	-1.4			
- Total revenues	34.7	35.9	35.9	38.8	38.8	41.2	42.4	42.6			
- Total expenditure	37.0	38.2	40.3	45.1	42.9	43.6	43.9	44.0			
Of which: - Interest expenditure	3.4	3.4	3.2	3.4	3.3	3.4	3.3	3.1			
- Current primary expenditure	28.6	30.0	31.9	35.9	33.6	34.7	34.6	34.9			
- Gross fixed capital formation	2.9	2.9	3.0	3.4	4.0	3.1	3.3	3.3			
Primary balance	1.0	1.1	-1.2	-2.9	-0.8	1.1	1.7	1.7			
p.m. Tax burden	30.0	30.9	31.2	33.1	33.5	35.6	37.0	37.6			
Cyclically-adjusted balance	-3.0	-3.3	-5.0	-6.1	-3.8	-1.9	-1.2	-1.1			
One-off and temporary measures	0.0	0.0	0.0	1.8	1.1	0.9	0.0	0.0			
Structural balance ⁽²⁾	-3.0	-3.3	-5.0	-7.9	-4.8	-2.8	-1.2	-1.1			
Structural primary balance	0.3	0.1	-1.8	-4.5	-1.6	0.7	2.1	2.1			
Government gross debt	58.8	60.7	64.7	69.1	70.3	69.2	65.3	61.5			
p.m. Real GDP (% change)	5.0	4.0	2.0	1.8	4.2	3.9	3.8	3.8			
p.m. Output gap	2.1	2.9	1.4	-0.5	-0.7	-1.2	-1.0	-0.8			
p.m. GDP deflator (% change)	3.8	3.4	1.2	5.1	3.3	2.4	2.5	2.3			
Convergence programme						2005	2006	2007	2008	2009	2010
General government balance						-2.3	-1.9	-1.6	-0.7	-0.4	-0.1
Primary balance						1.1	1.4	1.4	2.1	2.1	2.2
Structural balance ^{(2) (3)}						-3.3	-1.9	-1.2	-0.3	0	0.3
Government gross debt						69.2	64.7	60.5	52.5	49	46.1
p.m. Real GDP (% change)						3.9	3.7	3.9	4.1	4.1	4.1

⁽¹⁾ Commission services' Spring 2007 Forecast.

⁽²⁾ Cyclically-adjusted balance excluding one-off and other temporary measures.

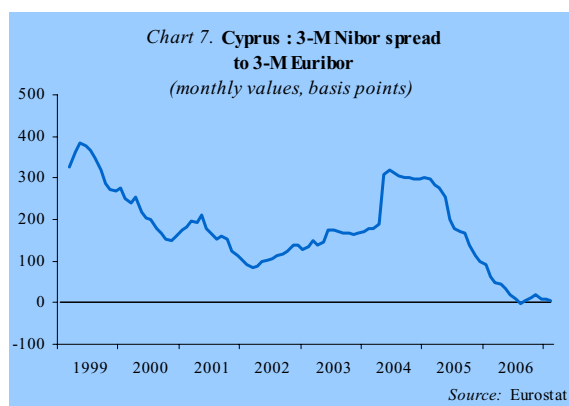
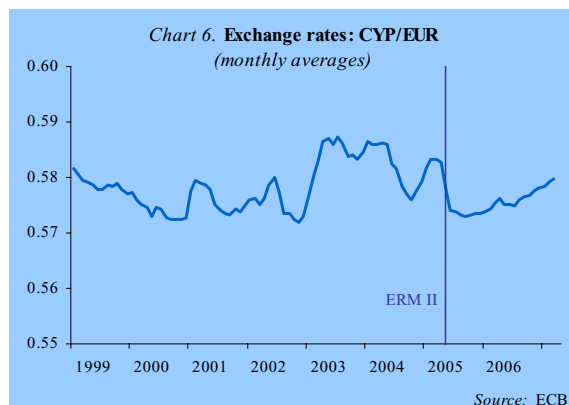
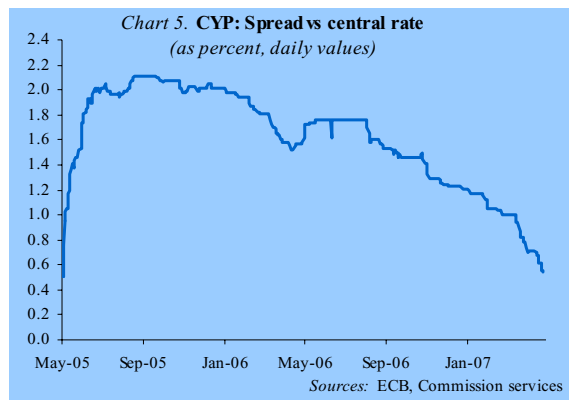
⁽³⁾ Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures according to the programme are 1.3% of GDP in 2005 and 0.4% of GDP in 2006, both deficit-reducing. These one-off measures include 0.4% of GDP in both years accounting for EU funds-related transactions, which the Commission services do not consider as one-off measures.

