Executive Board Minutes 22/47-1

May 25, 2022–10:00 a.m.

Cyprus—2022 Article IV Consultation

Documents: SM/22/94 and Cor. 1, and Cor. 2, and Sup. 1

Staff: Maliszewski, EUR; Rother, SPR

Length: 47 minutes

ISSUED: February 13, 2023
APPROVAL: February 21, 2023

CEDA OGADA
Secretary

TABLE OF CONTENTS[1]

[1] Minutes are the official record of a formal Board meeting in which the Board may adopt decisions and reach understandings related to the business of the Fund. Staff background documents issued before the meeting are the principal basis for the meeting. Preliminary "gray" or "buff" statements by Executive Directors and staff's responses to Directors' technical questions are circulated prior to the meeting. Adopted decisions and/or summings up—the Chair's "sense of the meeting" or policy conclusions/recommendations—are issued after the meeting. The minutes include all these elements, as well as the discussion record (a verbatim transcript of the discussion lightly edited for clarity). Minutes are made public consistent with the IMF's Open Archives Policy.

THE ACTING CHAIR'S SUMMING UP

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their policy response to the pandemic, which supported the recovery of output and employment. Directors noted that the pace of the recovery is expected to slow down in the near-term—mainly due to the war in Ukraine—but should regain momentum over the medium-term. However, the outlook is subject to risks, stemming from a prolonged war in Ukraine, uncontrolled COVID outbreaks, and abrupt monetary tightening in advanced economies. Directors stressed the need to calibrate a policy response to manage the pandemic and war-related shocks in the near-term, while pressing ahead with financial sector and structural reforms to reduce vulnerabilities and improve growth prospects and resilience over the medium-term.

Directors concurred that fiscal policy should continue providing support but aim to gradually rebuild buffers. They supported a gradual fiscal adjustment and emphasized that additional discretionary measures, if needed, should be temporary and well-targeted, and not hinder labor reallocation. Directors underscored the importance of fiscal discipline over the medium-term to place the public debt on a firmly declining path. They encouraged further efforts to control public sector wage growth, address risks from the National Health System, and monitor the financial sector's contingent liabilities.

Directors noted that the financial system has stayed resilient. They agreed that the authorities should enhance monitoring and address asset quality given the worsened outlook. Directors emphasized that resolving legacy non-performing loans requires more forceful implementation of existing tools, including by further improving the working environment of credit acquiring companies and credit servicing companies. They underscored the criticality of an effective foreclosure framework for addressing strategic defaulters and providing incentives for borrowers to engage in restructurings, and recommended enhancing the implementation of the 2019 amendments to the framework. Directors also stressed that the planned Mortgage-to-Rent scheme should be well-targeted to minimize the fiscal cost and to ensure transparency and accountability.

Directors emphasized that structural reforms are key to raise medium-term growth potential. They welcomed the progress in implementing the Recovery and Resilience Plan, including passing legislation on corruption and on civil service and local government reforms. Directors encouraged the authorities to continue to make progress in strengthening the AML-CFT and governance frameworks, and in tackling the skills, digital, and infrastructure gaps. Reforms of the judicial system are also a priority.

Directors agreed that achieving the national climate goals can help Cyprus transition to a more resilient and sustainable growth model. They recommended continued efforts to address the challenges to implement the green agenda, including the planned green tax reform. Additional measures, including feebates, to enhance the emissions reduction could also be considered.

It is expected that the next Article IV Consultation with Cyprus will be held on the standard 12-month cycle.

EXECUTIVE BOARD ATTENDANCE[2]

K. Okamura, Acting Chair

Executive Directors	Alternate Executive Directors
	W. Nakunyada (AE)
	R. Bah (AF), Temporary
	B. Lischinsky (AG), Temporary
	O. Parkyn (AP)
	F. Fuentes (BR)
Z. Zhang (CC)	
	R. Moral Betere (CE), Temporary
	F. O'Brolchain (CO)
	C. Just (EC)
A. Buisse (FF)	
	A. Rieck (GR)
	R. Goyal (IN), Temporary
	M. Massourakis (IT)
	M. Kashima (JA)
	B. Boostani (MD), Temporary
	D. Hamzah (MI), Temporary
	L. Dresse (NE)
M. Poso (NO)	
A. Mozhin (RU)	
	Z. Abdelrahman (SA), Temporary
R. Lim (ST)	
	T. Abdygulov (SZ), Temporary
	T. Chrimes (UK), Temporary
	C. Westphal (US), Temporary

S. Bhatia, Acting Secretary
L. Briamonte, Summing Up Officer
M. Guerra Bradford, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: J. De Haro. European Central Bank: D. Rakitzis, R. Rueffer. European Department: P. Gerson, W. Maliszewski, R. Zhang. Legal Department: C. Acosta, A. Aly. Monetary and Capital Markets Department: Z. Cheng. Strategy, Policy, and Review

[2] For countries in each constituency, please see the Constituency Codes in the annex.

Department: B. Rother. Executive Director: A. Andrianarivelo (AF), S. Bhalla (IN), A. BinZarah (SA), H. Hosseini (MD), P. Jennings (CO), M. Mohieldin (MI), P. Moreno (CE), D. Palotai (EC). Alternate Executive Director: A. Alhosani (MI), M. Alrashed (SA), C. Amarasekara (IN), H. Azal (EC), M. El Qorchi (MD), A. Guerra (CE), F. Mochtar (ST), R. N'Sonde (AF), M. Peter (SZ), C. Roman (FF), J. Romero (CE), F. Sylla (AF), V. Vumendlini (AE). Senior Advisors to Executive Directors: H. Andrianometiana (AF), E. Cartagena (CE), M. Choueiri (MI), A. Ekelund (NO), V. Grossmann-Wirth (FF), L. Marek (EC), J. Rojas (CE), C. Sassanpour (MD), F. Spadafora (IT), A. Tolstikov (RU). Advisors to Executive Directors: F. Al-Kohlany (MI), P. Al-Riffai (MI), A. Arevalo Arroyo (CE), M. Damane (AE), R. Fayez (MI), K. Florestal (BR), M. Ghalanos (NE), W. Hteik (ST), R. Karl (AP), V. Lankester Campos (CE), R. Lopes Varela (AF), M. Merhi (MI), P. Mooney (CO), B. Piasecki (SZ), C. Ramos Capaquira (AG), E. Shimada (JA), I. Valdes Fernandez (NO), O. Zubareva (RU), A Abobakr (SA), F. Lopez (CE), L. Wilbert (GR).

DISCUSSION RECORD[3]

The Acting Chair (Mr. Okamura):

As a tourism-dependent economy, Cyprus has been susceptible to the COVID-19 pandemic, but a prompt policy response has cushioned its impact and fostered a strong recovery in 2021. But shocks related to the war in Ukraine would take a heavy toll on the economy in the near-term. The recovery is expected to resume over the medium-term, supported by measures in the Recovery and Resilience Plan (RRP).

In their gray statements, Directors commend the authorities for the policy support during the pandemic and highlight the need to further calibrate a policy response to the war-related shocks. Progress notwithstanding, the authorities also need to address remaining legacy vulnerabilities in the financial system, exacerbated by the recent shocks. Addressing structural bottlenecks remains another priority.

Mr. Dresse:

Many thanks to Mr. Maliszewski and his team for the discussion with the authorities, the insightful report, and the written responses to Directors' questions.

I would like also to thank Executive Directors for their written statements, their emphasis on the key aspects, and the policy advice on the way forward. The authorities broadly concur with the thrust of the staff analysis, so let me make a few points for emphasis.

Cyprus was hit by one exogenous shock on the top of another—first, the pandemic, as the Chair mentioned, the effects of which still linger; and second, the war in Ukraine, with repercussions primarily on tourism and inflation.

Regarding exposure to Russia, there are far weaker financial sector linkages than in the past, especially after the winding down of the RCB Bank's banking operations.

[3] Edited for clarity.

Russia does represent the second-most important tourist market after the U.K. However, signs of a revived demand from traditional sources and emerging demand from new sources are encouraging.

On the fiscal side, the economy has robust automatic stabilizers and ample buffers for time-bound support, where needed, while the government remains committed to keeping public debt on a firm downward trajectory from its current high level. At the same time, the financial sector maintains a sound position, bolstered by the decisive reduction of non-performing loans (NPLs) in the banking system. Nevertheless, the authorities are vigilantly monitoring the evolution of underperforming loans and are carefully managing the evolution of the Cyprus Asset Management Company (KEDIPES) into a national asset management company. They are guided by clear principles on minimizing the fiscal risks and precluding moral hazards between debtors and sellers. The authorities are also working on further improving the working environment for the credit acquiring companies (CACs) and credit servicing companies.

In the medium-term, Cyprus's Recovery and Resilience Plan includes measures to address vulnerabilities to climate change and enhance digitalization skills and infrastructure. Structural reforms will provide a permanent strengthening of fundamentals and efficiency, including for the civil service, local administration, judiciary system, and the management of NPLs.

Finally, a range of reforms under the Recovery and Resilience Plan (RRP) to tackle corruption has already been implemented this year, while the authorities remain committed to addressing the findings of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism's (MONEYVAL) assessment in the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework, with an eye on decisively extenuating reputational risks.

The staff representative from the European Department (Mr. Maliszewski):

We responded to most questions in writing, so I will not be repeating those. I would like to take this opportunity to emphasize a couple of points, also in the context of the recent economic developments in Cyprus and especially how our policy advice is becoming even more relevant in this context.

First, starting from the growth outlook. Indeed, the 5.8 percent Q1 growth was slightly stronger than we expected, and this confirms an underlying strength in Cyprus's economy. This strength is underpinned by new sources of growth, to some extent, including in the information and communication technologies (ICT) sector. This is good news. This is even more important, given that the tourism recovery has been relatively slow. Despite the fact that the backbone of the economy was not performing that well, growth was still strong. This bodes well for 2022; nevertheless, the headwinds are still there. The exposures to the fallout from the war in Ukraine is very significant, as we described in the staff report. And the other headwinds, including from deteriorating market sentiment, including from the impact of lockdowns in China, are becoming even stronger than we assessed it at the time of the Article IV.

All in all, given these two factors, the developments on the ground in Q1 and the headwinds, we are assessing growth prospects similar to what we had in the staff report and how we saw it at the time of the Article IV mission. But, at the same time, this makes our policy advice even more relevant, as I will explain in a second.

Before doing this, let me make a point on inflation. At 8.6 percent in April, it is higher than what we expected. We responded, in our written responses to Directors, that our baseline projection still assumes that inflation will moderate and there will be a pass-through from global food and energy prices, but wage dynamics so far have been relatively contained. In fact, during the peak of the pandemic, wages were downward flexible, which facilitated the adjustment. But there are growing pressures on wages, and these growing pressures are particularly in the context of re-establishing the cost-of-living adjustments that were suspended during the program and partially restored in the recent years. These cost-of-living adjustments affect only some sectors of the economy, but the public sector is one of the largest here. Hence, our policy advice to keep public sector wages under control is still very relevant in the context of this pickup in inflation.

On fiscal policy, other than the wage policy. The big picture that we are seeing is a significant adverse shock that may not, however, affect all sectors of the economy in the same way. Some new sectors such asICT may be still growing quite strongly. There are still some bright spots, as this Q1 data illustrated quite well. At least this is our preliminary reading of these numbers. At the same time, there are these growing inflationary pressures. This context makes our policy advice of targeted and temporary measures even more relevant. This support should mainly be directed to workers in transition to new jobs, rather than any particular sectors or companies. And, again, maintaining strict wage discipline in the public sector is quite important in the context of the recent inflation developments.

One point on the financial sector policies. As we emphasize in the report, legacy NPLs impaired both credit demands and banks' ability to supply credit. This is a constraint to growth for these new sectors too that we were highlighting. And this is why the resolution of these high NPLs remains very critical. They now reside, to a large extent, outside the banking sector, in asset management companies; and the expansion of the public asset management company, KEDIPES, is an important policy step to address this issue in this context. However—and we agree with the authorities on this-- steps in this direction should be taken very carefully, and especially this scheme should be strictly targeted. Also, we have to make sure that the existing foreclosure framework fully works.

On the structural policies, again, we are in broad agreement with the authorities on the importance of this element of the authorities' policy agenda. And in the context of the current economic developments, again, to support these new sources of growth, some of these structural reforms are critically important.

Cyprus is already a relatively attractive investment destination. We saw it even during the pandemic, with substantial foreign direct investments (FDI) in some of these new growth sectors. But some of these structural reforms under the RRP will be quite effective in accelerating this growth, even in the short term. And here, we are talking, again, about the efficiency of the public sector, especially the judiciary system and the other reforms in this direction.

There are also reforms that will take much longer for the effects of them to materialize. And that is why we have a slight deviation, compared to the authorities, in terms of our assessment of the impact of these reforms; but nevertheless, we all agree that they will have a substantial impact overall in the medium- to long-term. I am talking here about the education system reform. That is critically important for creating a strong underfooting for these new growth sectors, but their effects may take a little bit longer to materialize.

Mr. Pösö:

Cyprus endured the pandemic well and rebounded strongly from the COVID shock, also thanks to the exceptional fiscal support. However, Russia's war against Ukraine will, indeed, slow down growth this year, even if the direct linkages to Russia appear contained and have decreased in recent years. As staff, we expect strong growth to resume in 2023.

The country used the favorable economic conditions to improve its public finances; but on account of the still high level of public debt and fiscal risks, some of them in the form of contingent liabilities in the banking sector, fiscal policy should continue to aim at rebuilding fiscal buffers. At the same time, the fiscal response must remain flexible and provide targeted support, if needed, as Mr. Maliszewski also emphasized.

Cyprus's Recovery and Resilience Plan is ambitious and comprehensive and effectively addresses key structural challenges. It offers the opportunity to press ahead with reforms, aimed at removing structural bottlenecks, and moving toward a more sustainable growth model. A swift implementation of the plan is crucial to sustain Cyprus's strong economic performance. The plan also attaches particular importance to the green and digital transitions; but, as staff, we also recommend that Cyprus does more to achieve the national climate targets. In this regard, we welcome the government's plans to promote renewable energy sources and to introduce a carbon tax for fuels used in the sectors not covered by the emissions trading scheme (ETS).

We also agree with staff that the authorities should address asset quality, given the worsened outlook, and, in particular, the legacy of NPLs through a more forceful implementation of the existing tools. However, we are also of the view that staff could give more credit to the progress made so far, especially by the largest banks. At the same time, more emphasis should be put on the need to sustain profitability through higher cost efficiency.

