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Recommendation for a

COUNCIL RECOMMENDATION

on the National Reform Programme 2011 for Cyprus

and delivering a Council opinion

on the updated Stability Programme of Cyprus, 2011-2014

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, and in particular Article 5(3) thereof,

Having regard to the recommendation of the European Commission²,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

- (1) On 26 March 2010, the European Council agreed to the European Commission's proposal to launch a new strategy for jobs and growth, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.
- (2) On 13 July 2010, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States,³ which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

¹ OJ L 209, 2.8.1997, p. 1.

² OJ C , p. .

³ Maintained for 2011 by Council Decision 2011/308/EU of 19 May 2011.

- (3) On 12 January 2011, the Commission adopted the first Annual Growth Survey, marking the start of a new cycle of economic governance in the EU and the first European semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy.
- (4) On 25 March 2011, the European Council endorsed the priorities for fiscal consolidation and structural reform (in line with the Council's conclusions of 15 February and 7 March 2011 and further to the Commission's Annual Growth Survey). It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms and making new efforts to enhance growth. It requested Member States to translate these priorities into concrete measures to be included in their Stability or Convergence Programmes and National Reform Programmes.
- (5) On 25 March 2011, the European Council also invited the Member States participating in the Euro Plus Pact to present their commitments in time to be included in their Stability or Convergence Programmes and their National Reform Programmes.
- (6) On 6 May 2011, Cyprus submitted its National Reform Programme and on 7 May 2011 its updated Stability Programme covering the period 2010-2014. In order to take account of the interlinkages, the two programmes have been assessed at the same time.
- (7) The Cypriot economy is recovering moderately after experiencing the first economic contraction in the last thirty-five years in 2009, when real GDP fell by 1.7%. The labour market suffered from the recession, with unemployment reaching 6.5% in 2010. Public finances also deteriorated. From a surplus, the general government budget dropped to a deficit of 6% of GDP in 2009, driven by automatic stabilisers, discretionary fiscal stimulus measures to counter the economic downturn and rather large effects due to a less tax-rich growth pattern. Economic activity improved moderately in 2010 with growth at 1%, mainly driven by inventory accumulation, after the large destocking that took place in 2009, in tandem with a mild resumption of private consumption. The strengthening economic outlook is expected to benefit the labour market, employment is projected to recover modestly while unemployment should ease gradually from its peak at the end of 2010.
- (8) Based on the assessment of the updated Stability Programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections is plausible until 2012, but too favourable thereafter, as assessed against the Commission services' spring 2011 forecast. The Stability Programme aims to reduce the budgetary deficit to 4% of GDP in 2011 and 2.6% in 2012, in line with the Council recommendations, and to continue consolidation afterwards. The programme projects the debt ratio to peak in 2012 and to decline thereafter. The annual average improvement in the structural balance for the period 2011-12 is 1.5% of GDP, in line with the Council recommendations. However, the structural improvement is set to be below the requirements of the Stability and Growth Pact in both 2013 and 2014. The medium-term objective (MTO), which is reaffirmed as a balanced budget in structural terms, will not be reached within the programme period. While the overall adjustment planned is based on expenditure restraint, most measures in 2011 are on the revenue side. Overall, there are downside risks to the consolidation path mapped out in the programme, associated with the continued rebalancing towards a less tax-rich growth pattern, the practice of adopting

supplementary budgets during the course of the year and the timely implementation of measures which are still to be agreed with the social partners and others still to be specified (e.g. containment of current expenditure). In view of these risks, additional measures may need to be adopted if macroeconomic or budgetary developments turn out to be worse than expected.