Sources: Eurostat, Commission services and December 2006 update of the convergence programme.

5. EXCHANGE RATE STABILITY

The Cyprus pound entered ERM II on 2 May 2005 at a central parity of 0.585274 pounds per euro (unchanged from the parity at which it had been linked unilaterally to the euro since 1999), with a standard fluctuation band of ± 15 percent. By the time of the adoption of this report, it has spent 24 months in the mechanism. Before ERM II entry, the Central Bank of Cyprus had been operating a system to contain fluctuations against the euro within a relatively narrow band of $\pm 2\frac{1}{4}$ percent from the central rate. A wider ± 15 percent official fluctuation band had been effective as of 2001, but the wider fluctuation margins were not used in practice. In the two years preceding ERM II entry, the Cyprus pound showed some short-term volatility against the euro, but deviations from the future central rate have been no more than around 2%. Immediately after entry into ERM II, the Cyprus pound appreciated to around two percent above the central parity. Subsequently, the currency has gradually weakened, to 0.5 percent above the central parity at the end of the reference period (26 April 2007). Within the ERM II period, the average spread to the central parity was 1.6 percent in the stronger half of the fluctuation band, with minimum and maximum deviations of 0.5 and 2.1% respectively.

The development of additional indicators does not point to exchange rate pressures on the Cyprus pound. Due to the relatively thin foreign exchange market, on most business days, the central bank clears the market to smooth exchange rate fluctuations. The regular operations of the Central Bank of Cyprus in the exchange markets in the context of stabilising the exchange rate mainly reflect a response to foreign exchange flows. They also exhibit a marked seasonal pattern partly related to the time profile of activity in the tourism sector. Since 2005, the central bank has mainly been purchasing foreign currency in response to foreign inflows. This has led to an increase in foreign exchange reserves to about 29% of GDP by end-2006 from about 22% of GDP at end-2004.



The Central Bank of Cyprus has substantially cut official interest rates since ERM II entry, while preserving a stable exchange rate to the euro. The Central Bank of Cyprus lowered the official interest rate by 25 basis point in February 2005 and then by a total of 100 basis points in May and June 2005. The easing of policy interest rates reflects the relatively favourable development of underlying inflation and attempts not to encourage further capital inflows. The official interest rate was left unchanged during the first half of 2006, but was raised by 25 basis points in September 2006 in order to counteract inflationary pressures and strong credit growth.²⁸ The 2006 monetary tightening was however substantially smaller than the 100 basis points hike in euro area official interest rates in the course of 2006.

As a result, money markets interest spreads *vis-à-vis* the euro area have declined sharply after ERM II accession, reflecting the policy rate convergence as well as abundant liquidity due to significant capital inflows. Since August 2006, 3-month NIBOR money market spreads have almost vanished, although their interpretation is hindered by the fact that these are primary rates, due to illiquid secondary markets.

