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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Cyprus

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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 Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU) Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) On 13 July 2010, the Council decided, in accordance with Article 126(6) TFEU that an excessive deficit existed in Cyprus[1] and issued a Recommendation to correct the excessive deficit by 2012 at the latest, in accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

(4) On 27 January 2011, the Commission concluded in a Communication to the Council that Cyprus had taken effective action in compliance with the Council recommendation of 13 July 2010 to bring its government deficit below the 3% of GDP reference value and considered that no additional steps under the excessive deficit procedure were necessary.

(5) On 11 January 2012, the Commission confirmed in a second Communication to the Council that Cyprus had taken effective action in compliance with the Council recommendation of 13 July 2010 to bring its government deficit below the 3% of GDP reference value and considered that no additional steps under the excessive deficit procedure were necessary.

[1] OJ L 186, 20.07. 2012, p. 30.

(6) According to Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occured after the adoption of the initial recommendation. The occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation.

(7) In accordance with Article 126(7) of the TFEU and Article 3 of Council Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(8) On the basis of an in-depth review of the nature, origin, and severity of macroeconomic developments in Cyprus, the Commission concluded in May 2012 that Cyprus was experiencing very serious imbalances, in particular as regards the external position, public finances, and the financial sector, which needed to be urgently addressed. The situation in the Cypriot banking sector was seen to threaten the sustainability of the country's position. On the external side, the current account balance exhibited sizeable and persistent decifits, linked to a gradual erosion of price/cost competitiveness, while the international investment position was found to be a cause for concern. Moreover, the situation in the Cypriot banking sector was seen to threaten the sustainability of the country's position. On the internal side, the highly leveraged private sector, with the outstanding debt level of non-financial corporations and very high household indebtedness were a source of concern. In addition, government finances have swung to annual deficits and widened even as the economy recovered from recession, with recent efforts to correct the excessive deficit found to possibly not be sufficient. The public debt has progressively been above the Treaty-based threshold and was expected to increase sharply.

(9) On 10 July 2012, the Council addressed country-specific recommendations to Cyprus based, inter alia, on the assessment of Cyprus's national reform programme and Cyprus's stability programme covering the period 2012-15. The first recommendation calls for the rigorous implementation of the budgetary strategy in 2013 and beyond. It also calls for an acceleration of the phase-in of an enforcable multianuual budgetary framework with a binding staturory basis and corrective mechanism. This framework should be reinforced also by the implementation of programme and performance budgeting. Given the inefficiencies in the tax administration and the tax collection, measures improving tax compliance and combating tax evasion need to be adopted.

(10) In view of increasingly severe economic and financial conditions, the Cypriot authorities officially requested financial assistance under the terms of a loan by the European Financial Stability Facility / European Stability Mechanism (ESM) on 25 June 2012, as well as from the International Monetary Fund (IMF), with a view to

supporting the return of the economy to sustainable growth, ensuring a properly-functioning banking system and safeguarding financial stability in the European Union and in the euro area. On 27 June 2012, the Eurogroup invited the Commission, in liaison with the ECB, the Cypriot authorities, and the IMF to agree on a macroeconomic adjustment programme, including the financing needs, and to take appropriate action to safeguard financial stability in the very challenging environment with a risk of spill-over effects from sovereign market turbulence. On 16 March and 25 March 2013, the Eurogroup reached a political agreement with Cyprus on a financial assistance and the key elements of a programme. On 12 April 2013, the Eurogroup considered that the necessary elements of the macroeconomic adjustment programme were in place to launch the relevant national procedures for the formal approval of the ESM financial assistance facility. On 25 April 2013, the Council adopted a decision under Article 136 TFEU containing the main elements of the macroeconomic adjustment programme to be implemented by Cyprus. On 26 April 2013, a Memorandum of Understanding consistent with the said decision was signed by the Cypriot authorities and the Commission, acting on behalf of the ESM.