- (9) Despite the decline to around 9% of GDP in 2010, the current account deficit is still large and likely to constrain economic growth over the medium term. High public-sector outgoings need to be financed by either foreign debt or higher domestic private savings. The latter would imply lower output growth by crowding out private consumption or investment. In the medium term, the deficit would continue improving, but at a moderate rate. On 13 July 2010, in the context of the excessive deficit procedure, the Council recommended to the Cypriot authorities to strengthen the binding nature of their medium-term budgetary framework too. Until now, no progress has been reported. According to the Stability Programme, the medium-term budgetary framework is to be fully implemented from the fiscal year 2014 onwards, rather than 2012, as expected until recently. Therefore, its impact would be felt only in the medium term. Timely implementation of the new framework would be important for successful and lasting consolidation of the public finances.
- (10) The banking sector weathered the global financial crisis and the sovereign debt crisis in the euro area well, without any need for government intervention. However, with assets of more than six times GDP, excluding subsidiaries and branches of foreign banks, and ten times GDP when they are included, the banking sector is large in relation to the economy. Moreover, it is relatively concentrated, with the market dominated by three domestic groups that hold about 55% of total consolidated banking assets, excluding the cooperative banks. The ongoing risks on international financial markets call for continuation of conservative balance-sheet management and for prudent supervision. There are two different supervisors: the Central Bank of Cyprus for commercial banks and the Authority for the Supervision and Development of Cooperative Societies (ASDCS) for cooperative credit institutions. In spite of the IMF recommendation to have a single supervisor for both banks and cooperative credit institutions, no progress has been made.
- (11) The projected long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively strong increase in pension expenditure as a share of GDP over the decades ahead. A pension reform was introduced in April 2009. It is aimed mainly at the revenue side and would only slightly slow down the rise in pension expenditure. Progress on healthcare reform, with the aim of curbing the projected rise in expenditure by establishing a national health system and transforming public hospitals into autonomous entities, has been very limited.
- (12) The twice-a-year automatic cost-of-living allowance (COLA) adjustment is linked directly to the average percentage change in the consumer price index (CPI) over the last six months compared with the preceding six months. It enjoys strong support from the social partners and has remained non-negotiable during the collective bargaining process. However, its uniform application does not allow wages to reflect productivity differences across sectors. The shortcomings of the COLA are, first, that wages are connected to product prices only and not to productivity gains. Second, those benefiting most from this system are those with higher incomes (70% of whom have wages that are index-linked via the COLA), whereas most of the lowest-paid

(e.g. unskilled workers) are not covered (only 6% are index-linked by the COLA). Third, the COLA also has a significant impact on public finances as, beyond wages and salaries, it is also an integral feature of pensions, benefits and other allowances.

- (13) While labour participation in Cyprus is higher than the EU average, the labour market displays strong gender imbalances. Gender employment gaps, the cost and availability of childcare facilities (including geographical location and proximity to places of work), the scarcity of flexible forms of employment and the persistently high gender pay gap are acknowledged in the NRP as major bottlenecks hindering employment and growth. While educational attainment at secondary school and university level in Cyprus is high, vocational education and training (VET) does not appear to be an attractive option. High youth unemployment, combined with a high proportion of people with high educational attainment in total unemployment, is a sign of a significant skills mismatch in the Cypriot economy. Also, participation in lifelong learning is low for a country that has generally good educational levels, particularly for certain groups (the low-skilled, older people and the unemployed). To address these issues, the NRP envisages establishing a series of new post-secondary VET institutions from 2012-2013 on. There are also plans to introduce the new apprenticeship system in the same academic year. Overall, the country's strategic objective of shifting from low- to high-productivity jobs would benefit greatly from the reorientation of the education and training system to bring about a better mix of skills to match the labour market demand.
- (14) Cyprus adopted a general law for transposition of the Services Directive in July 2010. However, there are concerns about the completeness and thoroughness of the transposition, as many obstacles to establishment and free provision of services persist in sector-specific legislation, where no amendments have been made. These obstacles range from generally applicable ones, such as authorisations required by local authorities for any business activity or the limited duration of authorisations, irrespective of the field and the risks involved, to very specific ones, such as fixed tariffs applicable to tourism services, economic needs tests and involvement of competitors in the authorisations for car rentals, discriminatory treatment of construction companies from other Member States and bans on architects and engineers exercising their profession as legal persons.
- (15) Overall, environmental constraints and issues connected with resource and energy use could create severe bottlenecks to growth. These are related to its specific geographical location and to the consequences of climate change in the form of severe droughts. The cost-effectiveness of support schemes for renewable energy would need to be assessed. The functioning of the energy sector can be significantly improved in the short term already, by means of market liberalisation, introduction of competition and facilitation of infrastructure investments.
- (16) Cyprus has made a number of commitments under the Euro Plus Pact.⁴ On the fiscal side, the Pact commits the country to strengthen fiscal sustainability by preparing a framework law for dealing with financial crises and setting up a fully independent Financial Stability Fund. Furthermore, a dialogue on restructuring the public pension system is taking place and should be concluded by the end of 2011. Employment