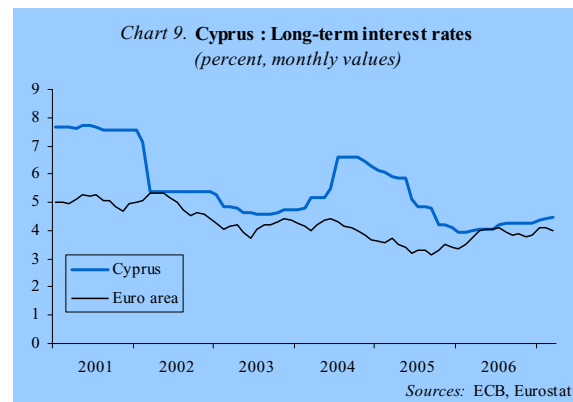
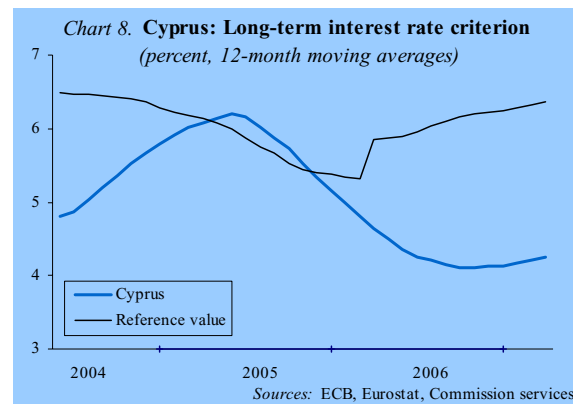
²⁸ In interpreting changes in policy interest rates, due account has to be taken of the change in operational framework on 1 September 2006. From that day onwards the Central Bank of Cyprus decided to use the bid rate on the main refinancing operations as the basis for the pricing of credit institution loans in Cyprus pounds, instead of the interest rate on the marginal lending facility (Lombard) that had been used previously. This was done to achieve gradual harmonisation with euro area practice, but did imply a substantial increase in the minimum bid rate of 125 basis points, whereas the rate actually used as a reference by the banking sector for granting loans was only raised by 25 basis points in the switch-over to the new system.

6. LONG TERM INTEREST RATES

Long-term interest rates in Cyprus used for the convergence examination reflect primary market yields on a benchmark government bond, due to a lack of a liquid secondary market for government bonds. Hence, short-term fluctuations in the spread mostly mirror the volatility of government bond yields in the euro area.

In March 2007 the reference value, calculated on the basis of long-term interest rates in Finland, Poland and Sweden, stood at 6.4%. For Cyprus, the 12-month moving average long-term interest rate relevant for the assessment has declined from a peak of slightly above 6% in mid-2005 to 4.2% in March 2007, 2.2 percentage points below the reference value.

Long-term interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Spreads decreased from around 230 basis points on long-term government bonds issued in April 2005, shortly before ERM II entry, to about 30 basis points at the most recent auction in early April 2007.²⁹ This trend is indicative of higher capital inflows upon ERM II entry, an improved fiscal situation, and increased confidence in the financial markets about the convergence process. The remaining positive differential at auctions is accounted for by the illiquidity of Cypriot government securities and by the residual currency risk premium incurred by foreign investors.



²⁹ The temporary narrowing of the spreads in mid-2006 is due the fact that there was no Cypriot government auction between March and June 2006, a period during which the ECB raised interest rate.

7. ADDITIONAL FACTORS

7.1. Financial market integration³⁰

Reflecting its history as a regional financial centre, the Cypriot financial system is substantially interlinked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating from Cyprus. In the context of EU accession, Cyprus has progressively dismantled its off-shore centre and the former international banking units (IBUs) have been fully incorporated into the domestic banking system since 1 January 2006. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition process of legislation adopted under the Financial Services Action Plan is close to completion.³¹

The financial sector in Cyprus is well developed in relation to its stage of economic development.³² The banking sector intermediates the largest share of funds, but other financial intermediaries are also established in the market. In terms of GDP, the value of outstanding bank credit exceeds the euro area average, while the importance of the Cypriot capital market for private sector funding remains limited despite a relatively high value of outstanding domestic fixed-income securities and stock market capitalisation compared to the EU10 average.

Banks predominate among financial intermediaries. Commercial banks account for the bulk of total bank lending, but co-operative credit and savings societies have also a significant market share, especially in rural areas. In 2005, Cypriot banks expanded their overseas operations, with a notable growth in deposits and loans particularly in Greece. There are 32 foreign-owned banking institutions operating in Cyprus, originating from 11 different countries.³³ Despite the latest developments, foreign ownership remains low relative to elsewhere in the EU10, while the degree of market concentration in terms of a CR5 ratio³⁴ of 59 per cent is not unusual for a relatively small market and broadly in line with the EU10 average. Other intermediaries are of limited importance in the sector, with the pensions mainly provided via public funding.

