

**FOR
INFORMATION**

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May 24, 2022

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Cyprus—Statement by the European Central Bank Representative**

Board Action: Executive Directors' **information**

Additional Information: For the Executive Board discussion on Cyprus to be held on Wednesday, May 25, 2022.

23 May 2022

**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.