Finally, the authorities should strengthen the implementation of the AML/CFT framework, also reflecting MONEYVAL's assessment.

Mr. Massourakis:

First, we want to reiterate our agreement with staff on the need to calibrate the authorities' policy response to the new shocks, with a view to safeguarding macroeconomic stability. At the same time, however, to pave the way for a sustained recovery, we encourage the authorities to give priority to advancing investment and implementing structural reforms in the Recovery and Resilience Plan. The latter includes important measures to facilitate the transition toward a greener and digital economy and ultimately improve growth prospects.

Despite significant progress, legacy issues from the financial crisis—notably, high indebtedness and NPLs—remain challenging, potentially impacting on the financial system. To improve the soundness of the financial system, three priorities stand out in our assessment.

First, strengthening the effectiveness of the foreclosure framework is critical for accelerating NPL reduction, addressing strategic defaulters, and restoring credit discipline in a durable and credible way.

Second, improving the oversight and operational capabilities of the credit acquiring companies which, by now, are the major holders of NPLs from households and businesses.

Third, expanding the mandate of KEDIPES to become a national asset management company and cover private NPLs. However, in doing so, we share the staff's concern that any relevant risks need to be addressed by a means of adequate safeguards to protect the payment culture and maintain credit discipline. In particular, to limit moral hazard, the envisaged mortgage-to-lend scheme should be limited to the most vulnerable households on a means-tested basis. To further minimize risks in designing the asset management company, we call on the authorities to pay attention to the robust and prudent valuation of assets and transfer prices, as well as effective governance mechanisms, including clear targets for value recovery, a sunset clause, enhanced transparency, and the independence of the board.

Mr. Buissé:

I agree with the thrust of the staff appraisal, and I can associate myself with Mr. Pösö's statement. We have issued a gray statement, and I would like to mention only two quick points for emphasis today.

First, on fiscal policy, I would like to insist on the need to swiftly adapt in case of a further deterioration in the economic outlook. As for many other economies at this critical juncture, fiscal policy will need to be carefully calibrated, depending on the strength of the recovery, and the size, unfortunately, of the war-related shock. The authorities will need to carefully adjust their fiscal stance in 2022 with possible additional temporary and targeted fiscal support, if necessary, on top of automatic stabilizers. Once a continuation of the recovery is secure, a gradual fiscal adjustment is, of course, still required to place the public debt ratio on a declining path, while preserving economic growth.

Second, on climate, I would like to support the swift implementation of energy transition and climate measures in Cyprus, in line with its ambitious targets. I support, in particular, the planned increase in carbon pricing on non-ETS sectors and encourage a swift implementation of the investment projects and measures to support renewable energy sources and energy efficiency. I also would like to commend staff for the very good Annex IV on climate, including the suggestions on how to best alleviate the cost of carbon pricing for lower-income households and the simulations of greenhouse gas emissions across sectors.

Ms. Moral Betere:

We regret that Cyprus's promising recovery is being undermined by the spillovers from Russia's war against Ukraine. However, we remain confident that, in the medium-term, the investments and the structural reforms envisaged in the Recovery and Resilience Plan will support growth and help the transition toward a greener and more digital economy. In this vein, we believe that a timely and effective implementation of the plan will be essential. Despite the efforts made so far in several areas, we believe that further efforts will be essential, especially in the fields of AML/CFT and governance, to enhance confidence.

On the fiscal front, we concur with the staff that in the medium-term, the authorities will need to rebuild fiscal buffers. However, in the short-term, and while uncertainty remains, a certain degree of flexibility will be necessary, with well-targeted measures, as already foreseen in the authorities' contingency plans. In this vein, we concur with others, that the expansion of support measures to protect the living conditions of vulnerable borrowers through KEDIPES should be done in a targeted way to minimize fiscal impact.

On the financial front, despite the progress, a more forceful implementation of the NPL strategy will be paramount. In this regard, judicial reforms to ensure the effective implementation of the insolvency and foreclosure framework are key, as well as the effective use of the already available tools, such as the effective governance of KEDIPES and the working environment for credit acquisition and credit servicing companies.

Finally, we would like to commend Cyprus's authorities for their ambitious climate goals. We concur with the staff that it may be challenging, but the intention to introduce a carbon tax for fuels used in the sectors that are not covered by the EU ETS and the planned investment to increase the share of renewable energy sources should put Cyprus in the right direction.

Mr. Fuentes:

We issued a gray statement, in which we generally agree with the thrust of the staff appraisal. Today, I just want to emphasize the following two points.

First, Cyprus must find a prudent balance between addressing the new shock and replenishing buffers to safeguard macroeconomic stability. Considering the widespread impact of the war and the economy, policy support measures may have to be reinstated. And a more gradual fiscal adjustment would be more appropriate to help the economy accommodate the shock and protect the vulnerable population, particularly considering the acceleration of inflation and high uncertainty regarding the duration and further escalation of the war. Under these circumstances, we encourage the authorities to ensure adequate targeting, greater transparency, and accountability in their implementation.

We certainly welcome the authorities' expressed commit to budget prudence and medium-term debt sustainability. Having said that, achieving these objectives will require strict fiscal discipline, considering the elevated post-pandemic debt level and the sensitivity of the high gross financing needs to shocks.

Finally, while Cyprus banks have continued to offload legacy nonperforming assets, further progress is needed and stronger vigilance by supervisors is warranted, considering the emerging shocks brought on by the war in Ukraine and the fact that some loans are registering significant deteriorations, especially during the pandemic.

We also concur with staff that, beyond the act of the restructuring of loans, a broader use of insolvency tools is warranted. We encourage the authorities to take additional steps to strengthen the legal framework and address the remaining legal uncertainties surrounding the implementation of the foreclosure framework.

Ms. Kashima:

As we issued a joint gray statement with Ms. Grant and Mr. Mochtar, in broad support of the staff appraisal, I would like to offer the following three comments for emphasis.

First, while we note the need to remain vigilant toward potential war-induced negative impacts, it is crucial to put public debt on a downward path. And, like others, we welcome the authorities' firm commitment to build fiscal buffers. We encourage the authorities to ensure that any additional support is well-targeted and temporary. The authorities could also consider revenue mobilization measures, as staff recommended, on immovable property tax.

Second, in relation to the available funding from the Recovery and Resilience Plan, like Mr. Palotai, we share the staff's view that absorption capacity is key for the efficient implementation of relevant reforms. We, therefore, encourage the authorities to continue enhancing public investment management to ensure solid planning and oversight.

Third, on the financial front, a further resolution of persistently high nonperforming loans is essential. While we welcome the authorities' efforts in recent years to reduce NPLs, the level of NPLs still stands out among the EU countries. We also agree with Mr. Hosseini, that financial vulnerabilities may aggravate due to the negative spillovers from the war in Ukraine. We, therefore, echo Ms. Rieck and Mr. Massourakis on the importance of implementing a suitable legal framework and an official judicial system, including an effective foreclosure framework.

Like Ms. Medearis, we also caution against the planned mortgage-to-rent scheme and strongly encourage the authorities to make the scheme targeted to safeguard fiscal sustainability.

Mr. Zhang:

As we have issued a detailed gray statement, I will emphasize two aspects of our points to the staff report.

Firstly, we positively note that the Cyprus banking sector remains resilient during the crisis, and we welcome the recent progress in reducing NPLs. However, the stock of NPLs in the banking system is still high, and their restructuring is proceeding slower than expected. Resolving legacy NPLs requires a more forceful implementation of the existing tools, notably, effective foreclosure and insolvency frameworks. Moreover, to avoid further weakening credit discipline and to minimize fiscal impacts, the planned expansion of the public asset management company should be well-targeted to the most vulnerable households and include safeguards with time-bound settings.

Second, we note the response of staff on the anti-money laundering framework related to the sanctions. We would like to highlight that there are two kinds of sanctions. The first one are the sanctions imposed by the UN; that is the multilateral sanctions. Every country should implement or strengthen their framework to implement these sanctions to antiterrorism financing and the antiproliferation financing to safeguard the global security environment. The second kind of sanctions are the unilateral sanctions. It is our longstanding, consistent position that these sanctions are not legal, especially with respect to the no-harm rule principle.

Members that strengthen anti-money laundering and CFT should not be seen as agreeing with these unilateral sanctions, so the staff should be clear with this point. These unilateral sanctions cannot be legal under the no-harm rule beyond national jurisdiction principle. This is also true when they noticed that recently, Treasury Secretary Janet Yellen said the freeze of central banks assets is not legal in the current U.S. framework.

Mr. Abdygulov:

We agree that policy priorities should support greater market diversification, competition, and technology adoption.

In early May this year, the authorities announced a big reserve of natural gas was discovered. We asked this question in our gray statement, and we want to ask one more time to get a clarification from the staff. In this context, potential gas extraction and exports could provide diversification and fiscal resources to finance structural reforms and support consolidation. Could staff comment on this potential source of revenue and its potential impact on Cyprus's fiscal and external balance?

The staff representative from the European Department (Mr. Maliszewski):

Let me address two issues that were raised in Directors' remarks.

First, on the question of NPLs' reduction, in response to Mr. Pösö's emphasis on the very impressive reduction of NPLs in the banking system, we fully agree. We report that this is a very significant achievement. In fact, we were surprised by the speed of this NPL reduction in the banking system, especially given that the pandemic environment was not conducive to doing so. We fully acknowledge the progress here. But at the same time, these NPLs have not totally disappeared from the economy. They still reside, to a large extent, outside the banking system, in asset management companies, in CACs.

And here, all the support that we are hearing for the policies to make sure that this NPL problem is addressed is even more relevant. Maybe, I have not emphasized it enough; but we are, indeed, very much in tune with all the support for the policies to strengthen the operational framework for credit acquiring companies, for credit servicing companies, to strengthen the judiciary system also in this regard, and to make sure that the foreclosure framework is fully allowed to operate.

Now, on the point of energy dependence and the gas discovery. To some extent, this is also related to all the very helpful remarks about the green transition and the importance of green reforms. Cyprus is uniquely dependent on oil as a source of energy. Both the green transition and potentially new sources of energy in the form of gas discoveries could be a lifesaver in the context of the potential elimination, to some extent, of the weakness or vulnerability of the Cyprus economy, especially in the context of the current shocks to oil prices.

In terms of the green agenda, we covered it quite extensively in the staff report.

On the gas reserves discovery, for now, we are not incorporating this in our projections because this, as a source of revenue and a source of energy diversification, is still uncertain. According to the preliminary information that we received, there is, indeed, a possibility that Cyprus will become an exporter of natural gas in 2026, which is quite soon. And maybe this uncertainty will disappear very quickly. We are very closely monitoring this; but, for now, again, I would emphasize uncertainty surrounding these discoveries.

Mr. Dresse:

I will duly convey the recommendations to the authorities.

The Acting Chair (Mr. Okamura):

Cyprus is an Article VIII member, and no decision is proposed. The 2022 Article IV Consultation with Cyprus is hereby concluded.

As Directors pointed out, the war in Ukraine is negatively affecting Cyprus's economy. And while the fiscal policy should remain flexible in the short term, the authorities should maintain strict discipline and aim at a gradual fiscal adjustment in the medium term.

Directors called on the authorities to closely monitor the asset quality of the banking sector, resolve legacy nonperforming loans, and address uncertainties related to the foreclosure framework. Their advice to accelerate structural reforms, including in the context of the Recovery and Resilience Plan, is also well taken.

The Acting Chair (Mr. Okamura) adjourned the discussion.

ANNEX

- Gray Statements
- European Central Bank Statement
- Staff's Responses to Executive Directors' Technical Questions
- Constituency Codes

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

BUFF/ED/22/57

May 20, 2022

Statement by Mr. Dresse and Mr. Ghalanos on Cyprus
Executive Board Meeting
May 25, 2022

On behalf of the authorities of the Republic of Cyprus, we thank the mission team, led by Mr. Maliszewski, for the productive discussions in March and the insightful report. The authorities broadly concur with the thrust of the staff analysis and will take the report's recommendations into pertinent consideration.

Macroeconomic developments and outlook

Cyprus weathered the pandemic waves well. Output recovered strongly from the 5.0 percent contraction in 2020 owing to the pandemic, with real GDP growth registered at 5.5 percent in 2021. High vaccination coverage and improved epidemiological developments have allowed the gradual lifting of almost all restrictive measures. While uncertainty about the course of the pandemic is not to be discounted, the ongoing war in Ukraine produces an additional set of adverse shocks that compounds uncertainty. Vulnerabilities mostly pertain to the tourism industry: about 20 percent of arrivals in the period 2017 to 2019 came from Russia. However, tourists from traditional markets such as the UK are showing a revived interest following the pandemic recovery. Reflecting also outreach to new and other existing markets, and incentives to prop up domestic tourism, the authorities project tourist arrivals in 2022 to reach 70 percent of the arrivals recorded in 2019, a record year in terms of arrivals. Moreover, economic diversification is reducing dependence on tourism in favor of high value-added sectors such as ICT. Other vulnerabilities relate to professional services, which are expected to be impacted by the sanctions on Russia. Exports of financial and other business services to Russia accounted for 2.7 percent of GDP on average over the period 2016 to 2021. Overall, exports of goods and services to Russia amounted to about 15 percent of total exports over the period 2016 to 2021.

At the present juncture, the authorities consider inflation to be the greatest risk: Harmonized Index of Consumer Prices (HICP) year-on-year inflation is estimated at 8.6 percent in April 2022, climbing from 5.0 percent in January 2022. This is mainly driven by rising international oil prices, which have a significant impact on domestic prices of energy products. However, the impact of inflation on consumer disposable income and confidence has not translated to material wage pressures. In addition, the pass-through of the automatic wage indexation system, which applies to employees in the government and part of the private sector, was weakened by the 2013 reform undertaken during the financial program with international creditors. As a result, Cyprus largely maintains the wage competitiveness achieved with substantial internal devaluation during the financial program. Real estate prices, which also fell sharply during the program period, are only now approaching the long-term trend, with a real estate sector relying more on domestic demand.

In aggregate, the impact of the ongoing pandemic, the war in Ukraine and rising global inflation is projected by the authorities to lower GDP growth this year to a range between 2.3 and 2.7 percent. This is slightly more optimistic than the 2.0 percent growth projected in the staff report, given the uncertainty. The May 2022 flash estimate for 2022-Q1 points to a higher-than-expected growth rate for the quarter, 5.8 percent over Q1 of 2021, which may positively affect the outcome for the year.

