

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.