COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2007 ON CYPRUS

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

{SEC(2007) 623}

1. PURPOSE OF THE REPORT

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

This report has been prepared in response to the request of Cyprus, submitted on 13 February 2007. A more detailed assessment of the state of convergence in Cyprus is provided in a technical annex to this report (SEC(2007) 623).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB (ESCB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and by taking account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

This report only examines 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).

The examination of the compatibility of ***national legislation***, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

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”. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is likely to meet the reference value in the months ahead[1].

The inflation reference value was calculated to be 3.0% in March 2007[2] with Finland, Poland and Sweden as the three best-performing Member States.

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".

The relevant two-year period for assessing exchange rate stability in this report is 27 April 2005 to 26 April 2007.

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 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".

1 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.

2 The cut-off date for the data used in this report is 26 April 2007.

The interest rate reference value was calculated to be 6.4% in March 2007.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

In the December 2006 Convergence Report, the Commission assessment was that Cyprus fulfilled three of the convergence criteria (on price stability, government budgetary situation and long-term interest rates). Pending the adoption of the draft Law amending the Central Bank of Cyprus Law of 2002 and 2003, legislation in Cyprus, in particular the Central Bank of Cyprus law, was considered not fully compatible with Article 109 of the Treaty and the ESCB Statute as regards central bank integration into the ESCB at the time of the adoption of the euro.

2. LEGAL COMPATIBILITY

All outstanding incompatibilities have been addressed in a Law amending the Central Bank of Cyprus Laws of 2002 and 2003 adopted by Parliament on 15 March 2007. The Law entered into force on the day of its adoption, though certain provisions will take effect on the date of the introduction of the euro in Cyprus. In particular, the Law has repealed or amended a series of articles so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and EC Council. This concerns notably provisions on monetary policy, on monetary operations and instruments of the ESCB, on the conduct of foreign exchange operations and on the issue of banknotes and coins.

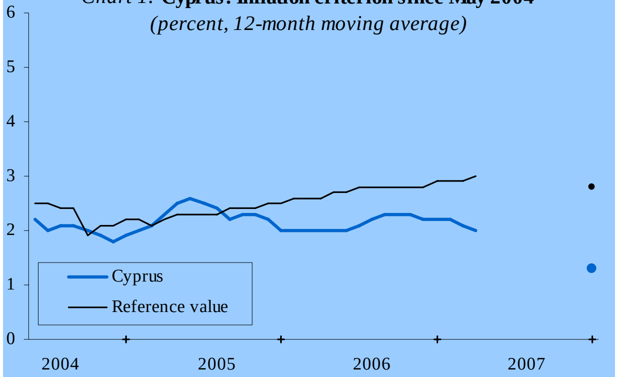
Legislation in Cyprus, in particular the Central Bank of Cyprus Law, is compatible with the requirements of the EC Treaty and the ESCB Statute.

3. PRICE STABILITY

Respect of the reference value

12-month average inflation in Cyprus has been below the reference value since August 2005. The average inflation rate in Cyprus during the 12 months to March 2007 was 2.0%, below the reference value of 3.0%, and it is likely to remain below the reference value in the months ahead[3].

Chart 1. **Cyprus: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' Spring 2007 Forecast

3 According to the Commission Spring 2007 Forecast, 12-month average inflation in Cyprus will decrease to 1.3% in December 2007, while the reference value is forecast to stand at 2.8%.

Underlying factors and sustainability

Cyprus has traditionally enjoyed relatively low, although at times volatile, inflation, reflecting the sensitivity of its small and open economy to external price shocks. HICP inflation was 2.6% on average in 1999-2006. However, inflation reached highs of around 6% 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 excise duties. Inflation increased in the first half of 2006, but declined thereafter to 1.4% in March 2007, largely as a reflection of swings in energy and food prices.

HICP inflation excluding energy and unprocessed food has been contained, averaging below 1% since 2004. Moderate core inflation suggests that underlying inflationary pressures have remained limited, against the background of a negative output gap and moderate increases in unit labour costs (between 1 and 2% annually since 2004). Wage pressures in recent years, in the context of tightening labour market, were mitigated by an increasing share of foreign workers in the labour force and exemplary wage discipline in the public and private sectors. The effective exchange rate of the Cypriot pound was stable in 2005-2006, thus remaining neutral with respect to import prices.

Inflation is expected to remain low in the coming months largely due to a favourable oil price base effect, lower prices of clothing and footwear and the reduction of excises on cars. Inflation performance over the medium term will, to a large extent, depend on the development of energy and other import prices and on the containment of possible wage and demand pressures in a context of strong cyclical conditions and interest rate and reserve requirement convergence. Increases in VAT rates on foodstuff, pharmaceuticals and restaurants that are related to fulfilling EU requirements, as the current derogations expire at the end of 2007, are expected to have a significant (around one percentage point) impact on inflation. Although this impact is expected to be temporary, some second-round effects cannot be excluded, in particular via the inclusion of VAT increases in the cost of living index.

Cyprus fulfils the criterion on price stability.

4. GOVERNMENT BUDGETARY POSITION

Cyprus is not at present the subject of a Council Decision on the existence of an excessive deficit, the Decision on the existence of such deficit in Cyprus adopted by the Council on 5 July 2004[4] having been abrogated by the Council Decision of 11 July 2006[5].