Private sector credit has expanded at an annual rate of about 10% in recent years, with credit growth accelerating to 19% in the course of 2006. This can mainly be related to an expansion of personal and professional loans by over 25%, as well as loans to the building and construction sector, which account for a share of 50 and 20% of outstanding loans, respectively. The share of foreign currency loans in outstanding claims on the private sector from domestic banks is still comparatively moderate, but continued to increase to 17% in December 2006. While euro-denominated loans accounted for 55% of outstanding foreign currency in December 2006, the share of Swiss franc loans expanded to 37%.

The Cypriot capital market remains comparatively small. While the stock market capitalisation in terms of GDP has more than doubled over 2006, this reflects in fact only the rally of shares prices of two major banks. Fixed-income securities, which have been mainly issued by the central government, are almost

³⁰ This section draws mainly on information provided in recent publications of the Central Bank of Cyprus and the Cyprus Stock Exchange as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

³¹ See: Transposition of FSAP Directives - State of play as of 15/01/2007.
http://ec.europa.eu/internal_market/finances/docs/action_plan/index/070124_annex_b_en.pdf

³² Cyprus' GDP per capita level (PPS) stood at 83% of the EU-25 average, which is the highest level among the New Member States before Slovenia (80), the Czech Republic (73) and Malta (69).

³³ Austria, Bulgaria, France, Greece, United Kingdom, Jordan, Ireland, Lebanon, Ukraine, Russia and Tanzania.

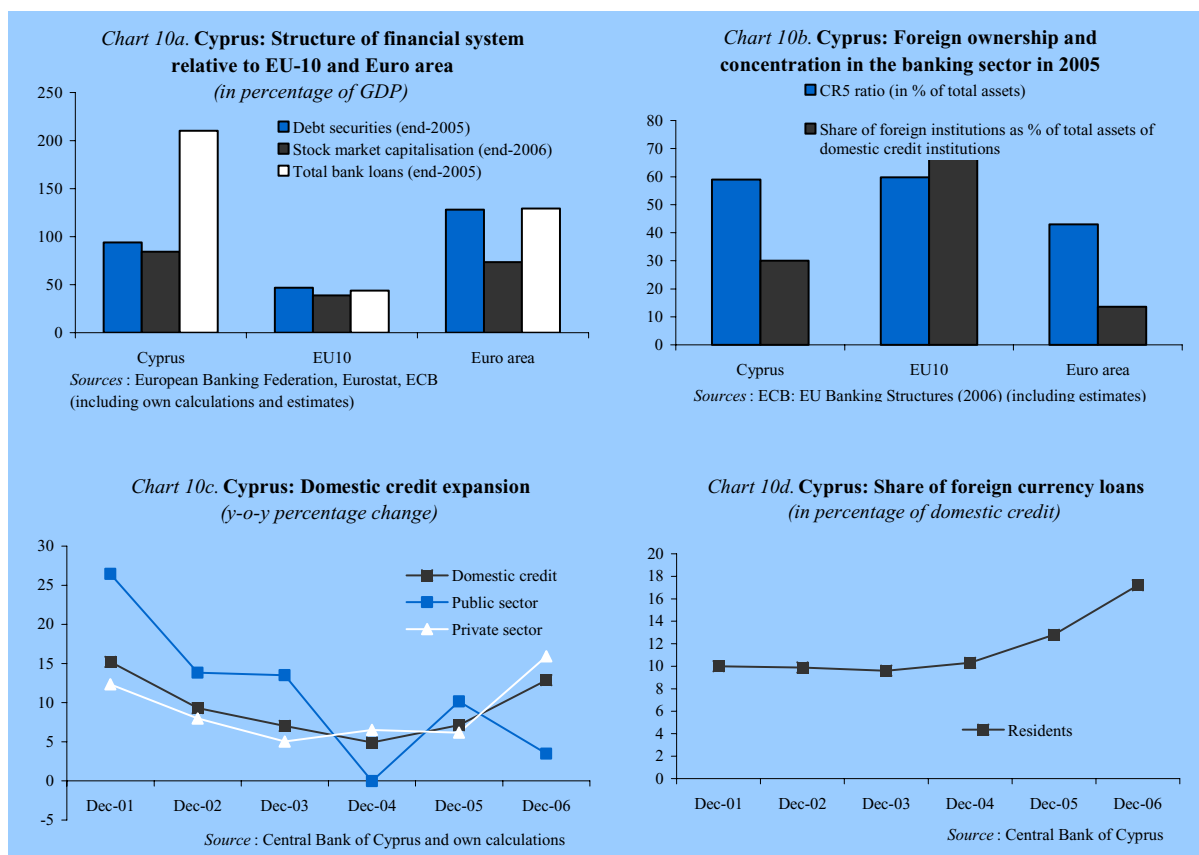
³⁴ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

exclusively long-term and denominated in euro. The limited private-sector issuance originates mainly from the financial sector.

