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REPORT FROM THE COMMISSION

Cyprus

Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

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1. INTRODUCTION

On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact. The clause, as set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97, facilitates the coordination of budgetary policies in times of severe economic downturn. In its Communication, the Commission shared with the Council its view that, given the expected severe economic downturn resulting from the COVID-19 outbreak, the current conditions permit activation of the clause. On 23 March 2020, the Ministers of Finance of the Member States agreed with the assessment of the Commission. The activation of the general escape clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. For the corrective arm, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory. The general escape clause does not suspend the procedures of the Stability and Growth Pact. It allows Member States to depart from the budgetary requirements that would normally apply while enabling the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact.

Data notified by the Cypriot authorities on 31 March 2020 and subsequently validated by Eurostat[1] show that the general government surplus in Cyprus reached 1.7% of GDP in 2019, while general government gross debt stood at 95.5% of GDP[2]. According to the 2020 Stability Programme, Cyprus plans a deficit of 4.3% of GDP in 2020, while debt is planned at 116.8% of GDP.

The planned deficit for 2020 provides *prima facie* evidence of the existence of an excessive deficit as defined by the Stability and Growth Pact.

Moreover, the data for 2019 imply a lack of compliance with the debt reduction benchmark,which also provides *prima facie* evidence of the existence of an excessive deficit as defined by the Stability and Growth Pact.

[1] https://ec.europa.eu/eurostat/documents/2995521/10294648/2-22042020-AP-EN.pdf/6c8f0ef4-6221-1094-fef7-a07764b0369f

[2] The debt-to-GDP ratio increased in 2018, to 100.6% of GDP, due one-off operations to support the banking sector.

Against this background, the Commission has therefore prepared this report, which analyses Cyprus' compliance with the deficit and debt criteria of the Treaty. It assesses all relevant factors and gives due consideration to the major economic shock linked to the COVID-19 pandemic.

Table 1. General government deficit and debt (% of GDP)

		2016	2017	2018	2019	2020 COM	2021 COM
Deficit criterion	General government balance	0.3%	2%	-3.7	1.7	-7%	-1.8%
Debt criterion	General government gross debt	103.4%	93.9%	100.6	95.5	115.7%	105%
	Gap to the debt reduction benchmark				0.1	3.0%	-0.4%

Note Source: Eurostat, Commission 2020 spring forecast

2. Deficit criterion

Based on the 2020 Stability Programme, Cyprus' general government deficit in 2020 is expected to reach 4.3% of GDP, well above and not close to the Treaty reference value of 3% of GDP. The deficit is expected to be primarily due to the deficit-increasing fiscal impact of the measures adopted by the government to fight the pandemic (estimated at 4.4% of GDP) and the assumed contraction of tax revenue in the wake of to the deterioration of the macroeconomic situation.

The planned excess over the Treaty reference value in 2020 is exceptional, as it results from a severe economic downturn. Taking into account the impact of the COVID-19 pandemic, the Commission 2020 spring forecast projects a contraction of real GDP growth in 2020 by 7.4%.

The planned excess over the Treaty reference value would be temporary, based on the Commission 2020 spring forecast, which projects the deficit to decline below 3% of GDP in 2021. However, those projections are surrounded by an exceptionnally high degree of uncertainty.

In sum, the planned deficit for 2020 is above and not close to the 3%-of-GDP Treaty reference value. The excess is considered to be exceptional as defined by the Treaty and the Stability and Growth Pact, while the nature of the excess is currently considered temporary. Hence, the analysis suggests that *prima facie* the deficit criterion as defined by the Treaty and Regulation (EC) No 1467/97 is not fulfilled.

3. Debt criterion

After decreasing substantially to 93.9% of GDP in 2017, the government debt-to-GDP ratio increased to 100.6% in 2018. The increase was mainly due to the issuing of a series of government bonds (EUR 3.2 billion, over 15% of GDP) to finance the one-off government support for the sale and orderly winding down of the Cyprus Cooperative Bank (CCB).

The government debt-to-GDP ratio decreased substantially to 95.5% in 2019 from 100.6% of GDP in 2018. Debt reduction was due to a comfortable headline budgetary surplus combined with nominal GDP growth. It was partially offset by the debt-increasing impact of stock-flow adjustments in 2019 (+0.4% of GDP), which reflected increased cash reserves held by the government.

The notified data show that Cyprus did not comply with the debt reduction benchmark in 2019 (see Table 1), as the gap to the benchmark is 0.1% of GDP.

The analysis thus suggests that *prima facie* the debt criterion is not fulfilled based on the 2019 outturn data.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that, if a Member State does not fulfil the requirements under one or both of those criteria, the Commission has to prepare a report. That report must also "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".