The current account deficit widened in 2020 owing to the exogenous shock of the pandemic, but narrowed in 2021 by about 3 percentage points, down to 7.2 percent of GDP. In 2022 it is expected to widen due to the war and the rise in oil and commodity prices impacting the trade balance. Strong FDI flows are the main contributor to financing.

Public finances

Cyprus recorded a significant fiscal correction in 2021: Budget deficit declined to -1.7 percent of GDP from -5.8 percent in 2020, and public debt dropped to 103.6 percent from 115.0 percent. This contributed to the build-up of extensive buffers to cope with near-term risks. While pandemic support measures lapsed for the most part towards the end of last year, a limited set of measures has been put in place to alleviate the impact from rising inflation on production costs and incomes. These range from targeted fiscal transfers to protect vulnerable households and to support affected agricultural sector segments, to across-the-board temporary reductions in VAT for electricity and excise duties on fuels to contain economic repercussions. The authorities agree with staff that additional support should be temporary, targeted, and not hinder labor reallocation should the situation deteriorate, as already foreseen in the authorities' contingency plans.

At the same time, the authorities underscore their firm commitment to further enhance fiscal buffers and maintain solid public finances over the medium-term. The authorities project for 2022 a return to a primary budget surplus and a reduction in public debt to below 100 percent of GDP, as expected before the pandemic, and sustained fiscal consolidation thereafter to anchor public debt reduction on a firmly downward path. Staff projects the same trend albeit at a more gradual pace. Ensuring the public wage bill does not accelerate beyond productivity and undertaking efficiency reforms in the National Health System (NHS) remain central to the government's objectives. The track record and policy credibility of the authorities towards maintaining a sound fiscal position is recognized by credit rating agencies, with one rating upgrade in April and two affirmations in March, amid the current challenging environment.

Financial sector

The banking sector remained resilient during the pandemic and faced the fallout from the Russian invasion of Ukraine from a sound position, reflecting adequate capitalization and ample liquidity. Non-performing loans (NPLs) on bank balance sheets fell to 11.3 percent (including branches of third countries) at the end of February 2022 from around 50 percent of total loans during the financial crisis in 2013. This was accomplished mainly by sales and transfers to credit acquiring companies (CACs) and write-offs. The performance of exposures exiting the pandemic moratoria schemes is encouraging as well. About 92 percent of the exposures started being repaid as of December 2021 and only a small residual is either in default or arrears. Lending is also showing signs of recovery for both households and NFCs, despite the economic shocks and the high level of indebtedness.

A source of concern, nevertheless, as also noted by staff, relates to the level and evolution of stage 2 loans – defined as under-performing loans with increased credit risk relative to their origination. Despite a recent improvement, stage 2 loans increased during the pandemic to 15 percent of total loans as of December 2021, versus a 9 percent EU average. While profitability improved over 2021, owing to lower loss provisioning, it remains a challenge, amidst a low-interest environment and cost rigidities.

Direct banking exposure to Russia is low. Russian deposits accounted for 3.5 percent of total deposits (including interbank deposits) in end-December 2021 and declined further to 1.8 percent at the end of March 2022. Loan exposure to Russia amounted to 0.6 percent of total lending (including interbank loans) at the end of March 2022. The Central Bank of Cyprus does not hold reserves with the Central Bank of the Russian Federation. The RCB Bank, a systemically important bank in Cyprus whose business model was affected by the war and ensuing sanctions, is voluntarily winding down its banking operations. Thanks to proactive measures by the Central Bank of Cyprus and the Single Supervisory Mechanism, all deposits were safeguarded without any loss to the taxpayer or any negative spillover to the rest of the banking sector.

Plans to transform the Cyprus Asset Management Company (KEDIPES) into a national asset management company are ongoing, conditional on, among other things, a well-functioning foreclosure framework and in conjunction with a mortgage-to-rent scheme for indebted households and firms. The authorities share staff's recommendation that the planned expansion of KEDIPES should be well-targeted and include safeguards to avoid weakening credit discipline. The authorities are also promoting further improvements in the working environment of CACs and credit servicing companies, including access to data from the land registry.

The authorities share staff's view of the criticality of maintaining a robust foreclosure framework to resolve legacy NPLs and are committed to enhancing its implementation. They also remain committed to mitigating reputational risks related to money laundering and corruption. Cyprus is fully or largely compliant with 36 out of the 40 FATF recommendations, based on a follow-up assessment by MONEYVAL in December 2021, and rated as partially compliant with 4 recommendations. There are ongoing efforts to fully address the findings of the MONEYVAL assessment. The Cyprus Investment Program (CIP) was abolished in October 2020 and citizenships granted without due diligence were revoked. A law establishing a national anti-corruption authority and a bill regulating political lobbying were ratified by the Parliament in February 2022, after the adoption of the whistleblower protection law a month earlier.

Structural reforms, digitalization, and the green transition

The authorities appreciate staff's dedicated analysis of the Recovery and Resilience Plan (RRP) and climate policies. The allocated amount to Cyprus from the Recovery and Resilience Facility (RRF) of Next Generation EU (NGEU) corresponds to EUR 1.2 billion in grants and loans, spread over 2021-2026. This is a significant amount considering the size of the economy. The RRP of Cyprus foresees 41 percent of the amount to be used for financing the green transition, 23 percent for advancing digitalization, and the remaining amount for other related issues such as promoting resilience and efficiency in the health care sector.

In addition to investments, a series of structural reforms is encompassed in the RRP. Envisaged judicial reforms to enable timely proceedings would enhance the resilience of the financial sector, including through accelerating NPL workouts. Recent approved legislation refers to civil service and public administration reforms.

The medium-term prospects for inclusive and environmentally sustainable growth are promising: A study by the University of Cyprus in May 2021 estimates that the RRP can increase the GDP of Cyprus by about 3 percent in the short-term and by around 7 percent in the medium-term, compared to baseline. The authorities welcome staff’s analysis projecting a more moderate but still significant impact.

The authorities reiterate the importance of achieving national climate targets as part of the country’s environmental agenda. Despite rising energy prices, efforts on advancing the green transition continue unabated. In this regard, the authorities welcome staff’s analysis of climate policies and dynamics.

GRAY/22/1299

May 23, 2022

Statement by Mr. Nakunyada, Ms. Vumendlini, and Mr. Damane on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the comprehensive report, as well as Messrs. Dresse and Ghalanos for their insightful Buff Statement.

The war in Ukraine has weighed on Cyprus's recovery momentum attained following the adverse effects of the COVID-19 pandemic on growth. We commend the authorities for the vaccination progress alongside strong policy support that helped cushion vulnerable households and reduce unemployment to set the stage for a recovery in 2021. Nevertheless, near-term growth prospects remain challenged by the adverse impact of the war and sanctions including on terms of trade, given the country's high exposure to the conflict. Additionally, risks stemming from the abrupt monetary tightening could worsen public finances and trigger capital flow reversals, while legacy NPLs and governance vulnerabilities require urgent actions. The authorities should, therefore, focus policy efforts on fiscal adjustment to rebuild buffers, strengthening the NPL resolution framework, and advancing structural reforms as articulated in the Recovery and Resilience Plan (RRP). We, therefore, share the staff assessment and provide the following remarks for emphasis.

Discretionary fiscal support should be provided as needed, but fiscal adjustment would be essential to gradually rebuild buffers and place public debt on a firm downward path. We positively note the instrumental role played by fiscal buffers to help tackle the pandemic shock. Considering the strong fiscal performance in 2021 and robust social safety nets, prominence should be attached to cushioning the most vulnerable from the negative effects of the conflict. Meanwhile, automatic stabilizers should be allowed to fully operate to mitigate the effects of the shock. Concurrently, active labor market policies should be scaled up to absorb redundant labour and provide targeted and temporary transfers to moderate the impact of rising energy prices and preserve social cohesion. Going forward, a gradual fiscal adjustment would be required to ensure fiscal and debt sustainability, in the context of elevated debt levels and significant fiscal risks from contingent liabilities. We welcome the authorities' commitment to further enhance fiscal buffers and maintain solid public finances, as outlined in the Buff statement. Further efforts are, however, required to contain the wage bill and ensure the self-sustainability of the public health system. As such, we welcome on-going efforts to address attendant irregularities in the system.

While the financial sector has remained resilient with strong capital and liquidity buffers, underlying vulnerabilities should be addressed. Specifically, we encourage decisive actions to tackle the deterioration in asset quality within stage 2 loans. We welcome progress made in cleaning bank balance sheets of toxic legacy assets but stress the need to accelerate progress in the resolution of the NPLs transferred to credit acquiring companies (CACs) and the public asset management company. To this end, we encourage the urgent deployment of existing solvency tools and the strengthening of the foreclosure framework and the CAC regulatory framework. That said, we welcome progress made in strengthening the AML/CFT framework and the authorities' commitment to address the remaining deficiencies. *Could staff elaborate on the pros and cons of the debt for asset swap planned by the authorities? In addition, could staff elaborate on the political pressure to weaken the foreclosure framework?*

Structural reform efforts should be intensified to address governance weaknesses, bridge skills and infrastructure gaps, and strengthen growth prospects. We, therefore, welcome the authorities' commitment to address impediments to growth, including the rule of law, corruption, and digital and infrastructure gaps as articulated in the RRP. We also view the RRP's focus on measures to enhance teaching quality, improve digital skills at all levels of education, and strengthen vocational education, as important steps to address attendant skills mismatches. We also welcome progress in the recently passed legislation on the public service reform, as critical to improve performance and efficiency of public services. In addition, we welcome the recently passed anti-corruption legislation designed to create a strong legal framework against corruption. Nevertheless, further efforts would be required to reform the judicial system to enhance the efficiency of NPL resolution. That said, we commend the authorities drive to promote electricity generation from cleaner sources, improve electricity connectivity, increase energy efficiency in the residential sectors, and enhance public transport. In addition, we welcome the authorities' ambitious plans to reduce greenhouse gas emissions by 2030. *Could staff clarify on progress made in mobilizing financing for the climate change initiatives and elaborate on the other challenges faced in meeting the national climate targets?*

GRAY/22/1300

May 23, 2022

Statement by Mr. Fuentes and Ms. Florestal on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the report and Mr. Dresse and Mr. Ghalanos for the helpful buff statement. After successfully handling the pandemic shock and fostering a strong recovery in 2021, economic activity in Cyprus stands to be severely impacted by the conflict in Ukraine given the country's close trade and financial ties with Russia. Even considering that staff had identified the risks to the Cypriot economic outlook stemming from an escalation and longer duration of the war in Ukraine, the indirect impact of the conflict on energy and food prices will most likely intensify the potential headwinds further. Actually, the higher energy prices are currently rising inflationary pressures and exacerbating the downside risks of de-anchoring inflation expectations. Under these circumstances, further policy support may be needed in the near term to buttress the recovery without losing sight of the fiscal prudence and steadfast commitment to reform warranted to bolster medium-term fiscal sustainability and avoid deepening the scarring effects from the pandemic.

The authorities must carefully calibrate addressing the policy response to the war shock and the need to replenish fiscal buffers. A strong fiscal position allowed the government to address the initial impact of the pandemic with a comprehensive emergency package and an extensive set of measures to support the financial sector. Following that massive policy effort, public finances recorded a significant correction in terms of budget deficit and debt-to-GDP ratio in 2021. However, amid the current shock of the war in Ukraine, a more gradual fiscal adjustment will be necessary in 2022 to bolster economic activity and protect the vulnerable population. In this regard, we concur with staff that any additional support measure should be temporary and well-targeted. Against this background, we welcome the authorities' expressed commitment to achieve a primary budget surplus by 2024 and place public debt on a declining path. Yet, achieving these objectives will require strict fiscal discipline considering the elevated post-pandemic debt level and the sensitivity of the high gross financing to shocks. In addition, we concur that even if the public wage bill has been contained within the nominal GDP growth to maintain debt sustainability, a more durable mechanism to keep it in check is needed. In that vein, further progress in legislative reforms of SOEs and the implementation of measures to mitigate the fiscal risks emanating from the National Health System (NHS) are also critical to support medium-term fiscal sustainability.

The financial system has shown resilience throughout the pandemic, but closer monitoring is needed considering the new risks brought on by the war in Ukraine. While banks remain liquid and well-capitalized, legacy NPLs continue to be high, and 'stage 2' loans have grown steadily during the pandemic. In this regard, while direct banking exposure to Russia is low, loans with significantly deteriorated credit quality appear to be concentrated in tourism-related sectors, which are likely to be the most affected by war-related shocks. Therefore, we concur with staff on the need for a more forceful implementation of the reduction strategy of legacy NPLs and to improve loan restructuring tools. Furthermore, we encourage the authorities to take additional steps to strengthen the legal framework and, most particularly, to remove uncertainties related to the implementation of foreclosures.

Reforms to strengthen governance and address bottlenecks are key to improve growth prospects. The progress registered in the implementation of past Fund advice is to be commended, particularly related to strengthening judicial efficiency and commercial claims. Yet, advancing in the implementation of the Recovery and Resilience Plan (RRP) remains critical to boost potential growth by narrowing gaps and reducing mismatches in human capital skills, infrastructure, and digitalization. In addition, structural reforms aimed at raising productivity and enhancing competitiveness are also crucial to improve the external position, which has been weaken by the pandemic, the deterioration in terms of trade and the sustained decline in primary income. Furthermore, we take note of staff's assessment on the potential impact of Ukrainian refugees on the Cypriot economy regarding alleviating the labor shortage in some economic sectors, as well as bringing entrepreneurship by reallocating their businesses to Cyprus.

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

GRAY/22/1301

May 23, 2022

Statement by Mr. Sylla and Mrs. Bah on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the comprehensive reports and Mr. Dresse and Mr. Ghalanos for their insightful Buff statement.

We welcome the Cypriot authorities' endeavors to foster recovery and maintain well-being amid still ongoing efforts to address financial vulnerabilities inherited from the 2012-2013 financial crisis and the difficult health and geopolitical contexts. A swift policy response to the pandemic helped reduce its adverse effects on the population and businesses, notably by safeguarding mobility and economic activity. However, the growth momentum gained in 2021 has been overshadowed by the negative spillovers from the war in Ukraine, given the country's high dependency on demand from Russia, especially in the tourism sector and professional services. To supplement the country's strong social safety net, the Cypriot government should continue to support the most vulnerable with well-targeted measures to help face the multiple shocks and prevent permanent scarring. The authorities should remain vigilant on the materialization of downside risks to the outlook stemming from a heightened and prolonged war in Ukraine, unfavorable international financial conditions, and possibilities of new aggressive COVID waves.