The importance of adequate supervisory structures is heightened by Cyprus' importance as a regional financial centre, the integration of the former international banking units in the domestic banking sector and increased competitive pressure after joining the EU. Supervisory duties remain split between a

number of bodies. However, the central bank (entrusted with the supervision of commercial banks),

the Securities and Exchange Commission and the Insurance Companies' Control Service signed a Memorandum of Understanding on cross-sector supervisory co-operation and coordination in 2003. Moreover, the central bank has continued to establish and promote bilateral ties with overseas supervisory authorities.



7.2. Product market integration

Cyprus is a small open economy highly integrated in terms of trade and FDI with the EU25 and the euro-area. This reinforces competition pressures on product markets and therefore promotes efficiency. However, the small size of the economy hampers the scope for the diversification of production activities and leads to a high degree of trade specialisation, which increases its exposure to asymmetric shocks determined by the evolution of international markets. The ongoing transition towards a more diversified and innovation-driven economy is important to increase the resilience

of the economy to the inevitable competition pressure from lower-cost economies.

The ratio of trade openness is well above the EU25 average revealing a high degree of trade integration. However, trade openness is below the average for the small EU Member States, which suggests that there is still scope for further integration. Increasingly, the EU25 reinforces its position as the main trading partner and the importance of trade with extra-EU Member States decreases. In 2005 the share of extra-EU trade in total trade was around 35%, which was similar to that observed in the EU25. Moreover, trade integration with the euro-area is particularly well

advanced. In 2005, 70% of the total trade of Cyprus with the EU25 was with euro-area partners.

International trade is highly specialised. In 2005, the share of intra-industry trade in total manufacturing trade with the EU25 was the lowest among the EU25 Member States. The importance of services, primarily tourism, business and financial services which exploit the country's abundant endowments of skilled labour and good infrastructure as well as its geographic location is another outstanding feature of Cyprus' external trade. In 2005, services contributed to around 55% of total trade flows in contrast with the EU25 where services accounted for 22% of total trade. Moreover, services also dominate trade flows with the rest of the EU and the surplus of the balance of trade in services partly compensates the deficit in goods with the EU25. In manufacturing, with the exception of pharmaceuticals, Cyprus' revealed comparative advantage is concentrated in low and medium-low tech sectors namely food, drink and tobacco, non-metallic mineral products and clothing.³⁵

The process of integration with the EU is also fuelled by important inflows of FDI from the EU25, while FDI outflows remain very limited. In 2004 the stock of inward FDI represented around 50% of GDP, which is similar to the EU25 average. The EU25 Member States are the main investors accounting for around 51% of all inward FDI stock (34% of total inward stock comes from the euro-area). The foreign capital is overwhelmingly concentrated in tradable services, particularly financial services but also increasingly in other business services like accounting, legal and consulting as well as computer activities.

As a result of the ongoing integration with the rest of the EU, price convergence to the EU average level is well advanced. Aggregate price levels for goods and services are now just slightly below the EU25 average. However, price convergence is less advanced for services where important gaps vis-à-vis the EU25 average price level persist, notably in communication services, for which in 2005 prices were around 43% of the EU25 average level.³⁶

The still relatively important specialisation of manufacturing trade in low and medium technology

sectors reflects the low level of technological sophistication of the economy. The improvements in the functioning of product and labour markets and the initiatives to develop a comprehensive research and innovation system play an important role in facilitating the restructuring of production towards more innovation-driven manufacturing and services activities which would prevent competitiveness strains as income catches up with EU average levels.