Those factors are further clarified in Article 2(3) of Regulation (EC) No 1467/97, which also provides that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and to the Commission" need to be given due consideration.

For the apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach. In that respect, at least the following three main aspects need to be considered when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability: (i) adherence to the MTO or the adjustment path towards it, (ii) the implementation of structural reforms, and (iii) the prevailing economic conditions.

As specified in Article 2(4) of Regulation (EC) No 1467/97, as regards compliance with the deficit criterion in 2020, since the government debt-to-GDP ratio exceeds the 60% reference value and the double condition is not met - i.e. that the deficit remains close to the reference value and that its excess over the reference value is temporary - those relevant factors cannot be taken into account in the steps leading to the decision on the existence of an excessive deficit on the basis of the deficit criterion for Cyprus. In the current situation, a key additional factor to take into consideration regarding 2020 is the economic impact of the COVID-19 pandemic, which has a very substantial impact on the budgetary situation and results in a highly uncertain outlook. The pandemic has also led to the activation of the general escape clause.

4.1. COVID-19 pandemic

The COVID-19 pandemic has led to a major economic shock that is having a significant negative impact throughout the European Union. The consequences for GDP growth will depend on the duration of both the pandemic and of the measures taken by national authorities and at European and global level to slow its spread, protect production capacities and support aggregate demand. Member States have already adopted or are adopting budgetary measures to increase the capacity of health systems and provide relief to those individuals and sectors that are particularly affected. Significant liquidity support measures and other guarantees have also been adopted. Subject to more detailed information, the competent statistical authorities are to examine whether those measures entail an immediate impact on the general government balance. Together with the fall in economic activity, these measures will contribute to substantially higher government deficit and debt positions.

4.2 Medium-term economic position including structural reforms

Since 2016, real GDP growth has been growing increasingly above potential, driven by consumption. Nominal growth has also been very strong since 2016. Hence, it cannot be argued that macroeconomic conditions are a mitigating factor in explaining Cyprus' lack of sufficient progress towards meeting the debt reduction benchmark in 2019.

As a result of the COVID-19 pandemic, the Commission 2020 spring forecast projects GDP to decline by almost 7½% in 2020, reflecting the disruption in economic activity caused by the travel restrictions and lockdown measures, as well as an expected significant fall in external demand for services, and in particular for tourism. The macroeconomic outlook is marked by a significant degree of uncertainty related to the duration of the pandemic and its economic impact.This is a mitigating factor in the assessment of Cyprus' compliance with the deficit criterion in 2020.

In its 2020 Country Report[3], the Commission assessed that Cyprus has made overall limited progress in addressing the 2019 Country Specific Recommendations. More specifically, Cyprus has made some progress notably in improving the governance of State-owned enterprises; facilitating the reduction of non-performing loans; strengthening the effectiveness of the public employment services and outreach to young people; improving R&D ; easing the access to finance for the SMEs, and implementing the first phase of the reform of the National Health Insurance System. Only limited progress has been made in (i) reforming the public administration and local governments; (ii) focusing investment-related economic policy on sustainable transport, waste and water management, digitalisation and digital skills; (iii) improving the effectiveness of the justice system and payment discipline; (iv) setting up a reliable system to issue and transfer immovable property rights. No progress has been made on implementing privatisation projects.

4.3 Medium-term budgetary position, including government investment

The headline budgetary position improved from a deficit of 3.7% of GDP in 2018 to a surplus of 1.7% in 2019. The improvement of the headline balance in 2019 compared to 2018 mainly reflects the temporary nature of the deficit in 2018, which was due to one-off government support to the banking sector in 2018 (7.4% of GDP). Public investment has fallen from 5.7% of GDP in 2018 to 1.7% in 2019 due to the one-off impact on public investment of the financial support measures to CCB in 2018.

[3] See Commission Staff Working Document SWD (2020) 512 final, 26.2.2020, "*Country Report Cyprus 2020. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

Based on outturn data and the Commission forecast, Cyprus' structural balance was in a surplus of 0.1% of GDP in 2019, thus complying with its medium-term bugdetary objective of a balanced structural budget in 2019. Compliance with the preventive arm requirements is a mitigating factor for the assessment of Member State's prima facie non-compliance with the debt criterion in 2019.

The 2020 Stability Programme provides information on the expected temporary impact on public finances of the package of deficit-increasing measures adopted by the government to fight the pandemic (estimated at 4.4% of GDP). The medium-term fiscal outlook is characterised by an exceptional degree of uncertainty concerning both the duration of the pandemic and its economic impact.

