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May 23, 2022

**Statement by Mr. Moreno and Ms. Moral Betere on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022**

We thank staff for their insightful report in the context of the Cypriot Article IV consultation. We also thank Mr. Dresse and Mr. Ghalanos for their informative Buff statement, and we fully associate ourselves with Mr. Pösö's statement. We broadly concur with the thrust of staff's appraisal and would like to make the following comments.

Cyprus's recovery from the COVID-19 pandemic is being undermined by the spillovers from Russia's war against Ukraine. The spillovers of the war are already affecting Cyprus, primarily through the impact on tourism and demand for professional services, but also by the increase in energy prices and its effect on the terms-of-trade, undermining its promising recovery from the pandemic. In addition, given the high levels of private, public, and external debt, as well as the substantial stock of NPLs, risks are clearly to the downside due to the uncertainty surrounding the conflict and the normalization of global monetary conditions. In the medium term, the investments and structural reforms envisaged in the Resilience and Recovery Plan will be essential to support growth and help the transition towards a greener, more digital, and more sustainable economy.

We concur with staff that, in the medium term, authorities will need to rebuild fiscal buffers. In the short term, and while uncertainty remains, a certain degree of flexibility will be necessary to absorb shocks arising from the spillovers of the war, although we concur with staff that discretionary measures should not hinder labor reallocation and should be temporary and well targeted as already foreseen in the authorities' contingency plan. In the medium term, authorities will need to rebuild fiscal buffers by keeping expenditure growth under control, addressing the irregularities in the National Health System (NHS), and reining in

public sector wages. On the revenue side, we support the reintroduction of the immovable property tax to avoid expenditure pressure. Finally, close monitoring of the contingent liabilities arising from the financial sector is of the essence as they may create important downside risks to the budget. This is especially relevant given the already high NPLs and potential new ones arising from the withdrawal of support measures and the impact of the war. In this vein, we concur with staff that the expansion of support measures to protect the living conditions of vulnerable borrowers, through the public Asset Management Company (KEDIPES), should be done in a targeted way to minimize fiscal impact.

A more forceful implementation of the NPL strategy is paramount. Despite the progress in reducing NPLs in the banking system, the stock of NPLs remains elevated and the pace of resolutions at KEDIPES and the credit acquiring companies (CACs) is low. In this regard, minimizing uncertainty around the foreclosure framework remains crucial to engaging both debtors and creditors, improving financial stability and payment discipline, and increasing the role of credit in the economy. In addition, judicial reforms will be essential to ensure the effective implementation of the insolvency and foreclosure framework, thus also enhancing the resilience of the financial sector. It is also key that the authorities continue to facilitate the effective use of the tools currently available, such as by setting up an effective governance structure of the state-owned asset management company, and through further improvements in the working environment of CACs and credit servicing companies, as by including access to land registry data.

We welcome the authorities' recent progress in the implementation of the comprehensive and ambitious Recovery and Resilience Plan (RRP). A timely and effective implementation of the RRP will be essential to boost Cyprus' medium-term growth. Despite the progress made, we believe that further efforts will be essential, especially in the fields of AML/CFT and governance, to enhance confidence and investment while reducing Cyprus's reputational risks in the current environment. Addressing skill mismatches and closing the digital and infrastructure gaps will also be of the essence.

We welcome Cyprus's ambitious climate goals, which will help diversify its energy sources and transit to a sustainable growth model. We concur with staff that achieving Cyprus's national climate targets as part of the country's environmental agenda will be challenging. The intention to introduce a carbon tax for fuels used in the sectors that are not covered by the EU emissions trading system (ETS) is commendable, as is the planned investment to increase the share of Renewable Energy Sources and increase energy efficiency. This should put Cyprus in the right direction.

With all these remarks, we wish the Cypriot authorities and people all the best in their future endeavors.