

Cyprus: Policy Recommendations provided by the EU and the IMF from 2006 to 2011

This document presents the policy recommendations provided to Cyprus by the **EU** and the **IMF** before it requested the financial assistance programme.

- Before the setup of the European Semester, country specific recommendations were issued by the **Council** or by the **Commission** in line with the Broad Economic Policy Guidelines (BEPGs), or with the Employment Guidelines (EGs), or with the Integrated Guidelines (since 2005).
- The **IMF** regularly carries a surveillance exercise according to its [Article IV](#) consultation. The IMF Executive Board of Directors discusses the outcomes and proposes recommendations. This document presents extracts of the conclusions.
- The text of the recommendations has been rearranged with the aim of facilitating comparison over time, and bold format has been added to emphasize the main issues addressed in the recommendations.
- The outcomes of a research on recommendations to Cyprus concerning the financial sector made by **ESRB, EBA and the ECB** did not provide results. The ECB (on request by Cyprus) published the following opinions:
 - [Opinion 2011/29](#) on a special tax on banks and on the setting up of an independent financial stability fund
 - [Opinion 2011/93](#) on the management of financial crises and the setting up of an independent financial stability fund
 - [Opinion 2012/50](#) on the recapitalisation of the Cyprus Popular Bank

Recommendations to Cyprus by the Commission and the Council between 2006 and 2011

	2006 <u>Implementing the renewed Lisbon Strategy.</u> <i>See p. 80</i>	2007 <u>Strategic Report Country – Assessment of the NRPs</u> <i>See p. 15</i>	2008 <u>Council Country-Specific Recommendations</u> <i>See p. 28</i>	2009 <u>Council update of the 2008 Recommendations</u> <i>See p. 13</i>	2010 <u>COM - surveillance of intra-euro competitiveness and imbalances</u> <i>See p. 95-96</i>	2011 <u>Council Recommendations</u>
Public Finances	1. Take steps to implement reforms of the pension and health care systems and sets a timetable for their implementation with a view to improving long-term sustainability.	1. Take steps to implement reforms of the pension and health care systems and sets a timetable for their implementation with a view to improving fiscal sustainability.	1. Take steps to implement reforms of the pension and health care systems and set a timetable for their implementation with a view to improving fiscal sustainability	1. Take steps to implement reforms of the pension and health care systems and set a timetable for their implementation with a view to improving fiscal sustainability	Given the country's high current account deficit, prudent fiscal policies are crucial... controlling current primary expenditure , ..., would be paramount. Social support measures should be targeted to reach those in real need, in order to strengthen social cohesion without jeopardising the country's fiscal position. Efficiency in the use of public resources should also be improved through a restructuring of public expenditures towards growth-enhancing areas. In particular, public expenditure could become more productive through a reallocation towards public investment in knowledge, human and physical capital. This would increase the attractiveness of the country to business activities with higher technological content and added value.	1. Adopt the necessary measures of a permanent nature to achieve the budgetary target in 2011 and the correction of the excessive deficit by 2012, in line with the Council recommendations under the EDP. 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 and bring the public debt ratio on a downward path . 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 Adopt the necessary measures of a permanent nature to achieve the budgetary target in 2011 and the correction of the excessive deficit. The programme and performance budgeting should be implemented as soon as possible. 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...

	2006	2007	2008	2009	2010	2011
Labour Market Policies	<p>2. Enhance life-long learning, and increase employment and training opportunities for young people by accelerating the reforms of the vocational, education, training and apprenticeship system.</p>	<p>2. Enhance life-long learning, and increase employment and training opportunities for young people by implementing the reforms of the vocational, education, training and apprenticeship system.</p>	<p>2. Enhance life-long learning, and further increase employment and training opportunities for young people by implementing the recently approved Life Long Learning National Strategy and by implementing the reforms of the vocational, education, training and apprenticeship system, including the New Modern Apprenticeship Scheme.</p>	<p>2. Continue with the efforts to expand lifelong learning opportunities, especially for the low skilled, unemployed and disadvantaged groups by proceeding further with the implementation of actions within the approved Lifelong Learning National Strategy, including the reforms of the vocational, education, training and the New Modern Apprenticeship Scheme.</p>	<p>Restoring the link of wages to developments in productivity and ... ensure that labour market institutions do not unduly impede the efficiency of the wage-setting process.</p> <p>Improve the participation of female and older-age workers.</p> <p>Reforms to improve the human capital of the labour force for market services would appear particularly appropriate.</p>	<p>4. Take steps to 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.</p> <p>5. Take further steps, within the reforms planned for the vocational education and training system, to match education outcomes to labour market needs better, including by setting up post-secondary vocational education and training institutes. 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 low-skilled workers, women and older workers.</p>