While structural factors, like the importance of services such as tourism and business services partly explains the low investment in R&D, there are signs that the economy is catching-up with the EU average in terms of innovation performance.³⁷ According to recent survey evidence, 46% of firms declare innovation activity (against 42% for the EU27). ICT diffusion, namely broadband penetration, which is particularly important to increase tradability in services, remains one of the lowest in the EU25.³⁸

The business environment is generally favourable and recently efforts were stepped up to speed up and simplify the administrative procedures to start up companies. Dynamism in the business sector is also ensured by effective competition pressure in much of the economy. There are however exceptions, notably in the professional services sectors where restrictions such as pricing regulation and prohibition of advertising remain in place. Furthermore, while in sectors like electricity and telecommunications barriers to market access have been removed, competition remains limited and the market is still dominated by incumbents.

The improvement of the business environment and the innovation capacity of the economy should also contribute to attract more FDI, which could play a greater role in the future as a channel for technology, organisational- and managerial-skill transfer. The ongoing investment effort to upgrade basic transport and interconnection infrastructure with the rest of the EU economy is important in order to improve accessibility from abroad, thus promoting trade and investment links with the rest of the EU. The ongoing process of integration is also facilitated by the swift transposition of the EU directives that contributes to the smooth functioning of the Internal Market. According to the December 2006 Internal Market Scoreboard n° 15bis³⁹, in 2006 Cyprus managed to

³⁵ See: *EU Industry Structure*, DG ENTR, forthcoming.

³⁶ See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

³⁷ See: *2006 European Innovation Scoreboard*.

³⁸ See: *Fourth Community Innovation Survey*.

³⁹ http://ec.europa.eu/internal_market/score/index_en.htm

further reduce the deficit in the transposition of Internal Market directives, which is now at 0.8% compared to the EU25 average of 1.2%.

Table 5.

Cyprus: Product market integration

	Cyprus						EU25					
	2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
Trade openness ¹⁾ (%)	-	49.0	45.5	48.6	50.1	-	-	-	35.4	36.7	38.3	-
Extra-EU trade in goods GDP ratio ²⁾ (%)	8.3	8.4	6.9	6.6	7.1	7.4	9.9	9.4	9.1	9.6	10.4	11.1
Intra-EU trade in goods GDP ratio ³⁾ (%)	11.3	11.1	10.1	13.8	15.8	15.2	19.0	18.5	18.4	19.0	19.6	21.0
Intra-EU trade in services GDP ratio ⁴⁾ (%)	-	14.1	15.5	16.6	17.0	-	-	-	4.6	4.7	4.9	-
Intra-EU trade balance in goods ⁵⁾	-1.9	-2.0	-1.9	-2.5	-2.6	-3.0	89.4	96.2	90.7	77.9	72.6	81.4
Intra-EU trade balance in services ⁶⁾	-	1.4	1.5	1.7	1.8	-	-	-	1.9	17.0	15.9	-
Intra-EU trade balance GDP ratio ⁷⁾ (%)	-	-5.4	-3.0	-6.7	-5.8	-	-	-	0.9	0.9	0.8	-
Total FDI inflows GDP ratio ⁸⁾ (%)	9.8	10.1	6.7	6.9	7.2	-	5.8	5.0	3.6	2.2	4.6	-
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	4.3	4.1	5.0	4.8	4.2	-	4.3	3.7	2.3	1.6	3.7	-
FDI intensity ¹⁰⁾	3.2	4.0	4.0	3.8	2.8	-	3.9	3.7	2.5	1.9	3.8	-
Internal Market Directives ¹¹⁾	-	-	-	4.4	1.1	0.8	-	-	-	3.6	1.6	1.2
Price levels ¹²⁾	91.9	90.9	90.4	89.8	90.2	-	100	100	100	100	100	100

1) (Imports + Exports of goods and services/2xGDP at current prices)*100. (Foreign trade statistics/ Balance of payments).

2) (Extra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).

3) (Intra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).

4) Intra-EU25 trade in services (average credit and debit in % of GDP at current prices). (Balance of payments).

5) Difference between export and imports of goods (credit minus debit) in bn euros. (Foreign trade statistics).

6) Difference between export and imports of services (credit minus debit) in bn euros. (Balance of payments).

7) Difference between export and imports of goods and services as a % of GDP. (Foreign trade statistics/ Balance of payments).

8) Total FDI inflows as a % of GDP (at current prices).

9) Intra-EU total FDI inflows as a % of GDP (at current prices).

10) Average value of Intra-EU25 inward and outward FDI flows, divided by GDP and multiplied by 100.

11) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.