Given the gloomy geopolitical outlook, Cyprus should set a steady path towards restoring fiscal buffers to support the economy during dire times. To this end, containing public debt and reinforcing fiscal discipline would be essential to promote fiscal sustainability. Going forward, we see merit in rationalizing government expenditures, with additional efforts to control the wage bill and untargeted support measures. We agree that the reductions of excise duty on fuel and value-added tax on electricity bills contribute to bring some relief to vulnerable households. *However, how long would these measures be tenable for the Cypriot public finances, given renewed extensions? Staff comments are welcome*. We encourage the authorities to continue to strengthen the social safety nets, with improved targeting of the beneficiaries of social transfer programs to ensure that support goes to those who need it most. We also call for more vigilance to appropriately address the loopholes identified in the health and social systems to improve efficiency and cut undue costs.

Further progress in NPL resolution and a more robust management of the financial system should help improve financial stability and strengthen the role of credit in supporting growth. We acknowledge the progress made in the banking sector through the transfer of the burdensome NPL legacy from the financial crisis to credit acquiring companies (CAC), whose role is paramount to strengthening the claims enforcement process and confronting indelicate borrowers and defaulters among Cypriot households and businesses. Nevertheless, restructuring and foreclosure activity have been limited and should be increased as the socioeconomic context allows to avoid further weakening of credit discipline. In this respect, we take note that auctions of foreclosed properties are progressively being scheduled following the freeze imposed by the authorities due to the COVID-19 fallout. Scrutiny on financial asset quality is warranted amid heightened internal and external pressures. Moreover, we call on the Central Bank of Cyprus to continue to address identified weaknesses in governance and strengthen AML/CFT tools to further support the resilience of the banking system.

We encourage the authorities to maintain engagement in structural reforms to upgrade public service, improve productivity and support the transition to a greener economy. The court system should be further reshaped to reduce the delays in delivering justice to Cypriot households and businesses. To this end, we welcome the reforms introduced to streamline and alleviate the processes and procedures in the justice system. Concerning productivity enhancement, the Cypriot labor market needs the education system and vocational training programs to adapt to accommodate the rising demand for skilled workers and address the mismatches and digital gap. Moreover, reducing the dependency on foreign energy and achieving a swift green transition are critical to the country's sustainable development. *Nevertheless, it would be interesting to assess the possible contribution of these policies in fueling inflationary pressures. Staff's views would be appreciated*. In any case, the important amount allocated to Cyprus by the Recovery and Resilience Facility (RRF) of Next Generation EU (NGEU) to finance the green transition is appreciable, as stated in the Buff.

With these remarks, we wish the Cypriot authorities and population all success.

GRAY/22/1302

May 23, 2022

Statement by Mr. Pösö on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank Staff for their clear and insightful report in the context of Cyprus' Article IV consultation. We also thank Mr. Dresse and Mr. Ghalanos for their informative Buff statement. We commend the national and EU authorities' resolve to fight the economic, social, and health consequences of the ongoing pandemic.

The Cypriot economy weathered the pandemic well, rebounding strongly from the COVID-induced shock. After this year's slowdown, induced by Russia's war against Ukraine, robust growth is expected to return, in a context of increased uncertainty. The country has rightly used the favorable macroeconomic conditions to improve its public finances, but on account of its still high level of public debt, fiscal policy should continue to aim at rebuilding fiscal buffers, while remaining flexible and providing targeted support if needed. At the same time, to sustain its strong economic performance in the long term and reduce vulnerabilities, the implementation of structural reforms that counter impediments to growth remains crucial. The key structural challenges for the Cypriot economy are effectively addressed in Cyprus' Recovery and Resilience Plan (RRP), of which a swift implementation is key. Strong emphasis also needs to be put on further diversifying the economy, while ensuring environmental and social sustainability.

Macroeconomic Developments

We broadly agree with Staff's macroeconomic assessment, and also expect the Cypriot economy to resume its strong growth in 2023, despite the very high uncertainty. Until early 2020, Cyprus experienced a rapid expansion, which was interrupted by the pandemic. Growth bounced back strongly in 2021 on the back of robust domestic demand, underpinned by exceptional COVID-related fiscal support, and of net exports, despite the only partial recovery of the tourism sector. The Cypriot economy is expected to be directly affected by the Russian invasion of Ukraine through the drop in tourist arrivals, and by a hit on professional services' exchanges and investment flows with Russia. However, and although the exposure of the Cypriot economy to Russia is higher than in other euro area countries, direct financial, real estate and other linkages appear contained, and have declined in recent years. Therefore, we expect that the impact will be largely limited to 2022, and the economy is forecast to resume its strong growth momentum in 2023. Medium-term growth trends remain favorable, underpinned by the foreseen investments and reforms under the RRP. At the same time, long-standing imbalances constrain potential growth, and should also be addressed. Such factors include the high level of private debt, in particular of NFCs, and a significant current account deficit, which is expected to remain sizeable on account of high energy prices and the country’s large energy import dependency.

Fiscal policies

We concur that fiscal policy should aim at continuing to rebuild buffers, while remaining flexible and providing targeted support if needed. After a sharp deterioration reflecting pandemic-related fiscal spending, both the public debt ratio and deficit improved notably in 2021 and are projected to decline further in 2022 and 2023. The fiscal costs of the measures taken so far in response to higher energy prices have been limited, but should the need arise for additional support, measures should be temporary and targeted at vulnerable households, set the right incentives for an efficient energy use, and not hinder the reallocation of labor to expanding sectors of the economy, such as ICT. Fiscal risks lie primarily on the expenditure side and include the potential materialization of contingent liabilities related to the banking sector, the costs in the implementation of the National Health System reform, and long-term pension liabilities of public entities. In this context, and in light of its still high debt level, we concur that a prudent expenditure management is essential to rebuild fiscal buffers. In this respect, the government should resist pressures to unwind key reforms, contain the growth of the public wage bill, and enhance the efficiency of public sector spending. The implementation of fiscal institutional reforms, including those of Cyprus’ RRP, could also help to contain long-term risks.

Structural policies

Cyprus’ RRP effectively addresses key structural challenges and offers the opportunity to press ahead with reforms aimed at removing structural bottlenecks and achieving a more sustainable growth model. We agree that reforms to strengthen governance and the business environment, and to tackle skills, digital, and infrastructure gaps, are key to improve growth prospects. The Cypriot RRP is ambitious and comprehensive, addressing the majority of long-standing challenges and required reforms. It includes measures aimed at reducing economic vulnerabilities, such as non-performing loans and private indebtedness, and key institutional reforms in the judicial system, anti-corruption, efficiency of the public sector, and tackling aggressive tax planning. The RRP also attaches particular importance to the green and digital transitions. Although not included in the Plan, improving the governance of state-owned entities should also be a priority. As Staff, we also recommend that Cyprus enhances its efforts to achieve the national climate targets. We welcome the government’s plans to promote renewable energy sources and energy efficiency as well as its plan to introduce a carbon tax for fuels used in the non-ETS sectors.

Financial sector policies

We broadly agree that while the Cypriot financial system has proven resilient, authorities should address asset quality given the worsened outlook, and in particular the legacy of NPLs through a more forceful implementation of existing tools. Banks maintained adequate capital levels throughout the pandemic, but the amount of risk exposures is still sizeable, and vulnerabilities could increase if the outlook deteriorates. The stock of NPLs has continued to be reduced, but the resolution of NPLs by credit acquiring companies and the public Asset Management Company (KEDIPES) has indeed been slow. We agree that further addressing asset quality remains a key priority, and that resolving legacy NPLs requires more forceful implementation of the existing tools, notably effective foreclosure and insolvency frameworks. At the same time, the Staff report could also give more credit on the progress made so far, in particular by the largest banks. Authorities are preparing a legislative package with the objective of reducing legacy NPLs and improving their management, as well as expanding the scope of KEDIPES. In this context, it is important that such initiatives are carefully designed, that their fiscal risks are contained, and that risks for payment discipline are mitigated. Structurally low profitability also hinders further NPL reductions, and in this context, the report could put more emphasis on the need to sustain profitability, especially through cost efficiency, and given that organic capital generation capacity will continue to remain under pressure, and cost-savings through digitalization will take time to materialize. Finally, Authorities should continue to address identified weaknesses and strengthen the implementation of the anti-money laundering and countering financing of terrorism framework, reflecting MONEYVAL’s assessment.

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GRAY/22/1303

May 23, 2022

Joint Statement by Ms. Kashima, Mr. Mochtar, Mr. Parkyn, Ms. Fukuda, Mr. Hteik, and Ms. Karl on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the report and Mr. Dresse and Mr. Ghalanos for their informative Buff statement.

We commend the Cypriot authorities for their successful management of the pandemic and sizeable policy support, which has enabled output to recover to its pre-pandemic level and unemployment to decline. However, the war in Ukraine poses additional challenges given Cyprus's trade exposures to Russia, in addition to the lingering effects of the financial crises of 2012-2013 and the pandemic. Looking ahead, the risks are tilted to the downside due to the possibility of prolonged war and sanctions, abrupt global tightening, and uncontrolled and more severe Covid outbreaks. **We broadly agree with the thrust of the staff appraisal and would like to offer the following comments for emphasis.**

We agree with staff that the government's fiscal plan is consistent with generating a small fiscal surplus in the medium term and a steady decline in public debt. In the near-term, fiscal policy could be recalibrated as needed to address significant uncertainties arising from war-related shocks. If automatic stabilizers are enabled, Cyprus's substantial social safety net would shield the most vulnerable from the shock. We concur with staff that any additional support measures should be strictly targeted and timebound to remain consistent with fiscal consolidation efforts. Public investment management should be enhanced to strengthen fiscal discipline and to allow smooth absorption of the financing from the NGEU. Further, we encourage the authorities to address irregularities in NHS procurements and swiftly implement plans to achieve financial self-sufficiency of public health services.

While noting Cypriot banking sector has remained sound, the elevated level of non-performing loans (NPLs) requires close attention. We are encouraged by the authorities' efforts to lower NPLs to total gross loans ratio from 2019 to 2021 (Table 6). However, we agree with staff that more forceful implementation of the NPL reduction strategy, including enhancement of the foreclosure framework is necessary to expedite the process. We also note the envisaged expansion of the public Asset Management Company (KEDIPES) to support vulnerable borrowers. To this end, as too much easing could deplete fiscal buffers and erode market confidence, we see merit in refining the plan. *As Table*

6 shows that the provisions to NPLs ratio was declining over the last few years, we would be interested to know further the background for the drop and possible way forward for the recovery of the ratio.

We encourage the authorities to step up implementation of the Recovery and Resilience Plan (RRP). We see huge merit in accelerating efforts to address structural impediments to growth, including the rule of law, anti-corruption, education, and digital infrastructures. In particular, the judicial reforms would help address financial stability risks through enhanced NPL resolution. *Aside from training judges and improved processing, it would be interesting to know if there is any reform that could contribute to reducing backlogs of resolution cases under the RRP.* We also support the staff comment that continuous progress in enhancing the AML/CFT and governance frameworks is likely to help Cyprus manage its reputational risks in the current geopolitical setting.

Finally, we agree with staff that meeting the national climate target would enhance the economy's sustainability and energy security. We commend the authorities for their plans for energy diversification and green tax reform. Continued policy focus will be required to achieve the national mitigation targets and support adaptation and economic transition.

With these comments, we wish the authorities every success in their economic endeavors.

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GRAY/22/1304

May 23, 2022

Statement by Mr. Hosseini and Mr. Boostani on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the well-written set of papers and Mr. Dresse and Mr. Ghalanos for their insightful Buff statement. The Cypriot economy had rebounded strongly from the pandemic before being hit by the adverse shock of the war in Ukraine. The negative impact of the COVID-19 pandemic on growth and employment in Cyprus' tourism-dependent economy has been aggravated on the spillovers of the war in Ukraine through higher food and fuel prices and lower tourist receipts. The authorities responded swiftly to the health crisis and are expected to respond similarly to the latest crisis. That said, we concur with the thrust of the staff appraisal and policy recommendations and offer the following points for emphasis.

1. **Fiscal policy should continue rebuilding buffers and gradually lower the public debt ratio to a sustainable level.** While the debt ratio has been declining, it is still high, and fiscal consolidation through revenue mobilization and expenditure prioritization are needed to ensure debt sustainability in the medium term. We agree with the authorities that it would be appropriate to consider new taxes only within a broader tax reform initiative. *Could staff elaborate on the benefits of reintroduction of immovable property tax other than higher revenue?* As higher food and energy prices and a still weak tourist industry have hit the lower income households and vulnerable groups the hardest, the fiscal space should be employed in the short term to alleviate the pressure in a targeted manner.

2. **The negative spillovers of the war in Ukraine are likely to exacerbate the existing vulnerabilities in the financial system.** We positively note that banks have weathered the pandemic shock well, and NPL levels are on a downward path but are still high, particularly in tourism-related areas, and their restructuring is proceeding slower-than-expected. We agree with staff that improvements in restructuring tools, including a more effective foreclosure framework, are necessary to support timely restructuring of debt of viable firms. In the same vein, we support the efforts to introduce a framework to allow the central bank to

implement a countercyclical capital buffer (CCyB). *Could staff provide more details about the policy draft? Are the amendments only related to CCyB?*

3. **Outlook remains subject to downside risks with significant uncertainty.** Cyprus remains prone to the abrupt reversal of capital flows induced by the war in Ukraine, and a protracted low demand for tourist services and slower pace of reforms would harm growth in the medium term.

4. **Structural reforms are essential to paving the way for higher growth.** We welcome the implementation of the Recovery and Resilience Plan (RRP) which has expediated the recovery from the pandemic shock and are of the view that additional reforms would strengthen the Plan's impact. In particular, reforms that address skill gaps in the labor market and streamline reallocation of labor force would improve productivity and growth in the long term. High energy prices also provide an opportunity to accelerate the transition toward a green economy by reducing dependence on fossil fuels and enhancing energy efficiency.

With these remarks, we wish the Cypriot authorities and people every success in their endeavors.