	2006	2007	2008	2009	2010	2011
Competitiveness and environmental policies						<p>6. Abolish remaining obstacles to the establishment and free provision of services in sector-specific legislation by December 2011 in order to create more opportunities for growth and jobs in the services sector.</p> <p>7. Introduce measures to increase the diversity of the energy mix and the expansion of renewable energy sources. 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.</p>
Financial Markets						<p>2. Strengthen further the prudential framework for supervision of banks and cooperative credit societies to ensure early detection of risks.</p>

IMF Recommendations to Cyprus between 2006 and 2011

	<u>2006</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Public Finances	<p>Directors ... encouraged the authorities to remain ambitious in their fiscal adjustment efforts to safeguard against inflation risks by observing spending limits, avoiding supplementary budgets and saving any higher-than-envisaged revenues...</p> <p>Implement pension reforms that would allow the social security system to deal with adverse demographic trends, .. need to avert rising health care costs when the National Health Insurance System is introduced in 2008 and encouraged the authorities to consider adequate incentives to this end, such as user fees.</p>	<p>...fiscal adjustment should rely on reducing public consumption, particularly the wage bill, and on broader public administration reforms.</p> <p>... temporary stimulus measures should be allowed to expire once the recovery sets in, and the social support measures should be carefully targeted to the needy. ... A few Directors considered that additional pension reforms may be necessary in future, including raising the retirement age and better aligning public and private benefits.</p> <p>Directors recommended the adoption of a medium-term budget framework and more effective management of public sector liabilities. The government's recent initiative in this area could be further enhanced by monitoring contingent liabilities and minimizing the possibility of moral hazard and adverse selection in public sector aid programs.</p>	<p>Returning the economy to its potential growth depends critically on a credible fiscal consolidation, continued market confidence in the financial sector, and structural reforms to improve competitiveness and the business climate.</p> <p>...the immediate policy challenge is to reverse the large structural fiscal deficit following the sizeable stimulus in 2009, with a view to preserving debt sustainability and creating fiscal space to guard against financial sector risks.....</p> <p>Containing the wage bill and better targeting social transfers were seen as important elements. More fundamental reforms of the pension system would also be needed to lessen the burden on public finances, through lower replacement rates and higher retirement age.</p>	<p>Executive Directors noted that Cyprus faces daunting economic challenges in the face of faltering external demand, growing exposure to the turmoil in the euro area, particularly in Greece, and worsening domestic financial conditions. Directors thus urged the authorities to act forcefully and ...supported the authorities' plans to achieve fiscal balance over the next three years as an appropriate strategy for undertaking the necessary fiscal correction... without unduly damaging growth prospects. Directors considered that front-loading the adjustment with measures to reverse recent increases in public sector wages and poorly targeted transfers would provide a credible signal of the authorities' commitment to medium-term consolidation and bolster investor confidence. Reforms of the cost-of-living allowance system would also be important for achieving the fiscal targets and improving real wage flexibility and competitiveness.</p> <p>Directors underscored the importance of other fiscal reforms to underpin the consolidation efforts. Priorities should include the introduction of a medium-term budget framework and the adoption of fiscal rules consistent with EU directives. Directors also highlighted the need for reforming the national pension and healthcare systems, which threaten to put unsustainable pressures on the budget as the population ages.</p>

