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COVER NOTE

From: Secretary-General of the European Commission,
signed by Mr Jordi AYET PUIGARNAU, Director

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To: Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of
the European Union

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Subject: Recommendation for a COUNCIL RECOMMENDATION on the 2016
national reform programme of Cyprus and delivering a Council opinion on
the 2016 stability programme of Cyprus

Delegations will find attached document COM(2016) 333 final.

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COM(2016) 333 final

Recommendation for a

COUNCIL RECOMMENDATION

on the 2016 national reform programme of Cyprus

and delivering a Council opinion on the 2016 stability programme of Cyprus

Recommendation for a

COUNCIL RECOMMENDATION

on the 2016 national reform programme of Cyprus

and delivering a Council opinion on the 2016 stability programme of Cyprus

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(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances², and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission³,

Having regard to the resolutions of the European Parliament⁴,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

- (1) Cyprus was subject to a macroeconomic adjustment programme until 31 March 2016 in line with Article 1(2) of Council Implementing Decision 2013/463/EU⁵. Under

¹ OJ L 209, 2.8.1997, p. 1.

² OJ L 306, 23.11.2011, p. 25.

³ COM(2016) 333 final.

⁴ P8_TA(2016)0058, P8_TA(2016)0059, and P8_TA(2016)0060.

Article 12 of Regulation (EU) No 472/2013 of the European Parliament and of the Council⁶, Cyprus was exempt from the monitoring and assessment of the European Semester for economic policy coordination for the duration of the programme. Having exited the programme, Cyprus is now fully re-integrated into the European Semester.

- (2) On 26 November 2015, the Commission adopted the Annual Growth Survey⁷, marking the start of the 2016 European Semester of economic policy coordination. The priorities of the Annual Growth Survey were endorsed by the European Council on 17-18 March 2016. On 26 November 2015, on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report⁸, in which it indicated that the situation of Cyprus will be assessed in the context of the macroeconomic imbalances procedure after the conclusion of the macroeconomic adjustment programme. On the same day, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area⁹. This recommendation was endorsed by the European Council on 18-19 February 2016 and adopted by the Council on 8 March 2016. As a country whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Cyprus should ensure the full and timely implementation of the recommendation.
- (3) The 2016 country report for Cyprus¹⁰ was published on 7 April 2016. It assessed Cyprus' economic and social situation and challenges following its exit from the macroeconomic adjustment programme on 31 March 2016, and Cyprus' progress towards its national Europe 2020 targets. It also included the in-depth review under Article 5 of Regulation (EU) No 1176/2011. On 7 April 2016, the Commission presented the results of the in-depth review.¹¹ The Commission's analysis leads it to conclude that Cyprus is experiencing excessive macroeconomic imbalances. In particular, it is essential that it tackles the large stock of imbalances in the form of private, public and external debt overhang, and the high level of non-performing loans.
- (4) On 28 April 2016, Cyprus submitted its 2016 national reform programme, and on 13 May 2016, after the deadline, its 2016 stability programme. To take account of their interlinkages, the two programmes have been assessed at the same time.
- (5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013, where it is necessary to support the implementation of relevant Council recommendations, the

⁵ Council Implementing Decision 2013/463/EU of 13 September 2013 on approving the macroeconomic adjustment programme for Cyprus and repealing Decision 2013/236/EU (OJ L 250, 20.9.2013, p. 40).

⁶ Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability (OJ L 140, 27.5.2013, p. 1).

⁷ COM(2015) 690 final.

⁸ COM(2015) 691 final.

⁹ COM(2015) 692 final.

¹⁰ SWD(2016) 120 final.

¹¹ COM(2016) 95 final.

Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of this provision in guidelines on the application of the measures linking effectiveness of the European Structural and Investment Funds to sound economic governance¹².

- (6) [Following the abrogation of the excessive deficit procedure, Cyprus is in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule.] Based on the Commission 2016 spring forecast, the medium-term budgetary objective is expected to be met in 2016. However, under unchanged policies, there is a risk of some deviation from the medium-term budgetary objective in 2017. Cyprus' structural balance is projected to deteriorate more than what is allowed under the transitional debt rule. Based on its assessment of the stability programme and taking into account the Commission 2016 spring forecast, the Council is of the opinion that there is a risk that Cyprus will not comply with the provisions of the Stability and Growth Pact. Therefore, further measures will be needed to ensure compliance in 2017.
- (7) Cyprus has implemented important fiscal-structural reforms under its macroeconomic adjustment programme. Certain pieces of secondary legislation have still to be adopted as regards the procedures for budget preparation, requirements for within-year budgetary adjustments and the responsibilities of commitment control officers. The public sector is still characterised by inefficiencies. In particular, the public administration is marked by one of the highest wage bills (as a percentage of GDP) in the euro area, while efficiency indicators remain average and can be traced to the lack of mobility and performance incentives. State-provided utilities (telecommunications, energy) are marked by high prices and are still relatively shielded from competition. Under the programme, Cyprus has committed itself to adopting a binding mechanism for limiting wage increases for public employees as a means of guaranteeing the long-term sustainability of public finances. While the draft law has been prepared and submitted to the House of Representatives, it is still awaiting adoption. Under the programme, a horizontal reform of the public administration, a reform plan of local governments and a new law on the governance of state-owned entities have been put forward to improve the efficiency of the public sector, but have not yet been adopted.
- (8) Private sector debt in Cyprus remains excessive. While the reformed foreclosure and insolvency frameworks constitute an important step towards balancing the rights of borrowers and creditors, there is scope for improving their efficiency and extending their use. A number of deficiencies in the functioning of these frameworks hamper putting private debt on a sustainable downward path and a faster reduction of non-performing loans. This also weighs on the capacity to offer second opportunities to entrepreneurs. A number of deficiencies also remain in the functioning of private sector debt restructuring solutions. Furthermore, the adoption of all necessary regulations and rules of Court is important for the effective implementation of the insolvency legislation. To be fully operational, the Insolvency Service needs appropriate staffing, IT infrastructure and a sufficient number of properly trained and licensed insolvency practitioners. Furthermore, reliable and swift systems for the

¹²

COM(2014) 494 final.

issuance and transfer of title deeds are crucial to avoid backlogs and to provide purchasers with safeguards, ensuring the proper determining of property rights and contributing to the return of confidence in the housing market.