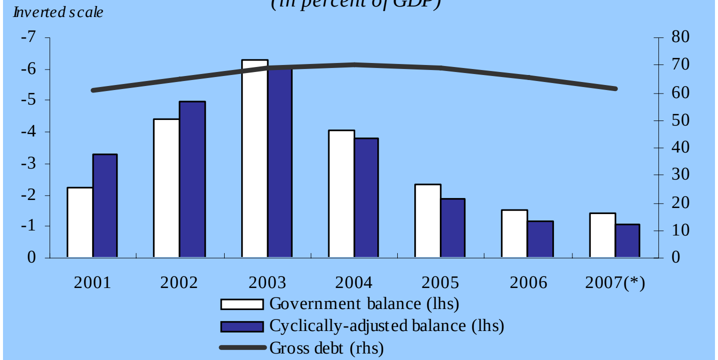
The general government deficit peaked at 6.3% of GDP in 2003, but was reduced markedly in the following years, to 1.5% of GDP in 2006, following the implementation of a strong fiscal adjustment in 2004 and 2005. For 2007, the Commission services' Spring 2007 Forecast projects an almost unchanged deficit (1.4% of GDP).

4 Decision 2005/184/EC (OJ L 62, 9.3.2005, p. 19).

5 Decision 2006/627/EC (OJ L 256, 20.9.2006, p. 13).

In its Opinion on the December 2006 update of the Convergence Programme of Cyprus, the Council considered that after the correction of the excessive deficit in 2005, Cyprus was making good progress towards the medium-term objective (MTO) and that the budgetary strategy in the programme seemed sufficient to ensure that the MTO is achieved by 2008. At the same time, 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.

Chart 2. **Cyprus: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2007 Forecast *Sources*: Eurostat and Commission services

During the seven years to 2006, both total revenue and total expenditure ratios followed, on average, an upward trend. Total revenue increased, mainly owing to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the *acquis* in May 2004 and measures to discourage tax evasion, while the one-off measures took the form of an exceptional dividend on past profits of semi-governmental organisations and a tax amnesty. Current primary expenditures increased, mainly owing to increases of wages and salaries and social transfers. From 2005 onwards, expenditure growth was restricted by the imposition of a ceiling on the nominal growth rates of current primary and capital expenditure.

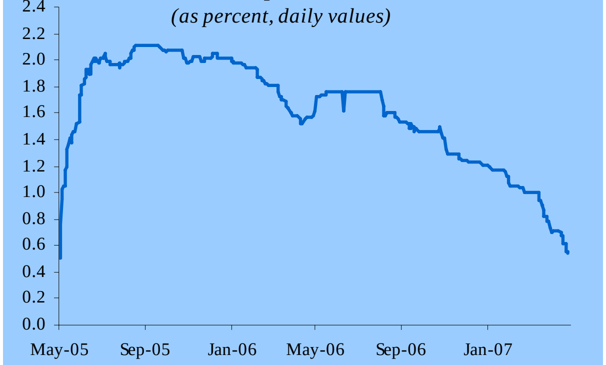
Government debt followed an upward trend between 2000 and 2004 but has been on a declining path since 2005. It decreased to 65.3% of GDP in 2006, and according to the Commission services' Spring 2007 Forecast, will continue to decline in 2007, reaching some 61.5% of GDP.

Cyprus fulfils the criterion on the government budgetary position.

5. EXCHANGE RATE STABILITY

The Cyprus pound has participated in ERM II since 2 May 2005, i.e. for 24 months at the time of adoption of this report. Before ERM II entry, the Central Bank of Cyprus had been operating a unilateral peg vis-à-vis the euro, containing fluctuations within relatively narrow margins. During the period of the assessment not covered by ERM II participation (27 April – 1 May 2005), the

Chart 3. **CYP: Spread vs central rate**
(as percent, daily values)

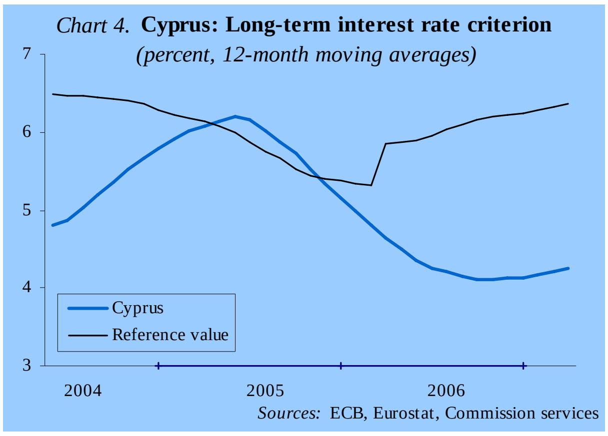


Sources: ECB, Commission services

pound stayed close to the future central rate. Since ERM II entry, the pound has consistently traded in the upper half of the fluctuation band, close to the central rate, and it has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate.

Cyprus fulfils the exchange rate criterion.

6. LONG-TERM INTEREST RATES



The average long-term interest rate in Cyprus in the year to March 2007 was 4.2%, below the reference value of 6.4%. Average long-term interest rates in Cyprus have been below the reference value since November 2005. Long-term interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Low yield spreads *vis-à-vis* the euro area indicate that the residual country risk priced in by markets is limited.

Cyprus fulfils the criterion on the convergence of long-term interest rates.

7. ADDITIONAL FACTORS

Additional factors have been examined, including product and financial market integration and balance of payments developments. The Cypriot economy is highly integrated with the EU. In particular, trade and FDI are increasing, and the Cypriot financial system is substantially inter-linked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating in Cyprus. The Cypriot current account deficit has widened in recent years, from 3.2% of GDP in 2003 to 5.9% of GDP in 2006. The deficit in the combined current and capital account increased from 1.9 to 5.9% of GDP in this period. The current account deficit reflects large disparities in net trade in goods and services. Traditionally, substantial surpluses on services trade have not fully offset very large deficits in goods trade and negative income balances. On the financing side, net FDI inflows have covered a substantial share of the current account balance.

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In the light of its assessment on the fulfilment of the convergence criteria, the Commission considers that Cyprus has achieved a high degree of sustainable convergence.