GRAY/22/1305

May 23, 2022

Statement by Ms. Medearis and Mr. Westphal on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for this report and Mr. Dresse and Mr. Ghalanos for their informative Buff statement. After a strong recovery in 2021, Cyprus faces a difficult outlook in light of significant trade, investment, and financial linkages to Russia and potential spillovers from Russia's invasion of Ukraine. **We encourage the authorities to rebuild fiscal space as conditions allow and to continue to address financial sector vulnerabilities, including those related to the resolution of NPLs.**

We welcome the authorities' plan to maintain fiscal discipline, rebuild buffers, and keep debt on a downward path. We agree that if the authorities do offer additional fiscal support in response to spillovers from the war, they should target the support to the most affected and the most vulnerable. We encourage the authorities to move forward on implementing their plan for public hospitals to reach financial self-sufficiency by extending service hours, providing additional services, addressing expenditure irregularities, and improving audits. We share staff's concerns about the risks posed by the proposed mortgage-to-rent scheme and agree that the authorities should explore safeguards to limit the potential fiscal impact of the program, including by targeting the program to the most vulnerable and making the support timebound.

We welcome that Cypriot banks have proven resilient in the wake of the pandemic; however, we urge the authorities to continue addressing financial sector risks, particularly those related to elevated NPLs. We welcome that banks have taken steps to reduce their exposures to NPLs by offloading the NPLs to credit acquiring companies (CACs). Going forward, the authorities need to strengthen their oversight of the CACs and encourage resolution of the NPLs by issuing clear guidance and removing ambiguities in the foreclosure framework. To further strengthen financial stability, the authorities should continue to promote the use of insolvency tools, supported by a timely implementation of the EU Directive on Preventive Restructuring and Second Chance. We also encourage the authorities to implement the recommendations from the last safeguards assessment on strengthening the central bank's governance and financial autonomy. We appreciate staff's recognition of potential vulnerabilities that could arise from Cyprus's deep financial connections to Russia. Finally, we urge the authorities to address the AML/CFT weaknesses identified in Cyprus's recent FATF mutual evaluation and follow up reports. We caution that individuals have used the weak beneficial ownership controls and the former citizenship by investment program to funnel money and obfuscate ownership and control. We would welcome deeper coverage of these issues going forward.

We support staff's recommendation that the authorities should use the EU-funded national Recovery and Resilience Plan (RRP) to strengthen governance, address skills gaps, and help meet the national climate targets. We appreciate staff's assessment that RRP investments and structural reforms could boost potential output substantially over the medium term. We also welcome staff's analysis of Cyprus's efforts to address climate change, including the insight that the authorities can largely offset any negative impact on GDP growth from a carbon tax by recycling the revenues. *We would welcome additional analysis on the distributional impacts of the recycling of such revenues, as well as insights that can be drawn from countries that have implemented such measures successfully.*

We appreciate staff's detailed external assessment, which highlights Cyprus's vulnerability to financial market risks due to its sizable public and private external debt. We welcome staff's coverage of the deterioration in the external position during the pandemic and that staff's projections suggest that the current account and the NIIP should improve again over the medium term. *We would appreciate insights from any sensitivity analysis that staff performed for these projections, particularly in light of Cyprus's deep trade, investment, and financial linkages to Russia.*

GRAY/22/1306

May 23, 2022

Statement by Mr. Massourakis and Mr. Spadafora on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for an informative set of reports and Mr. Dresse and Mr. Ghalanos for their candid Buff statement. We associate ourselves with Mr. Poso's statement and offer some additional comments for emphasis. Following a successful recovery from the pandemic, Cyprus is now affected by the fallout from the war in Ukraine, whose impact on tourism and professional services sectors is so far expected to be contained in 2022; GDP growth is projected to more than halve this year but recover strongly in 2023. The authorities should focus on advancing investment and implementing structural reforms in the Recovery and Resilience Plan (RRP) to regain the recovery momentum and facilitate the transition towards a greener, digital, and more sustainable economy. Continued efforts are also needed to resolve legacy issues from the financial crisis – namely high indebtedness and NPLs. We agree with staff that the key near-term challenge is to calibrate a policy response to the new shocks to safeguard macroeconomic stability and durably improve growth prospects.

- **We agree that, while automatic stabilizers should be allowed to operate, there may be a case for discretionary fiscal policy support in the short term**, which should be targeted and temporary. In the medium term, given the high financial sector's contingent liabilities, we welcome the government's plans to gradually rebuild fiscal buffers; we support the staff's call to take further action to rein in health spending and the public sector wage bill, with a view to securing the fiscal targets.
- **It is paramount to more resolutely implement the strategy to reduce persistently high NPLs and fully restore the banks' ability to provide credit to the economy**. To this end, we agree that an effective foreclosure framework, a more efficient judicial system and operational improvements for credit-acquiring companies (CACs) are all critical to speed up NPL resolution and restore credit discipline, including by addressing strategic defaulters. In the same vein, we support the staff's recommendation that, to uphold credit discipline and minimize the fiscal impact of the planned expansion of KEDIPES into a national AMC, the Mortgage-to-Rent scheme envisaged to protect vulnerable borrowers should be well targeted, based on strict means-tested criteria and complemented by the additional safeguards listed by staff in paragraph 30 to address risks.

- **We share staff's recommendation that the authorities could consider accelerating key reforms in the RRP** to address weaknesses in the areas of governance, skills and digital infrastructure that weigh on growth prospects despite Cyprus' competitiveness strengths. Further progress in improving AML/CFT and governance frameworks – along the lines suggested by staff in paragraphs 33 and 46 – remains a priority, including because of heightened reputational risks posed by the war in Ukraine.
- **We commend the authorities for the ambitious national climate targets**, a key component of the country's development agenda, which would also help diversify energy sources and improve energy security. While recognizing the challenges posed by current circumstances, we encourage the authorities to make the most of available EU funding – including from the RRP – to complement national budgets in financing green investment.

GRAY/22/1307

May 23, 2022

Statement by Mr. Zhang and Ms. Yang on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the well-written report and Mr. Dresse and Mr. Ghalanos for the helpful Buff statement. We commend the Cypriot authorities for their effective policy response to cushion the pandemic impact. While Cyprus weathered the pandemic well, the geopolitical crisis and high inflation will likely take a toll on the economy. Looking ahead, continuous efforts to address legacy issues of weak governance and structural bottlenecks are critical. We broadly agree with staff's appraisal and would like to focus our comments on the following points.

Near term fiscal policy should remain targeted and flexible, while medium-term fiscal adjustment is needed to build buffer and put public debt on a more sustainable footing. While we see the current fiscal policy stance as appropriate, we agree with staff that any additional support should be temporary, targeted, and not hinder labor reallocation should the situation deteriorate. We welcome the authorities' commitment to further enhance fiscal buffers and maintain solid public finances over the medium term. In this regard, the authorities should ensure the public wage bill does not accelerate beyond productivity and improve efficiency of the National Health System (NHS). Moreover, public investment management should be strengthened to fully utilize Next Generation EU funds and support economic transition.

We agree with staff recommendations on addressing financial vulnerabilities. Persistent high NPLs require forceful implementation of the NPL reduction strategy, particularly addressing uncertainties in the implementation of the foreclosure framework and improving working environment of CACs. To avoid further weakening credit discipline and to minimize fiscal impact, we share staff's recommendation that the planned expansion of KEDIPES should be well-targeted to the most vulnerable households and include safeguards with timebound settings. While banks have made progress in restructuring loans, improving restructuring tools is needed to support timely restructuring of viable businesses. Ongoing efforts are warranted to address weaknesses in the AML/CFT framework.

Finally, we encourage the authorities to advance their structural reforms, which are essential to achieve sustainable and inclusive growth. Weaknesses in governance, skill gaps and mismatches, and digital and infrastructure gaps weigh on growth prospects. An effective and timely implementation of the Recovery and Resilience Plan (RRP) would be instrumental in raising potential growth and supporting a structural transformation of the economy towards green and digital objectives. We welcome the authorities' ambitious climate targets, as well as its efforts to implement climate-related projects and provide incentives to the private sector for green transition. Although carbon taxation is favorably viewed by the public, the negative impact on households must be carefully considered and mitigated.

With these remarks, we wish the authorities every success in their policy endeavors.

GRAY/22/1308

May 23, 2022

Statement by Mr. Lischinsky and Ms. Ramos Capaquira on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the informative report and Messrs. Dresse and Ghalanos for their helpful Buff statement. **After being affected by the pandemic, the Cypriot economy recorded a very significant recovery in 2021 due to support policies grounded mainly on its sound fiscal position.** Indeed, after a 5 percent GDP drop in 2020, the economy grew by 5.5 percent in 2021, with output and unemployment returning to pre-pandemic levels, amid an impressive vaccination campaign and a set of support measures by the government. The recovery was encouraging that most of the policies were withdrawn; however, the uncertainty about the pandemic's path and the impact of the geopolitical tensions threaten the economy once again.

Although the geopolitical conflict is expected to impact on the Cypriot economy, the authorities are more optimistic given the progress on diversification. We highlight the slightly more optimistic position of the authorities, who foresee an impact mostly limited to the tourism and professional services sectors but contained in the former given an improvement in alternative tourism markets that could offset the effect on that sector from the stop of Russian arrivals. The economic diversification in recent years would moderate this impact as well; in this context, we welcome the country's efforts in this regard and the Recovery and Resilience Plan (RRP) to deepen these advances.

We commend Cyprus' strong fiscal correction in 2021, which will help the country face the current pressures and overcome a sustained growth in the medium term. We take positive note of the low fiscal deficit, the robust social safety nets, the expectation of a fiscal surplus in the medium term, the declining path of public debt, and the remarkable recent upgrades in credit ratings. We also welcome the authorities' commitment to restore buffers in the medium term and their willingness to implement support policies in the present juncture if needed, such as the current measures to tackle the rising prices and protect the most vulnerable households and sectors. Regarding the public debt, *could staff elaborate on the reasons behind the different pace of the debt decline projected by staff and the authorities in the medium term? Is this restricted to differences in growth and fiscal balance outlooks?*

Regarding the financial policy, the efforts and progress on reducing non-performing loans (NPLs) and ensuring improvements in financial stability were outstanding; the authorities are

encouraged to go further on them. The role played by the credit acquiring companies (CACs) and the Cyprus Asset Management Company (KEDIPES) was important in reducing NPLs; however, as noted by staff and acknowledged by the authorities, the expansion of KEDIPES through the mortgage-to-rent (MtR) mechanism should be well-targeted and safeguard the payment culture. Therefore, further efforts to address the vulnerabilities and to improve financial stability are encouraged. Moreover, in order to help face the current pressures on the economy, we concur with staff's recommendation about avoiding a broad tightening of financial conditions since loans are still recovering.

Finally, we commend the authorities' efforts on structural reforms through the Recovery and Resilience Plan (RRP) to guarantee sustained growth in the medium and long term. We welcome the authorities' commitment and ongoing efforts on diversifying the economy. Regarding the importance of public investment on this aim, we agree with staff about the need to improve public investment management to address growth bottlenecks, where the IMF can help through technical assistance, such as the Public Investment Management Assessment (PIMA). Additionally, we take positive note of the decision to strengthen renewable energy sources, which will help the country in its climate agenda and in reducing its dependence on fuel imports, consequently enhancing its external position. In relation to the RRP impact on growth in the near and medium term, *staff's comments on the differences in estimates from those provided in the Buff statement from a study by the University of Cyprus are welcome.*

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

GRAY/22/1309

May 23, 2022

Statement by Mr. Alhosani and Ms. Hamzah on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the well written report, we also thank Mr. Dresse and Mr. Ghalanos for their useful buff statement. We are in broad agreement with staff's policy recommendations and appraisal. We commend the authorities for protecting the lives and livelihoods of the population through swift vaccine roll-outs and the implementation of early and decisive measures to successfully prevent a COVID-19 outbreak which was evident through the low hospitalization and mortality rates with the Omicron Variant. While public sector support helped cushion the impact of the 2012-2013 financial crisis and the Pandemic, public debt figures are relatively high and the conflict in Ukraine is currently imposing new challenges to the Cypriot Economy. Against this backdrop, we would like to make the following points:

Fiscal policy should remain accommodative and gradually rebuilding fiscal buffers is a key priority. While public sector support helped cushion the impact of the financial crisis and the Pandemic, additional support measures should be temporary and targeted to the mostly impacted groups. *Can staff indicate which sectors and businesses were impacted the most by the Pandemic and should expect temporary and targeted support going forward?* We welcome that the government's fiscal plan is consistent with achieving a small fiscal surplus in 2024 and placing public debt on a downward trajectory, however we agree with staff that policies should aim at restoring buffers through a gradual fiscal adjustment.

The conflict in Ukraine and uncertainties regarding new COVID-19 variants would impose further vulnerabilities which can have a negative impact on economic activity. The tourism and trade sectors were highly impacted by the Pandemic and are now undergoing additional vulnerabilities due to the conflict in Ukraine. Although financial linkages to Russia have reduced since the financial crisis, exposures through trade in services, which mainly comprise of tourism and professional services, remain very high.

Exports to Russia also account for about 10 percent of GDP, which is the highest level in the Euro Area. Additionally, professional services are expected to be impacted further by the sanctions imposed on Russia. We positively take note that economic diversification is reducing the dependence on tourism in favor of high value-added sectors such as ICT and encourage the authorities to maintain their structural reforms agenda to help speed up the recovery and positively impact growth.

Structural reforms and improving the business environment are key to diversify sources of income for Cyprus. We positively take note of the authorities' commitment to structural reforms and welcome the initiatives under the Recovery and Resilience Plan (RRP) in addition to the strong growth in consumption and investment which is partly in response to the Cyprus Investment Program (CIP). We also take note of the progress made in passing the long-standing legislation on difficult civil service and local government reforms. We encourage the authorities to accelerate structural reforms in other areas critical for boosting potential growth and address key infrastructure gaps that may be exacerbating the costs of doing business, such as judicial reforms which are critical to the operation of the foreclosure framework.

Furthermore, we welcome the significant progress made in reducing banks' NPLs by offloading them to credit acquiring companies (CACs) and the public Asset Management Company (KEDIPES). However, we agree with staff that resolving legacy NPLs requires more forceful implementation of the existing tools and an effective foreclosure framework is critical for addressing strategic defaulters.

Finally, we encourage the authorities to continue to protect the lives and livelihoods of the Cypriot population to help prevent a local COVID-19 outbreak.