⁴ More details on the commitments made under the Euro Plus Pact can be found in (SEC(2011) 721).

measures are focusing on combating illegal and undeclared work, addressing the skills mismatch and increasing the competitiveness of enterprises. The competitiveness measures cover containing public-sector wages (redesigning the wage indexation mechanism), strengthening the competitiveness of SMEs, finalising the National Digital Strategy by 2011 and promoting energy efficiency and renewable energy sources. These commitments reflect the four areas of the Pact. They provide for continuity of the broader reform agenda outlined in the Stability and National Reform Programmes and confirm the plans already announced to deliver reforms to address the country's structural weaknesses, without at this stage specifying a timeframe to address issues such as the public-sector wages and pension system. These commitments have been assessed and taken into account in the recommendations.

- (17) The Commission has assessed the Stability Programme and National Reform Programme, including Euro Plus Pact commitments⁵. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Cyprus but also their respect of EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. In this light, the Commission considers that more efforts are needed on achieving the 2011 budget deficit target and that additional consolidation measures should be specified for 2012 and beyond. In order to improve the long-term sustainability of public finances, further action on the pension and healthcare system is needed. Further steps should also be taken to strengthen the prudential framework of banking supervision, to adjust the wage-indexation system and to improve vocational education, training and skills, the business environment and energy efficiency.
- (18) In the light of this assessment, also taking into account the Council Recommendation of 13 July 2010 under Article 126(7) of the Treaty on the Functioning of the European Union, the Council has examined the 2011 update of the Stability Programme of Cyprus and its opinion⁶ is reflected in particular in its recommendations (1) and (3) below. Taking into account the European Council conclusions of 25 March 2011, the Council has examined the National Reform Programme of Cyprus,

HEREBY RECOMMENDS that Cyprus should take action within the period 2011-2012 to:

- (1) Adopt the necessary measures of a permanent nature to achieve the correction of the excessive deficit by 2012. Take measures to keep tight control over expenditure and make use of any better-than-expected budgetary developments for faster deficit and debt reduction. Ensure progress towards the Medium Term Objective by at least 0.5% of GDP annually. Accelerate the phasing-in of an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanisms, as from the preparation of the 2012 Budget, as well as Programme and Performance Budgeting.
- (2) Strengthen further the prudential framework for supervision of banks and cooperative credit societies to ensure early detection of risks.

⁵ SEC(2011) 721.

⁶ Foreseen in Article 5(3) of Council Regulation (EC) No 1466/97.

- (3) Improve the long-term sustainability of public finances by implementing reform measures to control pension and healthcare expenditure in order to curb the projected increase in age-related expenditure. For pensions, extend years of contribution, link retirement age with life expectancy, while taking care to address the high at-risk-of-poverty rate for the elderly. For healthcare, take further steps to accelerate implementation of the national health insurance system.
- (4) Reform, in consultation with social partners and in accordance with national practices, the system of wage bargaining and wage indexation to ensure that wage growth better reflects developments in labour productivity and competitiveness.
- (5) Take further steps, within the reforms planned for the vocational education and training system, to match education outcomes to labour market needs better, notably by setting up a post-secondary vocational education and training institute. Take measures to increase the effectiveness of the vocational training system by increasing the incentives for and improving access to vocational education and training, especially for the low-skilled, women and older workers.
- (6) Abolish remaining obstacles to the establishment and free provision of services in sector-specific legislation by October 2011 in order to create more opportunities for growth and jobs in the services sector.
- (7) Introduce measures to increase competition in network services by allowing greater freedom to set prices. Establish, by 2012, a water management plan and a price-setting scheme reflecting cost efficiency and equity concerns in order to ensure more sustainable management of water resources.

Done at Brussels,

*For the Council
The President*