4.4. Medium-term government debt position

After declining considerably from 103.4% in 2016 to 93.9% of GDP in 2017, the public debt-to-GDP ratio increased to 100.6% of GDP in 2018. That increase was due to the one-off government support measures for the sale and orderly winding down of the CCB in 2018.

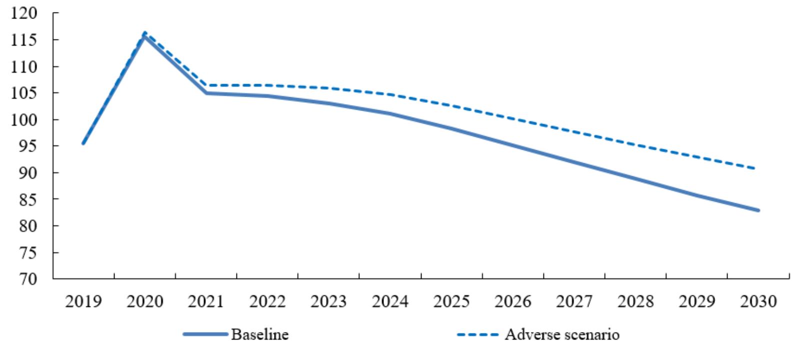
In 2019, the public debt-to-GDP ratio decreased substantially, to 95.5%, driven by a comfortable primary budget surplus as well as by a favourable snowball effect. Those debt-reducing factors were partially offset by the debt-increasing impact of stock-flow adjustments (+0.4% of GDP).

According to the Commission 2020 spring forecast, general government debt is expected to rise from 95.5% of GDP in 2019 to 115.7% by 2020.

The debt sustainability analysis has been updated with the Commission 2020 spring forecast. This analysis confirms that, notwithstanding risks, the debt position remain sustainable over the medium-term, also given important mitigating factors (including the debt profile). In particular, while the government debt position has deteriorated as a result of the COVID-19 crisis, the debt-to-GDP ratio in the baseline is expected to be on a sustainable (declining) trajectory over the medium term[4].

[4] The baseline is based on the Commission Spring 2020 forecast. Beyond 2021, a gradual adjustment of fiscal policy is assumed, consistent with the EU economic and fiscal coordination and surveillance frameworks. Real GDP growth is projected according to the so-called EPC/OGWG T+10 methodology. In particular, (real) actual GDP growth is driven by its potential growth and affected by any additional fiscal adjustment considered (through the fiscal multiplier). Inflation is assumed to converge gradually to 2%. Interest rates assumptions are set in line with financial market expectations. Under the adverse scenario, higher interest rates (by 500 bps.) and lower GDP growth (by -0.5 pp.), with respect to the baseline, are assumed (throughout the projection horizon).

Graph 1: Government debt-to-GDP ratio, Cyprus, % of GDP



Source: Commission services

4.5 Other factors put forward by the Member State

On 11 May 2020, the Cypriot authorities transmitted a letter with relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97. The analysis presented in the previous sections already broadly covers the key factors put forward by the authorities. In their letter, the Cypriot authorities also stressed the positive evolution of public finances in recent years, as reflected in the general government headline balance surpluses achieved over the last four years (2016-2019), exlcuding one-off impacts related to the CCB. The authorities also note that the cash buffer has marked an increase equivalent to approximately 2% of GDP at the end of 2019, compared to 2018, notably in view of the planned repayment of the IMF loan in early 2020.

5. CONCLUSIONS

According to the Stability Programme, Cyprus' headline general government deficit in 2020 is planned to increase to 4.3% of GDP, above and not close to the 3% of GDP Treaty reference value. The planned excess over the reference value is considered to be exceptional, and currently considered to be temporary.

The general government gross debt stood at 95.5% of GDP at the end of 2019, well above the 60% of GDP Treaty reference value. Cyprus did not comply with the debt reduction benchmark in 2019.

In line with the Treaty and the Stability and Growth Pact, this report also examined relevant factors. As specified in Article 2(4) of Regulation (EC) No 1467/97, as regards compliance with the deficit criterion in 2020, since the government debt-to-GDP ratio exceeds the 60% reference value and the double condition is not met - i.e. that the deficit remains close to the reference value and that its excess over the reference value is temporary - those relevant factors cannot be taken into account in the steps leading to the decision on the existence of an excessive deficit on the basis of the deficit criterion for Cyprus. Overall, the analysis suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fullfilled.

As regards compliance with the debt criterion in 2019, the relevant factors, in particular (i) the observed macroeconomic conditions; (ii) the limited progress with the implementation of growth enhancing structural reforms in past years, and (iii) the compliance with the medium term budgetary objective, lead to the conclusion that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is complied with.