

**EXECUTIVE
BOARD
MEETING**

SM/22/94
Correction 2

May 25, 2022

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Cyprus—Staff Report for the 2022 Article IV Consultation**

Board Action: The attached corrections to SM/22/94 (5/11/22) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

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Questions: Mr. Maliszewski, EUR (ext. 34855)

Box 1. Cyprus: Economic Fallout from the War in Ukraine (concluded)

There could be additional fiscal impact from a reduction in investment flows. Foreign companies registered in Cyprus are subject to corporate taxes, and a reduction in their activities will have a fiscal impact, even though it is difficult to estimate due to paucity of data. In addition, the recent amendments to the double taxation treaty between Russia and Cyprus (all dividend and interest payments from Russia to Cyprus are subject to a 15 percent withholding tax since 2021) might reduce the Russian business presence in Cyprus due to the lowered tax advantage.

Higher oil prices will have an impact on terms-of-trade (ToT), purchasing power, and prices. Cyprus is heavily dependent on imported fossil fuels, mainly refined petroleum (\$1.94 billion in 2019; 11.5 percent of total imports and 8.3 percent of GDP). It is used for both transport and electricity generation (which relies primarily on oil), making prices in Cyprus and its ToT highly sensitive to global crude oil prices. Cyprus, however, does not import natural gas, potentially shielding it from a direct impact of supply disruptions from Russia.

Direct financial sector linkages appear limited:

- **Russian depositors.** There has been a gradual decline in the share of Russian deposits in the banking system, which accounted for about 4 percent of total deposits at the end of 2021.
- **RCB bank.** The third largest [Cypriot Systematic Institution bank in Cyprus](#) has had significant Russian stake and business interests. VTB—a sanctioned Russian bank—held 46 percent stake in RCB Bank until February 24th, when it transferred its shares to [a company two companies](#) controlled by the bank's management. On March 24th, the bank announced its plan to phase out its banking operation in Cyprus. On the same day, the ECB restricted the RCB Bank's business and approved the sale of its domestic loan portfolio ([up to](#) around €560 million) to Hellenic Bank (the second largest bank in Cyprus). The first tranche of this transactions has been executed, and RCB Bank should now be capable of covering all its deposits. It will give up its banking license after the full payout of its depositors (excluding sanctioned individuals) and will continue to operate as a CAC upon approval from the Central Bank of Cyprus.

Refugees from Ukraine require government assistance but could have positive impact on the economy. By end-March, Cyprus has received around 10,000 Ukrainians and provided them a 12-month right to residence, food, education, health care, and employment. The fiscal impact from supporting refugees is expected to be small, while they could help alleviate the labor shortage in some economic sectors and bring entrepreneurship by reallocating their businesses.

POLICIES FOR SUSTAINABLE RECOVERY AND GROWTH

The key near-term challenge is to calibrate a policy response as the impact of the pandemic wanes, but the war-related shocks will likely take a toll on the economy. The cost of getting the policy package wrong is high in Cyprus: too restrictive policies may weaken private balance sheets already marred by the legacy NPLs; too much accommodation may leave fiscal buffers too low (given Cyprus's vulnerabilities) and undermine market confidence. In this context, a more forceful implementation of the strategy for NPL reduction is still paramount to reduce vulnerabilities. This, in turn, hinges on long-pending structural reforms to make the judicial system more efficient. More broadly, reforms to strengthen governance and address other bottlenecks—such as skills gaps and mismatches and infrastructure gaps—are key to improve growth prospects.