(11) More than a decade of sustained and strong economic expansion in Cyprus came to an end in 2009. Economic activity fell by 1¾%, with weak domestic demand and an adverse external environment weighing strongly on growth. Economic activity recovered in 2010 with real GDP growth of 1.1% and a growth of 1.5% was recorded in the first half of 2011. According to the Commission services’ 2010 Spring Forecast, which was underlying the Council recommendation under Article 126(7) TFEU of 13 July 2010, the Cypriot economy was expected to grow by 1.3% in 2011. Despite a very good tourist season in 2011, the recovery suffered a setback from the grave accident in July 2011 that destroyed the Vasilico electricity producing plant, accounting for half of total generating capacity. Moreover, the unwinding of very serious private and public sector imbalances in the Cypriot economy resulted in tightening financial and fiscal conditions, which compounded the negative effect on economic activity, caused a high degree of economic uncertainty and exacerbated the deterioration in labour market conditions. The continued weakness of the international environment prevented external demand from offsetting the impact on domestic demand. As a result, 2011 annual economic growth turned out at 0.5%, close to one percentage point below the Commission forecast at the time of the Council Recommendation. 2012 was beyond the forecast horizon at the time of the Commision forecast underlying the Council recommendation. However, under the hypothesis of a gradual closure of the negative output gap, higher growth than in 2011 was expected for 2012. According the latest Commission services' forecast, real GDP growth is expected to be -2.4% in 2012.

(12) The general government deficit reached 6.3% of GDP in 2011, increasing from 5.3% in 2010. The worsening of the budget balance took place in spite of the fiscal consolidation measures in the 2011 Budget Law and three sets of further deficit-reducing measures adopted over the course of 2011, which were insufficient to stem the deterioration of public finances. The abovementioned series of economic events, notably the unwinding of very serious private and public sector imbalances in the Cypriot economy, form the background of the developments in public finances, including non-negligible growth composition effects and higher debt financing cost implied by loss of access to longer-term market financing.

(13) According to the Commission services' most recent forecast, the general government deficit is projected to reach 6.3% of GDP in 2012. This projected deficit outturn is significantly worse than previous Commission services' forecasts, in particular due to a significant shortfall of both indirect and direct tax revenues (mostly due to VAT, corporate taxation and social contributions) and higher expenditures due to increasing unemployment and higher-than-expected early retirement. Compared to the Commission services' 2013 Winter Forecast, the 2012 deficit was adjusted upwards by around ½% of GDP due to an one-off expenditure relating to insurance costs from the explostion at the Vasilico electricity producting plant in July 2011, payable in a period of four years but booked fully in 2012, as well as the recording of a capital transfer for the capitalised interest payment on the recapitalisation bond for Cyprus Popular Bank.

(14) According to the Commission services' most recent economic forecast, the structural deficit was 5.7% and 6.6% of GDP in 2010 and 2011 respectively. It is expected to reach 6.6% of GDP in 2012. The Commission services' forecast underlying the Council Recommendation in July 2010 pointed to an expected average potential growth of around 1% over the adjustment period. Under the Commission services' most recent economic forecast, the average potential output for the years 2011-2012 is now considered to be negative (around -0.5%) and is estimated to remain negative over 2013-2016. Correcting for the downward revision of the potential output since the Council Recommendation, the average fiscal effort over 2011-2012 would be around 0.5%. However, the estimated change in the structural balance was also severely affected by unexpected revenue shortfalls, due to lower-than-projected final domestic demand and lower imports, as well as the stronger deterioration in the labour market. This led to major revenue shortfalls, notably in indirect taxes. Taking these effects into account, the overall adjusted fiscal effort is estimated at around 2.4% of GDP on average, well above the required average annual fiscal effort over 2011-2012 of at least 1½% of GDP recommended by the Council. Cyprus can therefore be considered to have taken effective action in line with the Council Recommendation.