- (9) Cyprus also faces critical challenges as regards the functioning of the judicial system. Inefficient court procedures and limited capacity lead to significant delays in processing court cases, which hamper the functioning of the foreclosure and insolvency framework and weaken the business environment in general. In the absence of a reform of the civil procedure law, the processing and enforcement of court decisions and the reduction of backlogs remain slow.
- (10) Significant progress has been made under the programme to restructure and restore confidence in the Cypriot financial system. However, Cyprus still faces the challenge of restoring normal lending to the economy and reducing non-performing loans, which stand at around 55% of total loans to households and non-financial corporations. High corporate debt makes businesses less competitive and weighs on their capacity to invest and grow. Banks' efforts to restructure the debt of viable borrowers have not yet shown tangible results, while the provisioning of their non-performing exposure remains relatively moderate. Weaknesses in contract enforcement and the repayment discipline weigh on the capacity to tackle strategic defaults and to stem the formation of non-performing loans. Banks also have limited access to information on borrowers' income and assets, despite the creation of the credit registry.
- (11) Cyprus has come a long way in steering the economy out of recession, but investment remains low and the growth potential of the economy is subdued. Under the programme, Cyprus adopted an action plan for growth, which was aimed at improving competition, enhancing incentives to innovation and facilitating investment by creating a more transparent and efficient environment for conducting business and easing licensing and permit procedures. The implementation of the privatisation plan and the strengthening of national regulatory authorities aim at attracting productivity-enhancing foreign investment. Start-ups and SMEs currently have very limited options for access to finance, amid tight bank credit conditions and the lack of alternative sources of financing. Access to finance is also hampered by a lack of coordination in the management of EU instruments such as the European Structural and Investment Funds, the European Fund for Strategic Investments and EU competitive programmes.
- (12) The labour market started recovering in 2015, but unemployment remains high. In particular, youth and long-term unemployment are a source of concern. Some measures have been taken in the areas of active labour market policies and public employment services. However, the latter still lack the capacity to meet demand, to deliver quality job-search assistance and counselling and to reach out to the non-registered unemployed. Plans to strengthen the administrative capacity of the public employment services, including specialisation of and an increase in the number of counsellors directly serving customers' needs, have been delayed. The effectiveness of active labour market policies is limited by the lack of effective monitoring of the quality of current programmes.
- (13) Participation of young people in vocational education and training remains low and is characterised by a lack of employer engagement in the education of students.

However, measures are currently being implemented, in line with the strategy on vocational education and training.

- (14) Cyprus lacks universal healthcare coverage and its healthcare system fails to provide adequate and effective access to care. With low public funding for healthcare, unmet needs – due to cost as well as out-of-pocket payments – are significantly higher than in other EU countries. There is scope for improving efficiency in the use of resources. More autonomy for public hospitals and the creation of a national health system are among the measures that have been considered relevant, but not yet adopted, to improve the adequacy and cost-effectiveness of the Cypriot health system.
- (15) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Cyprus's economic policy and published it in the 2016 country report. It has also assessed the stability programme and the national reform programme of Cyprus. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Cyprus but also their compliance with EU rules and guidance, given the need to strengthen the EU's overall economic governance by providing EU-level input into future national decisions. The recommendations under the European Semester are reflected in recommendations 1 to 5 below.
- (16) In the light of this assessment, the Council has examined the stability programme and its opinion¹³ is reflected in particular in recommendation 1 below.
- (17) In the light of the Commission's in-depth review and this assessment, the Council has examined the national reform programme and the stability programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 to 5 below,

HEREBY RECOMMENDS that Cyprus take action in 2016 and 2017 to:

1. Following the correction of the excessive deficit, respect the medium-term budgetary objective in 2016 and in 2017. By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public employees. By the end of 2016, adopt the horizontal reform of the public administration and the law on the governance of state-owned entities, and implement the reform of local governments. By the end of 2016, adopt the secondary legislation to complete the new budgetary framework.
2. By June 2017, eliminate impediments to the full implementation of the insolvency and foreclosure frameworks and ensure adequate resources for the Insolvency Service. Ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. Increase the efficiency and capacity of the court system. Reform the civil procedure law.
3. By the end of 2016, take measures to ensure a decline in non-performing loans and accurate valuations of collateral for provisioning purposes. Increase the range of information available for creditors to make the credit registry fully operational.

¹³ Under Article 5(2) of Council Regulation (EC) No 1466/97.

4. Remove impediments to investment, notably by implementing the action plan for growth, pursuing the privatisation plan and strengthening the national regulatory authorities. Take measures to increase access to finance for small and medium-sized enterprises.
5. Enhance the capacity of the public employment services and their provision to the long-term unemployed; improve outreach to the non-registered unemployed. Adopt legislation for a hospital reform and advance with the planned implementation of universal health care coverage.

Done at Brussels,

*For the Council
The President*