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

GRAY/22/1310

May 23, 2022

Statement by Mr. Jennings, Mr. O'Brolchain, and Mr. Mooney on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the comprehensive report and Mr. Dresse and Mr. Ghalanos for their helpful Buff statement. The economy of Cyprus had been growing strongly until the onset of the pandemic in 2020, while the Russian invasion of Ukraine has negatively impacted the tourism industry. However, strong growth momentum is anticipated to return in 2023, underpinned by the reforms contained in the Recovery and Resilience Plan (RRP). We agree with the thrust of the report and offer the following points for emphasis.

We agree with staff that fiscal policy should aim at continuing to rebuild buffers, while remaining flexible and providing targeted support as required. Furthermore, any additional support measures to mitigate higher energy prices should be temporary and targeted at vulnerable households, while incentivizing efficient energy use. We concur with staff that the authorities should continue to strengthen public investment management, including the investment planning through SOEs. We positively note the efforts made by the authorities to date to address the irregularities identified in the National Health System (NHS). The authorities should enhance the efficiency of public sector spending, while containing the growth of the public wage bill.

We positively note that the banking sector remains well capitalized, although a further deterioration to the outlook could increase vulnerabilities. In terms of supporting potentially viable businesses, we agree with staff that associated restructuring tools should be enhanced, and we welcome the amendments to the legislative framework to implement the EU Restructuring Directive on Preventive Insolvency Procedures. The reduction in the stock of NPLs is welcome, and we positively note the authorities’ agreement with staff on the importance of a sound foreclosure framework for NPL resolution and financial stability. The authorities should continue to address identified weaknesses and strengthen the implementation of AML/CFT measures.

We welcome the authorities' focus on making climate change an important element of the country's development agenda, as outlined in Appendix VI. We urge the authorities to enhance efforts to achieve the national climate targets, despite the associated challenges outlined in the report. We positively note that the RRP aims to tackle weak governance, skills gaps and mismatches, and digital and infrastructure gaps. In this regard, we welcome the establishment of a new anti-corruption agency, and the measures to facilitate private investments to upgrade the digital infrastructure.

The COVID-19 pandemic has had a disproportionate impact on female labor force participation. *In light of this, can staff outline the measures implemented by the Cypriot authorities to address this issue?*

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GRAY/22/1312

May 23, 2022

Statement by Ms. Rieck and Ms. Wilbert on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the informative report and Mr. Dresse and Mr. Ghalanos for the insightful Buff statement. We concur with the thrust of the staff appraisal and associate ourselves with Mr. Pösö's GRAY statement. We would like to offer some further comments:

We positively note the quick economic recovery in 2021 and the promising medium-term outlook in Cyprus. Nonetheless, the high public debt ratio and existing financial sector vulnerabilities continue to cloud the growth outlook, with Russia's war against Ukraine adding to uncertainty. Therefore, adequate policy action, including fiscal consolidation, financial sector resilience, and progress on the structural reform agenda are warranted.

We welcome the significant decline of the NPL ratio in recent years. Nonetheless, there is no room for complacency as the NPL ratio remains elevated and the ratio of loans with significantly increased credit risks (IFRS Stage 2) has further increased recently. The restructuring of problem loans needs to progress to build resilience against potential future defaults, inter alia in tourism-related industries, especially those with a significant share of Russian tourists before the war. As experience from other countries demonstrates, a suitable legal framework and an efficient judicial system play important roles in reducing NPLs. We therefore encourage progress in this regard. A further reduction of NPLs and the restructuring of problem loans are not only warranted to improve the banks' profitability and their capacity to provide new loans, but also to reduce the significant level of contingent liabilities from the financial sector. In this context, we agree with staff that the support scheme KEDIPES should be well targeted and calibrated not to overexert the fiscal capacities.

A successful implementation of the Recovery and Resilience Plan (RRP) and progress on the climate agenda should help to maintain broad-based, sustainable growth. While we agree with the focus areas of the RRP, we encourage the authorities to build up sufficient capacities to make appropriate use of the EU funding. Despite the challenging environment including elevated energy prices, the authorities should remain committed to their climate targets. Improving energy efficiency and investing in alternative energy sources will not only reduce emissions, but also curb energy dependency. In this context, we welcome the government's plan to introduce a carbon tax on fuels for sectors not covered by the ETS.

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The contents of this document are preliminary and subject to change.

GRAY/22/1313

May 23, 2022

Statement by Mr. Palotai, Mr. Just, and Mr. Marek on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the informative report, and Messrs. Dresse and Ghalanos for their helpful Buff statement. The authorities' sizable policy response and efficient vaccination campaign were instrumental in accelerating economic growth after the Covid-19 pandemic. At the same time, the medium- and long-term economic prospects depend on overcoming several of the past financial sector crisis' legacy issues, as well as mitigating economic vulnerabilities stemming from the war in Ukraine, and the impact on tourism and shipping. **We share the thrust of the staff appraisal, and particularly encourage the authorities to put public debt on a steadily downward path and keep contingent liabilities in the financial sector in check.** Strengthening governance, including the AML/CFT framework, and the sound implementation of Recovery and Resilience Facility-supported investments will be instrumental in boosting Cyprus' growth potential. We associate ourselves with Mr. Pösö's statement.

While we welcome that positive growth in 2021 helped reduce the elevated public debt-to-GDP ratio, the authorities need to be mindful of maintaining debt on a firmly downward trajectory. Fiscal consolidation should be underpinned by a positive fiscal balance in the medium term, as per the authorities' Stability Program 2022-25, and in line with the national fiscal rules. While the sound management of the National Health System is an important precondition for enhancing its financial sustainability and transparency, containing the relatively high wage bill in the public sector is critical to ease pressure on fiscal spending. Several risk factors in staff's Debt Sustainability Analysis merit close monitoring, in particular contingent liabilities in the financial sector, and the substantial impact which the planned expansion of the public asset management company (KEDIPES) would have on the fiscal position. *In this context, we would welcome staff's comments on the trade-offs related to shifting the financial risk from the financial to the public sector through KEDIPES.*

The financial sector's intermediary function needs to be enhanced by a decisive action to resolve the legacy non-performing loan (NPL) stock. While we positively note that the share of NPLs in the financial sector has been substantially reduced since 2014, we are concerned that it remains the second highest in the EU. In this context, the authorities are strongly encouraged to ensure that the foreclosure framework remains robust and fit for purpose. It is also critical to strengthen the transparency of credit acquiring agencies (CACs) through thorough oversight, in order to protect the level playing field on the credit market and improve the functioning of the real estate market. While we note the authorities' objective to protect vulnerable residents through the expansion of the KEDIPES, we consider such plans a crisis-solution, which should be temporary, well-targeted and based on a sound governance framework. We share staff's suggestions for the plan's refinements as usefully outlined in Annex VII, and caution against extending the scope for moral hazard in both the CACs and banking sectors. Enhancing the restructuring framework for businesses in line with EU rules is critical to mitigate the buildup of NPLs going forward.

The authorities need to move ahead with key structural reforms to lift the growth potential. Supporting the business and institutional environment through strengthening governance, including the AML/CFT framework, as well as advancing digitalization, is instrumental to ensure that Cyprus continues to be an open and stable economy. The authorities should diligently use the funding available under the Next Generation EU Funds to accelerate reforms in their Recovery and Resilience Plan (RRP). To this end, it is pivotal to enhance the funding absorption capacity through continued progress in strengthening public investment management. While building a pipeline with new projects can be challenging, we encourage the authorities to ensure that investment planning is on track. We welcome that a significant share of the total allocation in the RRP will be used for strengthening climate resilience and encourage the authorities to meet their climate goals.

GRAY/22/1314

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 discretional 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.

GRAY/22/1315

May 23, 2022

Statement by Mr. Peter and Mr. Abdygulov on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We broadly concur with the staff appraisal. Cyprus continues to recover from the COVID-19 pandemic, supported by accommodative fiscal policy and a strong vaccination drive, contributing to low hospitalization and mortality rates. The timely and swift policy response allowed to maintain relative macroeconomic stability. However, Cyprus is a regional financial center with considerable external assets and liabilities, which make Cyprus particularly exposed in periods of heightened volatility. Multiple exogenous shocks and spillovers from geopolitical conflicts, trade disruptions, and inflationary pressures are currently placing significant pressure on macroeconomic stability. We encourage the authorities to maintain strict fiscal discipline, build buffers, and accelerate structural reforms. We offer the following comments.

We encourage the authorities to continue fiscal adjustment and reforms to reduce risks to debt sustainability and bolster market confidence. Significant imbalances remain, such as high private, public, and external debt levels. Given Cyprus's high debt-to-GDP ratio and contingent liabilities from the banking sector, debt is highly susceptible to shocks to growth and the realization of contingent liabilities. Around 90 percent of public debt is owed to non-residents. A prolonged pandemic and sustained financial market volatility could increase vulnerability to macro-fiscal shocks. Additionally, private sector short-term foreign liabilities are large, reflecting mainly non-resident deposits in Cypriot banks and foreign debts of non-financial corporates. This may create pressure if liabilities are not rolled over or flows reverse.

Resolving legacy financial sector issues remains the top priority, and further efforts are needed to improve NPL resolution and debt workouts. We welcome recent progress in reducing NPLs, but the stock of NPLs in the banking system remains elevated. We encourage the authorities to implement the NPL reduction strategy more forcefully to tackle the considerable risks in the banking system. A weaker foreclosure framework due to policy reversals undermines also the NPL sales market and weakens payment discipline. Additionally, the slow resolution of legacy NPLs hinders bank profitability and the economy-wide access to credit, acting as a drag on growth. *Could staff comment on the effectiveness of the existing legal framework for NPL resolution?*

Structural reforms are key to raising the growth potential. Low productivity growth and investment and economic efficiency challenges are an obstacle to inclusive long-term growth. We agree that policy priorities should support greater market diversification, competition, and technology adoption. In this context, potential gas extraction and exports could provide diversification and fiscal resources to finance structural reforms and support consolidation. *Could staff comment on this potential source of revenue and its potential impact on Cyprus' fiscal and external balance?* Furthermore, complementary measures to strengthen public sector governance would support private sector development and increase the economy's competitiveness. While we welcome the ongoing improvements in the AML/CFT architecture, the authorities should continue tackling AML/CFT risks and further strengthening their AML/CFT framework.

GRAY/22/1316

May 23, 2022

Statement by Mr. Mozhin and Mr. Tolstikov on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for the well-written report and Mr. Dresse and Mr. Ghalanos for their informative Buff statement.

The Cypriot economy has recovered strongly in 2021, but growth is expected to slow down in 2022, and accelerating inflation is a growing concern. While the effects of the COVID-19 pandemic are diminishing, the economy is experiencing a new shock as sanctions against Russia hurt the tourism and professional services sector. High oil prices may further depress economic activity and increase inflation. In such circumstances, taking into account still elevated public and private debt levels, the authorities should carefully balance the need to support the economy with considerations of further reducing debt vulnerabilities.

On the fiscal side, we welcome the authorities' commitment to maintain fiscal discipline and rebuild fiscal buffers. In view of the current inflationary pressures, the fiscal stimulus above automatic stabilizers would be undesirable. The impact of higher oil prices could be cushioned through more targeted transfers to vulnerable households and laid-off workers. At the same time, the authorities should implement medium-term fiscal measures in order to gradually rebuild fiscal buffers. The concerns about financial sustainability of the National Health Service should be addressed, and public wage bill should be controlled through partial indexation and restrained employment. The funds from Next Generation EU should be used effectively to increase Cyprus's growth potential, facilitating transition towards a greener and more sustainable economy.

We note the acceleration of inflation in recent months, which the authorities consider as the greatest risk to the economy. Inflation increased from 5.0 percent in January 2022 to 8.6 percent in April. Being in the euro area, the Central Bank of Cyprus (CBC) has limited means to contain inflation, except for macroprudential tools. We note that staff do not advise tightening of the financial conditions in view of the negative credit gap and risks in the real estate market. *Do staff consider Cyprus's inflation as transitory? How could the competitiveness of the Cypriot economy be affected by high inflation and the ensuing real exchange rate appreciation?*

Notwithstanding the repeated shocks, the Cypriot banking sector remains resilient, well-capitalized, and liquid. Non-performing loans on bank balance sheets are declining, largely through sales and transfers to credit acquiring companies. However, the growing amount of the stage-2 loans is a concern, as it shows accumulating vulnerabilities, especially in tourism-related sectors affected by sanctions against Russia. The performance of the loan portfolio should be closely monitored. We also agree that the NPL framework should be further strengthened to address the legacy NPLs.

We welcome the authorities' structural reforms agenda and climate goals. The Recovery and Resilience Plan will support pro-growth reforms, addressing governance weaknesses, skills mismatches, and digital and infrastructure gaps. In the governance area, we take positive note of the measures to strengthen the judicial system and improve control of corruption, some of which have already been implemented. While we support the efforts to address weaknesses in anti-money laundering framework, we are surprised that staff connect these efforts with "current geopolitical context". We continue to believe that the intended purpose of anti-money laundering measures is to combat criminals and prevent them from using the proceeds of crime. *How could the AML work be linked to the current geopolitical context? Has the FATF issued any guidance on this? We would welcome staff comments in this regard.*

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GRAY/22/1317

May 23, 2022

Statement by Mr. Buissé, Mr. Roman, and Mr. Grossmann-Wirth on Cyprus (Preliminary)
Executive Board Meeting
May 25, 2022

We thank staff for an insightful report, including the important Annexes on climate policies, the expansion of the public AMC and the structural reforms under the Recovery and Resilience Plan (RRP). We also thank Mr. Dresse and Mr. Ghalanos for their comprehensive Buff statement.

We agree with the thrust of Staff's appraisal and policy recommendations, associate ourselves with Mr. Pösö's statement and would like to only offer a few additional remarks for emphasis and questions to staff:

- **We agree that fiscal policy will need to be carefully calibrated depending on the strength of the recovery and the size of the war-related shock.** Exceptional pandemic-related fiscal support enabled a strong recovery since 2021, despite the only partial recovery of the tourism sector. But as mentioned in the report, the Cypriot economy is now expected to be directly affected by the Russian invasion of Ukraine through a drop in tourism and a hit on professional services. We note that, according to the authorities, tourists from other countries and some recent economic diversification could partially compensate the negative impact on activity. Depending on the strength of the recovery, the authorities will need to carefully adjust their fiscal stance in 2022 with possible additional temporary and targeted fiscal support, if necessary, on top of automatic stabilizers. Once the continuation of the recovery is secured, a gradual fiscal adjustment is required to place the public debt ratio on a declining path while preserving economic growth.