(15) The 2012 Budget Law adopted on 16 December 2011 incorporated an expenditure-driven consolidation strategy consisting of mainly (i) contributions from public sector employees to their pensions combined with a freeze of emoluments in the broader public sector for two years (ii) inclusion of new public sector employees in the general pension scheme under the social security fund instead of in the more generous public sector pension scheme, (iii) a better targeting of social transfers, iv) cuts in selected government expenditure categories, (v) a hike of the VAT rate from 15% to 17%, (vi) a temporary contribution on gross earnings of private sector employees and pensioners and (vii) an increase in the tax rate on deemed dividend distribution. The aforementioned fiscal projections include also consolidation measures taken by the Cypriot authorities for the remaining part of 2012 after a provisional agreement with programme partners on fiscal policies in November 2012, in particular a scale reduction in emoluments of public and broader public sector pensioners and employees sector. In sum, Cyprus adopted consolidation measures in 2011-2012 with an estimated direct deficit-reducing impact of more than 5½% of GDP. This bottom-up assessment of the fiscal consolidation measures taken in the years 2011-2012 confirms the conclusion that effective action has been taken by Cyprus.

(16) Gross public debt rose to 71.1% of GDP in 2011, compared to 67.6% of GDP projected in the Commission services' 2010 Spring Forecast underlying the Council recommendation under Article 126(7) TFEU of 13 July 2010. Debt developments

were mostly driven by the higher-than-expected deficit outcomes, lower-than-expected growth, and Cyprus's difficulties in accessing international markets to cover its financing needs, which resulted in increases in the borrowing costs. These factors, together with the government's participation in the recapitalisation of one commercial bank in June 2012, led to an increase in the general government debt to about 85.8% of GDP in 2012. In the next years, the government debt will inevitably increase further, reflecting the weak growth and substantial fiscal financing needs. In 2013-14, the government debt will increase further upon receipt of the financial assistance. The debt-to-GDP ratio is forecast to peak at around 128% of GDP in 2015 before declining thereafter on the back of sustainable primary surpluses and the return to positive real GDP growth rates.

(17) Considering all these factors and in particular the substantial deterioration in the budgetary position resulting from the worse-than-expected economic downturn and the weaker overall position of the economy than envisaged at the time of the original Council recommendation under Article 126(7) TFEU implies that a new deadline for correction of the excessive deficit by Cyprus is warranted. Granting four additional years for the correction of the excessive deficit is necessary in view of the projected distance to the 3% of GDP reference value at end-2012 and the adverse macro-economic circumstances.

(18) Under the Commission services' most recent economic forecast for nominal GDP growth, the primary general government balance is projected to attain a deficit of 2.4 % of GDP in 2013, a deficit of 4.3 % of GDP in 2014, a deficit of 2.1 % of GDP in 2015 and a surplus of 1.2% of GDP in 2016, while the headline general government deficit is projected to reach 6.5% of GDP for 2013, 8.4% of GDP for 2014, 6.3% of GDP for 2015 and 2.9% of GDP in 2016. For monitoring purposes, and in view of the limited control of the Cypriot authorities over interest payments, the macroeconomic adjustment programme to be implemented by Cyprus sets primary balance fiscal targets.

(19) In order to ensure a sustainable correction of the excessive deficit, the appropriate adjustment path shall be established and evaluated on the basis of an overall assessment with the structural balance as the reference and with a minimum annual improvement in the structural balance of at least 0.5 % of GDP as a benchmark. Fully-specified consolidation measures of about 4¾% of GDP in 2013 are projected to result in an improvement in the structural fiscal balance of around 1.3% of GDP in 2013. For 2014, the adopted consolidation measures amount to around 1¾% of GDP and are estimated to improve the structural balance by 0.3% of GDP in 2014while the improvement of the structural balance is estimated at 0.7% of GDP in 2015 and 1.8% of GDP in 2016.

(20) The adjustment for 2013-16 contains measures to reduce the growth in expenditure mainly on the public sector wage bill and social benefits, and to increase revenue in partiuclar by increasing VAT rates, excise duties, tax rate on interest income, property and corporate taxation. Fiscal consolidation should be maintained over the medium term by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures.