12) Comparative price levels of final consumption by private households including direct taxes (EU25=100). Provisional data for 2004 and 2005.

Sources: Eurostat, Commission services.

7.3. Development of the balance of payments

Cyprus's current account balance has been persistently negative over the last ten years, averaging about - 3.5% of GDP. The current account deficit has widened from 2.3% of GDP in 2003 to 5.9 of GDP in 2006 (from 1.9 to 5.9% of GDP taking the combined current and capital account).

The development of the Cypriot balance of payments shows large disparities in net trade in goods and services. The persistently very high deficit in goods trade notably reflects the relatively weak competitive position of goods producing industries, with a high concentration in low technology sectors which have suffered from increased competition from lower-wage exporters and the shift of the Cypriot economy towards the tertiary sector. Buoyant domestic demand also contributed to the widening of the merchandise trade deficit, notably in 2004. In 2005 and 2006, the trade balance was also significantly affected by

soaring oil prices. In 2006, the effect of higher oil prices on import growth was compounded by lower-than-expected export growth, largely reflecting subdued re-export activity following its sharp expansion in 2005.

The negative trade balance in goods is only partly compensated for by substantial surplus on services trade, which mirrors the competitive advantages Cyprus has in services sectors such as tourism, financial services and business services (where the export shipping services has been growing very rapidly). The services trade surplus has little changed in 2004-06, as a sluggish tourism sector was offset by some improvement in the non-tourism services balance. The balance of income registered a deficit of 2.8% of GDP in 2006. However, about three quarter of the net income outflows are reinvested earnings of foreign firms based in Cyprus, which are treated as FDI inflows in the financial account. The relatively small net transfers inflows have been boosted by EU transfers connected to accession.

The worsening of the current account deficit in the last three years is essentially private sector-driven. It mainly reflects an increase in private investment together with a sharp reduction in private savings rate, the latter being partially offset by the reduction of government deficit following fiscal consolidation efforts.

A substantial part of the current account balance is covered by net FDI inflows. Net FDI inflows covered more than 100% of the current account deficit between 1995 and 2003, about half of the deficit in 2004 and about three-quarters in 2005 and 2006. More than half of net FDI inflows are reinvested earnings. Real estate and trade are the two largest FDI items and have attracted the majority of foreign investment in recent years. In 2004, substantial net portfolio investments (essentially bonds and money

market instruments issued by banks and by the government) provided additional financing. Net other inflows were also sizeable in 2005 and 2006, essentially reflecting the growth in non-residents deposits held in the Cypriot financial sector. As a result of large capital inflows, the net reserve position has markedly increased since 2004.

Looking forward, exploiting comparative advantages in traded goods and especially traded services is important to maintain a sustainable current account balance in the medium term. In addition, for exporting industries limiting increases in prices and wage costs *vis-à-vis* competitors is important to safeguard external competitiveness. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.

Table 6.

**Cyprus: Balance of payments
(percentage of GDP)**

	2001	2002	2003	2004	2005	2006
Current account	-3.3	-3.7	-2.3	-5.0	-5.6	-5.9
Of which: Balance of trade in goods	-26.6	-27.3	-23.9	-25.6	-25.0	-27.5
Balance of trade in services	28.2	26.2	23.4	22.9	22.4	23.4
Income balance	-5.4	-3.7	-2.8	-3.3	-3.5	-2.8
Balance of current transfers	0.6	1.1	1.1	1.1	0.5	1.1
Financial and capital accounts	3.7	4.4	2.1	4.1	5.0	6.7
Of which: Net FDI	7.2	5.1	2.4	2.5	4.3	4.2
Net portfolio inflows	2.8	-5.1	1.9	7.2	-0.9	-3.3
Net other inflows ⁽¹⁾	-0.1	8.5	-4.2	-3.7	5.3	11.2
Net capital account	0.1	0.2	0.4	0.6	0.5	0.0
Change in reserves (+ is a decrease)	-6.3	-4.3	1.6	-2.4	-4.3	-5.5
Errors and omissions	-0.4	-0.7	0.2	0.9	0.6	-0.7
Gross capital formation	16.4	18.8	17.4	20.2	19.4	19.6
Gross saving	13.2	15.1	15.2	15.2	13.8	13.7

⁽¹⁾ Including financial derivatives

Sources: Eurostat and Commission services.