- **We highlight the role of the RRP in supporting growth through both investment and structural reforms.** We agree with staff on the importance of reforms to strengthen governance and the business environment, as well as to tackle skills, digital, and infrastructure gaps. The RRP also includes measures aimed at reducing economic vulnerabilities, such as non-performing loans and private indebtedness, and key institutional reforms in the judicial system, anti-corruption, efficiency of the public sector, and aggressive tax planning. The RRP also attaches particular importance to the green and digital transitions (as mentioned in the report and in the Buff statement, 41 percent of the RRP funds are to be used for financing the green transition).

- **On non-performing loans, we agree that resolving legacy NPLs requires more forceful implementation of the existing tools**, notably effective foreclosure and insolvency frameworks. At the same time, we consider that the report could give more credit on the progress made so far, in particular by the largest banks.

- **We support the swift implementation of energy transition and climate measures in line with Cyprus ambitious targets.** We support the planned carbon tax on non-ETS sectors and encourage the swift implementation of the investment projects and measures to support renewable energy sources and energy efficiency included in the National Energy and Climate Plan (NECP). We command staff for presenting in Annex VI a first analysis on the proposed measures, including suggestions on how to best alleviate the cost of carbon pricing for lower-income households. We also welcome the simulations on GHG Emissions across sectors as well as the connection between these measures and the evolution of the country's growth model. *Could staff indicate if this analysis and GHG Emissions simulations could be generalized and presented in a uniform format in all article IV reports (with discrepancies only related to country specificities and data availability issues)?*

GRAY/22/1318

May 23, 2022

Statement by Mr. Bhalla and Mr. Goyal on Cyprus
(Preliminary)
Executive Board Meeting
May 25, 2022

1. We thank Staff for a comprehensive report and Mr. Dresse and Mr. Ghalanos for a helpful Buff statement on Cyprus.

2. We note that Cyprus is having significant economic impact due to the Ukraine conflict. With sizeable trade linkages with Russia, sanctions have adversely impacted the tourism industry and investment inflows. Moreover, the rise in energy prices has worsened the terms of trade that has affected the external balance. As a result, recovery from the economic slowdown caused by the pandemic would take longer, and it may gain momentum from 2023 onward. We note that these projections are based on the assumption that sanctions would not be stricter than the level in March 2022. Thus, there is a downside risk to growth prospects/ projections if sanctions are tightened further.

3. In the wake of additional Government spending during the pandemic, the fiscal situation worsened, and the public debt ratio rose to 115 per cent in 2020. The baseline scenario projected by Staff shows a significant improvement in fiscal balance and a sustained decline in the debt ratio. We observe downside risks to the fiscal situation arising from subsidies extended to National Health System (NHS) and efforts to reduce NPLs relating to households and non-financial corporates through credit acquiring companies such as KEDIPES. We encourage authorities to appropriately target the policies toward NHS and NPLs to limit the fiscal impact.

4. We support the Staff's suggestion that uncertainties in implementing the foreclosure framework, which got weakened under political pressures during the

pandemic, may be addressed effectively. This is essential to guard against the worsening of credit culture and repayment discipline.

5. We observe that all dividend and interest payments from Russia to Cyprus are subject to 15 per cent withholding tax since 2021. Can Staff provide the details of investment flows before and after the introduction of this tax until February 2022 and thereafter.

6. We note with concern that Cyprus is not only grappling with weak governance and structural bottlenecks its performance has worsened over the years. Given the role of Cyprus as a financial centre and business hub, we observe with concern that there is a sharp worsening of the 'control of corruption' indicator, and progress on AML/ CFT regulation is quite slow. As noted in the Report, there is no improvement on any of the recommendations concerning compliance with FATF standards. We encourage authorities to increase their efforts for improvement in these aspects.

We wish authorities all the best in their future endeavours.

Statement by Rasmus Rueffer (ECB Representative) and Dimitrios Rakitzis (Advisor) on Cyprus – 2022 Article IV Consultation
IMF Executive Board Meeting
25 May 2022

We would like to thank Messrs. Dresse and Ghalanos for their informative Buff statement and Staff for their balanced Report. We broadly agree with Staff and share many of the main findings, in particular those related to the challenges facing the Cypriot economy and priorities ahead. We associate ourselves with the statement of Mr. Pösö and would also like to highlight the following items for emphasis.

We concur with the macroeconomic assessment in the Staff report and also do not expect Russia's invasion of Ukraine to affect medium-term growth trends. The Cypriot economy will be affected by the Russia-Ukraine war mostly through the drop in tourist arrivals from Russian and Ukraine and through a hit on professional services. We share the view that the impact on the economy will be largely contained to 2022, but note that Staff's projections are somewhat lower than those of other institutions, including the ECB. The medium-term outlook remains favourable for Cyprus, underpinned by the foreseen investments and reforms under the Recovery and Resilience Programme (RRP).

At the same time, longer-standing issues that constrain potential growth are still cause for concern. Such factors include the high level of private debt and the significant current account deficit. Private sector debt, in particular of NFCs, is still among the highest in the euro area (even after adjusting for special purpose entities, SPEs). Furthermore, the current account deficit has remained persistently negative even after adjusting for the activities of special purpose entities. It is expected to remain sizable on account of high energy prices and the large energy import dependency of Cyprus – the second highest in the EU – and the exposure to tourism services. The net international investment position is negative, and significantly below the -35% of GDP threshold of the EU Macroeconomic Imbalance Procedure. Further work towards the resolution of these issues would enhance the Cypriot economy's growth prospects.

Turning to fiscal policies, we agree with Staff's assessment that in light of prevailing uncertainty further fiscal support should be targeted. The uncertainty surrounding the fiscal projection is high. Cyprus has so far provided very limited energy compensatory measures, amounting to 0.2% of GDP, which, however, could increase as time passes and support is sustained. However, the already legislated measures consist mainly of tax cuts which are to a large extent untargeted and do not provide the right price incentives for using energy efficiently. Possible additional fiscal support measures in response to high energy prices should therefore be well-targeted, temporary and set the right incentives for efficient energy use.

We share Staff's views as regards fiscal vulnerabilities in relation to public finances and the banking system. Following the extraordinary support in response to the pandemic, vulnerabilities related to public finances have intensified as evidenced by the high public debt ratio, even if the latter is expected to decline strongly over the coming years as the economy recovers. In the medium to long run, the projected gradual reduction in the public debt ratio should be underpinned by a favourable interest-growth differential as well as positive primary balances. Fiscal risks are also related to contingent liabilities from the banking system as well as spending pressures in the national health system. In particular, there are explicit contingent liabilities relating to the asset protection scheme covering potential unexpected losses on assets which have been acquired by Hellenic Bank from Cyprus Cooperative Bank (CCB). Contingent liabilities may also emanate from public entities, in particular through their long-term pension liabilities.

In view of those vulnerabilities, we concur with the Staff Report that the rebuilding of fiscal buffers is important. A prudent expenditure management is essential to firmly anchor the public debt-to-GDP ratio on a downward sloping path. In this respect, we concur with Staff that the government should resist pressure to unwind key reforms, as this would risk eroding confidence and increasing the sovereign risk premium. We also agree that the growth in the public wage bill should be contained as the share of the public sector wage bill in GDP is still high and has increased during the pandemic, and that the efficiency of public sector spending should be enhanced. Moreover, the implementation of fiscal institutional reforms, including those of Cyprus' RRP, could help to contain long-term risks.

As to the financial sector, we concur with Staff that the impact of the war in Ukraine will be felt mainly on tourism arrivals and demand for professional services rather than through direct financial channels. Tourists from Russia accounted for around 20% of total arrivals before the pandemic and the shock may be amplified by the fact that the same sector has been already impacted by the pandemic. A reduction in capital flows to and from Russia could also have an impact on professional services, given the strong foreign investment positions the two economies hold in one another. This could also affect tax collection via a decline in corporate taxes if foreign companies registered in Cyprus reduce their activities on the island. Other channels are expected to have a contained impact. Financial linkages to Russia have been reduced since the financial crisis, and the banking sector might only be affected via second round effects. The residential real estate market could be impacted since Russian citizens were the largest investors through the Cyprus Citizenship by Investment Programme (CIP), although the Programme already expired in 2020.

While Staff rightly points to the need for further progress in terms of financial soundness, the Report could give more credit to the progress made so far. We concur with Staff that further improving asset quality remains a key priority in the medium term and that progress to lower NPLs by credit acquiring companies (CACs) and the public Asset Management Company (KEDIPES) has been slow. However, the report could recognise more prominently the progress made to lower NPLs in the banking sector and make the distinction in performance between the largest banks and the CACs and KEDIPES clearer. Moreover, the Report could acknowledge existing heterogeneity between large and small banks, the latter lagging behind since it is more difficult for them to sell large stocks of NPLs. In that context, the Report could usefully emphasise that decisive progress in NPL resolution is essential for the small banks. Authorities are preparing a legislative package with the objective of reducing legacy NPLs and improving their management as well as expanding the scope of KEDIPES. In this context, it is important that such initiatives are carefully designed, that their fiscal risks are contained, and that risks for payment discipline are mitigated.

While the Report appropriately acknowledges effects from margin pressures and high costs on banks' profitability, it could put more emphasis on the need to boost cost efficiency in the banking sector. Structurally low bank profitability in Cyprus makes it difficult to lower NPLs further via massive write-offs and sales and makes the solvency position of banks vulnerable to further adverse shocks. Over the medium term, organic capital generation capacity will continue to remain under pressure due to still poor asset quality, low net interest income, excess liquidity, and limited income diversification. While cost-savings through digital transformation are underway, they cannot be expected to materialise in the short term. As a result, cost-cutting measures and measures to diversify income are needed to return the banking sector to sustainable profitability. Banks recognize they are lagging other euro area countries regarding cost-efficiency but stress that measures to lower staff costs and to diversify income are facing strong resistance by labour unions, opposition parties and consumers associations. Finally, the authorities should continue to address identified weaknesses and strengthen the implementation of the anti-money laundering and countering-financing of terrorism framework, taking into account the evaluation of MONEYVAL.

In our view, the Staff Report could better highlight the important work done by the authorities and banking supervision in ensuring a smooth wind-down of RCB, without triggering negative spill-overs to the economy and the banking sector. While progress in winding down RCB is mentioned in Box 1, the box could mention more explicitly the role of the ECB Supervisory Board (SB), which adopted three decisions (two of which are mentioned in the Box) to frame and oversee the orderly exit of RCB from banking operations. To recall, first the SB approved a transaction with Hellenic Bank to sell a portfolio of mainly SME loans in Cyprus in the volume of EUR 556 million, that will enable RCB to improve liquidity to initiate the process of repaying all depositors. Additionally, it decided that a temporary administrator, who shall work with the management body, will oversee the orderly repayment of depositors and the completion of the self-winddown plan of RCB (expected by the end of June 2022). The relevant Joint Supervisory Team (JST) will oversee together with the temporary administrator that the bank completes its announced exit of banking operations within the planned timeline. Finally, to avoid risks emerging during the bank's phasing-out process, the SB decided to restrict the business of RCB Bank.

We agree with Staff that the RRP effectively addresses key structural challenges and is therefore an opportunity to press ahead with reforms to address impediments to growth, including climate. The Cypriot RRP rightly emphasizes reforms in the areas of the judiciary, public administration and the business environment, where gaps to best practices are large. The RRP implementation is currently backloaded, and we agree that anticipating some key reforms may be beneficial. The RRP also attaches particular importance to the green and digital transitions.

Cyprus - 2022 Article IV Consultation

Responses to Technical Questions Posed by Executive Directors in Advance of EBM/22/47—May 25, 2022

Staff's responses to technical and factual questions are below.

Outlook/Risks

1. **We welcome staff's coverage of the deterioration in the external position during the pandemic and that staff's projections suggest that the current account and the NIIP should improve again over the medium term. *We would appreciate insights from any sensitivity analysis that staff performed for these projections, particularly in light of Cyprus's deep trade, investment, and financial linkages to Russia.***

The main risk to our projections stems from Cyprus's real linkages to Russia, namely its dependence on demand for tourism and professional services. The impact of the war-related shocks on growth and the current account may be larger or longer-lasting if the conflict escalates or is more prolonged, and our debt sustainability analysis shows that external debt dynamics is sensitive to such shocks. However, Cyprus would find it easier with time to find alternative markets for its services, hence the risks may moderate in the medium term. Separately, the war and sanctions may lead to some shifts in Russia-related investment positions, possibly reducing Cyprus's gross external debt.

2. **Do staff consider Cyprus's inflation as transitory? How could the competitiveness of the Cypriot economy be affected by high inflation and the ensuing real exchange rate appreciation.**

As of now, inflation dynamics is mainly driven by global energy and food prices. There is some evidence of a pass-through to core inflation (especially from the impact of higher food prices on hospitality industry), but wage dynamics in the private sector remain muted. This trend will likely continue if the labor market softens with the slower recovery, dampening the adverse impact of higher prices on competitiveness. Maintaining a tight control over the public sector wage bill is, however, essential to maintain external competitiveness.

Fiscal Policy

3. **We agree that the reductions of excise duty on fuel and value-added tax on electricity bills contribute to bring some relief to vulnerable households. *However, how long would these measures be tenable for the Cypriot public finances, given renewed extensions? Staff comments are welcome.***

To address the impact of increases in energy prices, the authorities are considering extending the reductions of excise duty on fuel and value-added tax on electricity bills for another 3-4 months. Staff understands that the decision has not been made. Staff estimates that the fiscal impact of the extensions appears manageable (cost is around 0.1 percent of GDP).

4. ***Could staff elaborate on the benefits of reintroduction of immovable property tax other than higher revenue?***

Other than higher revenues, studies suggest that immovable property tax is among the least distortive for economic growth. Applying a progressive rate schedule, possibly with income-dependent reductions, can contribute to reducing income and wealth inequality.

5. ***Could staff elaborate on the reasons behind the different pace of the debt decline projected by staff and the authorities in the medium term? Is this restricted to differences in growth and fiscal balance outlooks?***

The authorities project that the public debt to GDP declines by 27.2 percent from 2021 to 2025, while staff projects that the public debt to GDP declines by 19.5 percent over the same period. The difference (7.7 percent of GDP) mainly reflects different outlooks of growth (impact of around 1.7 percent of GDP) and fiscal balances (impact of around 3.7 percent of GDP). In addition, it reflects staff's projections on debt and cash management to meet at least 12-month financing needs. The projections consider refinancing needs and the new debt issuance, and take into account uncertainties related to financial conditions and contingent liabilities.