(21) In light of the substantial additional consolidation in 2013 and the adverse and highly uncertain macroeconomic conditions, inter alia due to the imposition of temporary

capital controls, loss of confidence and financial sector instability, an ex-ante obligation of further fiscal consolidation measures for 2014 (additional to the measures adopted in December 2012 with effect from 1 January 2014) was not considered appropriate. However, an obligation of the Cypriot authorities to stand ready to preserve the programme objectives by taking additonal measures in the event of underperformance of revenues or higher social spending, taking into account adverse macroeconomic effects, is laid down in the economic and financial adjustment programme.

(22) In 2014, the structural balance is estimated to improve by 0.3% of GDP on the basis of agreed fiscal consolidation measures that have remained unchanged compared to those that were laid down in the November 2012 draft MoU. The estimated structural effort in 2014 is therefore, based on the most recent Commission services' forecast, slightly below the minimum annual improvement in the structual balance of at least 0.5% of GDP as a benchmark. This level of improvement should nevertheless be considered acceptable in the current exceptional situation of highly uncertain macroeconomic conditions with significant shifts in actual and estimated potential output, structural balance estimates being more uncertain and subject to variation over time than under more stable macroeconomic conditions. The Commission services' Winter 2013 forecast took into account the consolidation measures for 2014 and indicated an improvement in the structural balance from 2013 to 2014 of around 1.4% of GDP. The lower improvement of the structural balance in 2014 now estimated – in spite of an unchanged set of consolidation measures – can be explained by (i) the deterioration of the tax base of the 2013 revenue measures, which implies that some of these measures are projected to have a decreasing impact in 2014; (ii) the downward revision of the impact of some of the consolidation measures already taken for 2014 due to the worse macroeconomic conditions throughout the programme period; (iii) a projected reduction of revenue collection in 2014 of some tax measures, the revenue of which (e.g. collection of income taxation and VAT) depends on economic activity of 2013 and (iv) the fact that the standard elasticity used to determine the split between the cyclical component and the structural balance may lead to underestimating the true underlying fiscal effort. A bottom-up view of discretionary consolidation measures, item-by-item, is an important element of an assessment of the fiscal policy stance. It may, in particular under highly uncertain macroeconomic conditions, give a useful complementary view of the true underlying fiscal effort. The amount of fiscal consolidation measures is on average above 3% of GDP for the years 2013-2014. Albeit significant, the corresponding improvement in the structural balance is only around ¾% of GDP on average.

(23) Monitoring of progress on implementation of Cyprus's EDP commitments will be carried out at regular intervals. In the event of underperformance of revenues or higher social spending needs, Cyprus should stand ready to take additional measures to preserve the attainment of fiscal targets.

(24) Cyprus fulfils the conditions for the extension of the deadline for correcting the excessive general government deficit as laid out in Article 3(5) of Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure,

HAS ADOPTED THIS RECOMMENDATION:

(1) Cyprus should put an end to the present excessive budget deficit situation by 2016.

(2) In order to bring the headline government deficit below the 3% of GDP reference value by 2016, Cyprus should achievethe headline general government deficit targets of 6.5% of GDP in 2013, 8.4% of GDP in 2014, 6.3% of GDP in 2015, and 2.9% of GDP in 2016.

(3) To this end, Cyprus should rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which should amount to at least EUR 351 million in 2013. Cyprus should fully implement the fiscal measures for 2014 that were adopted in December 2012, amounting to at least 270 million EUR in 2014. Cyprus should monitor the budgetary effect of consolidation measures taken on a monthly basis and stand ready to preserve fiscal targets by taking additional measures in the event of underperformance of revenues or higher social spending, taking into account macroeconomic circumstances.

(4) Cyprus should maintain fiscal consolidation over the medium term, converging towards its medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures.

(5) The Council establishes the deadline of 3 months for the Cypriot authorities to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Beyond the report foreseen in recommendation (5) and also in parallel to the financial adjustment programme, Cyprus should report on progress made in the implementation of these recommendations every three months as well as in a separate chapter in the stability programme, until full correction of the excessive deficit has taken place.

This Recommendation is addressed to the Republic of Cyprus.

Done at Brussels,

For the Council
The President