	2006	2009	2010	2011
Labour market and competitiveness policies	<p>Directors stressed the importance of safeguarding external competitiveness to sustain economic growth. While recognizing that the current wage-setting process has helped smoothen labour relations, Directors concurred that continued high real wage increases point to the need to move towards a mechanism that would better align real wage increases with productivity developments.</p> <p>Directors welcomed progress in opening the telecommunications and energy sectors, and saw scope for further progress to enhance competition in these markets...</p>	<p>Directors underlined the importance of improving competitiveness to assist the recovery and support external viability. They encouraged the authorities to reverse the deterioration in productivity and unit labor costs by implementing the broad-ranging National Reform Program, including cutting red tape, streamlining the bureaucracy, and implementing other structural reforms. Directors supported eliminating the automatic wage indexation mechanism (COLA) or mitigating its impact through productivity improvements and better targeting.</p>	<p>In light of the still large current account deficit, Directors stressed that structural reforms aimed at boosting competitiveness would be crucial for supporting the recovery and enhancing growth potential. Key priorities include restraining public sector wages and employment to free resources for the private sector, and phasing out the wage indexation system to allow wages to reflect productivity gains. Active labour market policies, aimed particularly at addressing skill mismatches, should help reduce unemployment.</p>	

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Financial markets	<p>.. the financial sector, Directors noted that commercial banks are profitable and well capitalized. Nonetheless, non-performing loans, while declining, remain high. Rapid credit growth and brisk house price increases could become sources of risk, and the authorities should stand ready to take appropriate measures if the pace of credit growth does not abate and risks increase. Directors welcomed improvements in financial sector supervision, while encouraging steps to consolidate the supervision of commercial banks and cooperative credit institutions. Irrespective of the institutional framework, supervisors should have clear responsibilities and objectives, operational independence, professional staff, and adequate resources. Directors encouraged the early adoption of legislation and regulations to accelerate the lengthy foreclosure process and welcomed the authorities' intention of completing a Financial Sector Assessment Program in time for the next Article IV consultation.</p>	<p>... given the size and concentration of the financial sector, ... problems can potentially become systemic, underscoring the importance of early detection of risks and intervention to preserve financial sector stability. .. the Central Bank of Cyprus (CBC) to enhance monitoring of banks' funding, cross-border exposures, and counterparty risk management. With the potential for a further deterioration in asset quality, the CBC should require higher capital buffers, particularly from systemically-important banks. ... supervision and the safety net be further improved over the medium term ..</p> <p>Cyprus' reputation as a financial centre relies on continued effective supervision by an independent and accountable central bank... a single supervisor for all credit institutions and a more integrated supervisory structure in the CBC should be considered. The stress-testing framework should be enhanced and supervisory and financial stability resources bolstered. ...</p>	<p>Directors observed that the banking sector remains sound and retains a capacity to absorb further shocks, as suggested by stress test results, including those conducted in the context of the EU-wide exercise. However, risks have risen significantly both in Cyprus and in the region. In light of the relatively large size and external exposure of Cyprus' financial sector, these risks call for continued vigilance, close cooperation with foreign supervisors, and an enhanced framework for crisis management and contingency planning, including for cross-border banks. Consideration could be given to enlarging the deposit insurance facility. Directors also highlighted the urgency of strengthening the supervision and transparency of cooperative credit societies. The recent modification of the definition of nonperforming loans for cooperative credit societies was a welcome step toward aligning it to the norm in place for commercial banks. Directors encouraged further progress in creating a level playing field in the financial sector.</p>	<p>Directors expressed concern about the vulnerabilities arising from Cyprus's large banking sector and the possibility of adverse feedback loops with the public finances and the real economy in the context of weakening balance sheets. They stressed the importance of building prudent capital buffers and of ensuring adequate liquidity in the financial system. These actions should be supported by contingency planning and the immediate passage of legislation to provide the authorities with full powers to recapitalize or resolve banks, if necessary. Cooperative credit institutions should also be watched closely and brought under the same regulatory and supervisory frameworks as banks.</p>

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