6. ***Can staff indicate which sectors and businesses were impacted the most by the Pandemic and should expect temporary and targeted support going forward?***

Due to containment measures during the pandemic, contact-intensive sectors, particularly the tourism-related industries, were impacted the most. The war in Ukraine and sanctions on Russia pose new challenges to the tourism-related industries given that around 22 percent of tourist arrivals are from Russia and Ukraine. Professional services (accounting, legal, etc.) are also expected to be adversely impacted reflecting the dependency on Russia (10 percent of total revenue is from Russia). Staff does not expect the need for public support under the baseline scenario. However, if the downside scenario materializes, temporary and targeted support for workers in affected industries and for viable companies to prevent scarring.

Financial Sector Policies

7. ***Could staff elaborate on the pros and cons of the debt for asset swap planned by the authorities?*** **Several risk factors in staff's Debt Sustainability Analysis merit close monitoring, in particular contingent liabilities in the financial sector, and the substantial**

impact which the planned expansion of the public asset management company (KEDIPES) would have on the fiscal position. *In this context, we would welcome staff's comments on the trade-offs related to shifting the financial risk from the financial to the public sector through KEDIPES.*

Pros. First, this plan provides a solution to the legacy NPL that is difficult to resolve due to the socially sensitive nature of the underlying assets (primary residences). Vulnerable households will be reasonably protected in this plan, being able to continue living in their primary homes with lower-than-market rent). Second, the plan, if implemented successfully, will further improve the banks' balance sheet, enhancing their ability to supply credit in supporting sustainable growth.

Cons. First, the plan may have a negative impact on the credit discipline and payment culture in Cyprus. Second, the plan may bring operational risks for KEDIPES. Third, the plan may have a considerable fiscal impact at up to 3½ percent of 2022 GDP. A robust transfer pricing mechanism and well targeting could help limit the actual fiscal cost.

8. ***In addition, could staff elaborate on the political pressure to weaken the foreclosure framework?***

Political pressure to weaken the foreclosure framework has been existing for years in Cyprus, given the social implications of foreclosure. Most recently, in the context of the pandemic, the foreclosure framework was suspended from March to June 2020. The suspension was extended until August 2020, then for the period from December to March 2021, and the last moratorium was introduced from April to July 2021. There remain legal uncertainties in the implementation of the Foreclosure Law, and data indicates that foreclosure of primary residences below a certain value threshold are not taking place.

9. ***As Table 6 shows that the provisions to NPLs ratio was declining over the last few years, we would be interested to know further the background for the drop and possible way forward for the recovery of the ratio.***

During the past few years, Cyprus's banks have been accelerating the NPL resolution process through offloading non-performing assets to credit acquiring companies and large write-offs, resulting in a lower provision to NPL ratio. An increase in this ratio would require comprehensive efforts from the banks, including continued NPL deleveraging accompanied with adequate provisioning in line with supervisory expectations or requirements, as well as forward-looking measures to control the credit risk. However, it is important to note that Cyprus's 48.8 percent NPL coverage ratio of at the end of 2021 is still above the EU average (44.7 percent).

10. *Could staff provide more details about the policy draft? Are the amendments only related to CCyB?*

The CBC is reviewing the methodology which underpins the setting of the counter cyclical buffer so as to enhance its flexibility. The policy is currently under drafting by CCB.

11. ***Could staff comment on the effectiveness of the existing legal framework for NPL resolution?***

The 2018 amendments to the foreclosure and insolvency legislation and the sales of loans law, as well as the adoption of a law on securitization, have enhanced the toolkit to address NPLs in Cyprus. While weaknesses remain and legal uncertainty from the 2019 amendments to the foreclosure framework persists, Cyprus has taken meaningful steps over the last year to strengthen its restructuring framework, including the implementation of the European Directive on Preventive Restructuring (which is awaiting legislative approval).

Structural Reforms

12. ***Could staff clarify on progress made in mobilizing financing for the climate change initiatives and elaborate on the other challenges faced in meeting the national climate targets***?

Based on the Cyprus's National Energy and Climate Plan (NECP) and staff's estimates, total public funding needs for climate change initiatives through 2030 are estimated at 25 percent of 2021 GDP. The financing for these initiatives includes: the Recovery of Resilience Plan (41 percent of the plan's total budget is allocated to support climate objectives); other EU funding including Cohesion Funds; public investments under national budgets. The authorities are in the process of assessing the funding gap to fulfil Cyprus's new target under the New Green Deal and the Fit for 55 package. Additional financing under consideration includes auction revenue of emissions rights and the revenue from carbon taxes that are expected to be introduced in 2023.

Other challenges faced in meeting the national climate targets include capacity constraints to implement the climate initiatives and measures. The current high energy prices may also pose implementation challenges for the green taxation policy. In addition, staff's analysis suggests that the planned green tax reform and other planned measures may not be sufficient to meet Cyprus's climate targets, additional measures such as feebates could be considered at the sectoral level to enhance the emissions reduction.

13. ***Aside from training judges and improved processing, it would be interesting to know if there is any reform that could contribute to reducing backlogs of resolution cases under the RRP.***

Resolution of case backlog requires a multi-faceted strategy to improve the efficiency of the court system and case processing after identification of key weaknesses and bottlenecks. Strengthening the institutional capacity of a court system is often a multi-year endeavor, and often involves not only increased court capacity, but also modernization efforts such as electronic case filings and remote hearings, and modernized rules of civil procedure. The authorities are taking important steps in this direction under the RRP. In addition to training judges and improving processing, the reforms include promoting digital transformation of courts and upgrading the infrastructure of Courts.

14. Moreover, reducing the dependency on foreign energy and achieving a swift green transition are critical to the country's sustainable development. *Nevertheless, it would be interesting to assess the possible contribution of these policies in fueling inflationary pressures. Staff's views would be appreciated.*

Implementation of climate measures and introducing carbon taxes could lead to inflationary pressures through higher demand and energy prices. However, staff is of the view that the inflationary pressures would be manageable if the measures are well designed and implemented. Regarding the green tax reform, the authorities currently plan to introduce the carbon tax in 2023, when the inflationary pressures are alleviated based on WEO projections. Also, the level of carbon taxes could be set at a relatively low level and gradually increased. The revenue of carbon taxes could be used to support the most vulnerable groups that are adversely impacted by inflation. Importantly, reducing the dependency on foreign energy and achieving a swift green transition could help Cyprus better weather the inflation shocks from price increases in traditional energy sources.

15. We also welcome staff's analysis of Cyprus's efforts to address climate change, including the insight that the authorities can largely offset any negative impact on GDP growth from a carbon tax by recycling the revenues. *We would welcome additional analysis on the distributional impacts of the recycling of such revenues, as well as insights that can be drawn from countries that have implemented such measures successfully.*

One concern of introducing a carbon tax is the burden on households, through the direct price effect of higher energy prices and the indirect price effect of higher prices for other consumer goods. Carbon pricing has a disproportionately large impact on the price of coal, intermediate impacts on the price of natural gas, and more moderate impacts on fuels. The impact on electricity prices depends on the country's mix of power generation fuels. Compared with many countries, the distributional impact of carbon taxes on Cyprus is relatively small because the usage of coal is basically negligible, and the production of power mainly relies on liquid fuel. Based on the IMF Carbon Pricing Assessment Tool, the increase in electricity prices at a carbon price at €100 is less than 10 percent, and the reduction of the household consumption is around one percent.

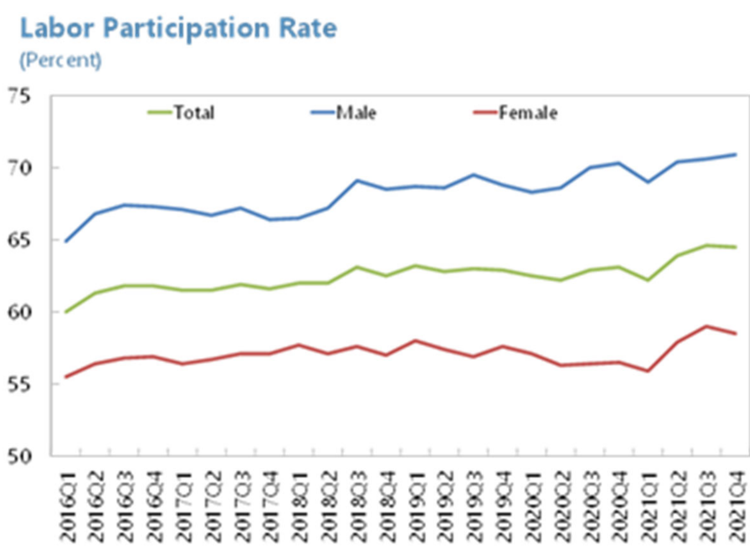
Studies suggest that the distributional impacts of revenue recycling impacts would highly depend on the design of the policies. Generally, targeted cash transfers are regarded as the most effective tool to protect the most vulnerable groups. Staff's analysis suggests that targeted transfers amounting to 15 percent of revenues gains could compensate the consumption loss of the bottom 30^{th} percentile of the households. Some countries have implemented similar measures, including social transfers for low- and middle-income households (Sweden) and financial assistance for low-income households on their energy bill (France).

16. In relation to the RRP impact on growth in the near and medium term, *staff's comments on the differences in estimates from those provided in the Buff statement from a study by the University of Cyprus are welcome.*

Both studies assess the same transmission channels, namely the short-term demand impact, the supply-side impact of additional public investments, and the impact of structural reforms. Staff estimates from a multi-country structural model point to a smaller short-term demand impact given a significant leakage through imports (particularly in the case of investment spending). The impact of structural reforms is also assessed to be smaller based on earlier cross-country studies conducted by Fund staff.

17. ***The COVID-19 pandemic has had a disproportionate impact on female labor force participation. In light of this, can staff outline the measures implemented by the Cypriot authorities to address this issue?***

While the pandemic indeed had a stronger impact on female labor force participation, it recovered very strongly in 2021 and is now well above the pre-pandemic level.



18. **In this context, potential gas extraction and exports could provide diversification and fiscal resources to finance structural reforms and support consolidation. *Could staff comment on this potential source of revenue and its potential impact on Cyprus' fiscal and external balance?***

Cyprus has granted licenses for gas exploration to a number of oil & gas companies. The authorities are targeting natural gas exports by 2026. However, the progress of gas extraction and the impact on Cyprus' fiscal and external balance are highly uncertain based on available information at this stage.

19. While we support the efforts to address weaknesses in anti-money laundering framework, we are surprised that staff connect these efforts with "current geopolitical context". We continue to believe that the intended purpose of anti-money laundering measures is to combat criminals and prevent them from using the proceeds of crime. *How could the AML work be linked to the current geopolitical context? Has the FATF issued any guidance on this? We would welcome staff comments in this regard.*

EU sanctions against individuals and entities that are legally applicable in Cyprus, and the extraterritorial impact of bilateral foreign sanctions against third countries (even if not legally applicable in Cyprus), potentially increase the risk exposure of Cypriot and foreign financial institutions when doing business with Cypriot counterparts. This increases regulatory risk for financial institutions. This in turn may lead to pressures on correspondent banking relationships for Cyprus. The current wave of economic sanctions is indeed not based on FATF requirements (FATF and UN targeted financial sanctions are related to terrorism financing and proliferation financing); however, countries are using the same legal framework for the current sanctions as they use for the traditional targeted financial sanctions, and countries are using AML/CFT measures to enforce these. FATF has indeed issued guidance in this regard in March 2022 (https://www.fatf-gafi.org/publications/fatfgeneral/documents/ukraine-2022.html)

20. *Could staff indicate if this analysis and GHG Emissions simulations could be generalized and presented in a uniform format in all article IV reports (with discrepancies only related to country specificities and data availability issues)?*

Different staff reports discuss climate at different depths and with different areas of emphasis. In addition, some teams rely on expert FAD support while others rely on own sources. All these factors will affect presentation and make a uniform format difficult to implement. This said, the upcoming guidance note and the strengthening of climate-specific review in the context of the structural budget augmentation will ensure consistency and even-handedness across country cases.

21. ***We observe that all dividend and interest payments from Russia to Cyprus are subject to 15 per cent withholding tax since 2021. Can Staff provide the details of investment flows before and after the introduction of this tax until February 2022 and thereafter***

Staff is working with the authorities on assessing the impact of the amendments to the Double Tax Treaty and the sanctions on Russia on investment flows. However, the assessment is not yet available due to paucity of data and difficulties in disentangling the influencing factors. Also, it is still too early to assess the fiscal impact of the tax amendments because the tax returns for the fiscal year 2021 will be submitted within 2023.

CONSTITUENCY CODES

OEDAE
Angola, Botswana, Burundi, Eritrea, Eswatini, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, Tanzania, Uganda, Zambia, and Zimbabwe

OEDAF
Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé & Príncipe, Senegal, Togo

OEDAG
Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay

OEDAP
Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, Nauru, New Zealand, Palau, Papua New Guinea, Samoa, Seychelles, Solomon Islands, Tuvalu, and Vanuatu

OEDBR
Brazil, Cabo Verde, Dominican Republic, Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, and Trinidad and Tobago

OEDCC
China

OEDCE
Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, and Spain

OEDCO
Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines

OEDEC
Austria, Belarus, Czech Republic, Hungary, Kosovo, Slovak Republic, Slovenia, and Turkey

OEDFF
France

OEDGR
Germany

OEDIN
Bangladesh, Bhutan, India, and Sri Lanka

OEDIT
Albania, Greece, Italy, Malta, Portugal, and San Marino

OEDJA
Japan

OEDMD
Afghanistan, Algeria, Ghana, Islamic Republic of Iran, Libya, Morocco, Pakistan, and Tunisia

OEDMI
Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Maldives, Oman, Qatar, United Arab Emirates, and Yemen

OEDNE
Andorra, Armenia, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Luxembourg, Moldova, Montenegro, Netherlands, Republic of North Macedonia, Romania, and Ukraine

OEDNO
Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden

OEDRU
Russian Federation and Syrian Arab Republic

OEDSA
Saudi Arabia

OEDST
Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Nepal, Philippines, Singapore, Thailand, Tonga, and Vietnam

OEDSZ
Azerbaijan, Kazakhstan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, and Uzbekistan

OEDUK
United Kingdom

OEDUS
United States