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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/101-3

11:40 a.m., November 28, 2018

3. Cyprus—2018 Article IV Consultation

Documents: SM/18/265 and Correction 1; and Supplement 1; SM/18/266; and Correction 1

Staff: Tuladhar, EUR; Porter, SPR

Length: 27 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors Alternate Executive Directors

<p>L. Levonian (CO)</p> <p>H. de Villeroché (FF)</p> <p>S. Meyer (GR)</p> <p>H. Beblawi (MI)</p> <p>A. De Lannoy (NE)</p> <p>T. Ostros (NO)</p>	<p>M. Ismail (AE), Temporary</p> <p>K. Carvalho da Silveira (AF), Temporary</p> <p>D. Vogel (AG), Temporary</p> <p>A. Park (AP), Temporary</p> <p>P. Fachada (BR)</p> <p>S. Fan (CC), Temporary</p> <p>J. Montero (CE), Temporary</p> <p>C. Just (EC)</p> <p>H. Joshi (IN), Temporary</p> <p>F. Spadafora (IT), Temporary</p> <p>Y. Saito (JA)</p> <p>C. Sassanpour (MD), Temporary</p> <p>L. Palei (RU)</p> <p>R. Alkhareif (SA)</p> <p>K. Tan (ST)</p> <p>P. Trabinski (SZ)</p> <p>E. Myers (UK), Temporary</p> <p>D. Crane (US), Temporary</p>
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H. Al-Atrash, Acting Secretary

J. Morco, Summing Up Officer

D. Alcantara / J. Acheson, Board Operations Officers

L. Nagy-Baker, Verbatim Reporting Officer

Also Present

African Department: S. Choi. European Central Bank: A. Meyler, R. Rueffer. European Department: P. Gerson, H. Takizawa, A. Tuladhar. Legal Department: R. Berkhout, N. Rendak, D. Schwarz. Monetary and Capital Markets Department: G. Mitchell Casselle. Strategy, Policy, and Review Department: N. Porter.

Executive Director: D. Fanizza (IT). Alternate Executive Director: A. McKiernan (CO). Senior Advisors to Executive Directors: M.Gilliot (FF), E. Hagara (EC), S. Rouai (SA), A. Tolstikov (RU). Advisors to Executive Directors: D. Cools (NE), M. Coronel (BR), D. Fadhel (MI), T. Gade (NO), N. Komura (JA), B. Parkanyi (GR).

3. **CYPRUS—2018 ARTICLE IV CONSULTATION**

Mr. De Lannoy and Mr. Cools submitted the following statement:

The Cyprus authorities thank staff for the in-depth discussions they have had during the September-October Article IV mission in Nicosia. In addition to the ongoing post-program monitoring, the Article IV mission provides the opportunity to take a broader and more long-term perspective at the Cypriot economy. The authorities broadly agree with staff's analysis and would like to make the following remarks.

Since this summer, S&P and Fitch have upgraded Cyprus to investment grade. The authorities take this as an encouragement to remain on the path of prudent fiscal policies and to continue reducing the overhang of non-performing loans ('NPLs') in the banking sector. They also interpret this encouragement as an invitation to deepen the many structural reforms that Cyprus has embarked upon.

Fiscal

Cyprus is expected to close 2018 with a healthy primary surplus of 5.4 percent of GDP and is projected to continue to record substantial primary surpluses, which under the baseline scenario will bring down the country's public debt from 104 percent of GDP in 2018 to below 85 percent by 2021. To safeguard further debt reduction, the authorities are firmly committed to keeping expenditure growth below the medium-term GDP growth rate. This also applies for the gradual reversal of the crisis-era wage cuts.

Cyprus' fiscal consolidation is supported by broad-based economic growth and a strong pick-up in employment. Taking into account growth rates in cumulative terms, Cyprus has recovered to its pre-crisis GDP levels in 2017. Looking ahead, growth is expected to total 15 percent for the four-year horizon 2018-2021. The authorities underline that growth is broad-based, spanning across all sectors, except the financial sector, with tourism at 1.3 p.p., construction at 1.0 p.p., professional services at 0.7 p.p., and manufacturing at 0.3 p.p. In addition, other sectors such as the investment fund industry and education are contributing to growth, the latter reflecting the various international educational institutions taking roots and expanding in Cyprus. Finally, the tourism industry is becoming more diverse, with an increasingly wider offering and a broader spread of tourists throughout the year.

Most of the investment in Cyprus is foreign-financed, reflecting strong investor appetite among international investors. The pick-up in construction had not led to a sizeable increase in real estate prices, with a notable exception for construction of prime residential real estate for a foreign clientele, mostly concentrated along the Limassol coastline. The authorities underline that foreign residential real estate investments related to the Citizenship by Investment (CbI) scheme are subjected to a recently strengthened 4-layer due diligence procedure, to continue to ensure compatibility with AML/CFT standards. More importantly, risks to the investment outlook are on the upside, despite any possible slowdown in CbI financed projects.

External Sector

Despite the overall global uncertainty, it is the authorities' view that the external sector developments in Cyprus are in line with the fundamentals of the Cyprus economy. Specifically, the projected current account deficit is considered to be at a sustainable level, in line with the overall domestic economic growth momentum.

Financial Sector

Whereas the high level of NPLs has not weighed on strong investor sentiment, the authorities do agree with staff that the high NPL levels pose a risk to debt sustainability. That said, the authorities have made great strides in reducing NPL levels. From a total of €28.4 billion at the end of 2014, NPLs have come down to €16.9 billion in the first half of 2018, with NPL reduction steadfastly continuing in 2018. The decrease in the first half of 2018 is mostly related to the sale of NPLs by Bank of Cyprus to Apollo Fund (Helix) in the order of €2,7 billion, although the sale is still subject to supervisory approval.

The reduction of NPLs is expected to continue at an increased pace in the second half of 2018, following the sale of CCB's good assets to Hellenic Bank. The CCB's NPLs amounting to €5.7 billion have remained outside the banking system, in a residual entity named the Cyprus Asset Management Company ('CAMC'). The CCB operation has come at a major public cost but was necessary to stem the sudden deposit outflows that CCB witnessed mainly in the first half of 2018. Additionally, other transactions to reduce the level of NPLs are in the pipeline, with international investors indeed taking a keen interest in buying blocks of Cypriot NPLs. The approval by the Cypriot parliament in July 2018 of a major legislative package to strengthen the NPL resolution, has strongly underpinned investor interest. The legislative package includes amendments to the sale of loans law, foreclosure law, bankruptcy

law, company law, personal insolvency laws, and the regulation on insolvency practitioners. The sale of NPLs to professional investors also allays concerns that NPLs will be simply warehoused.

The authorities of course agree with staff that work is not complete. The supervisory and regulatory framework for credit-acquiring firms needs to be finalized (including for CAMC), and a major reform of Cyprus' judicial system should speed up effective contract enforcement.

The authorities understand that concerns have been raised about the eligibility criteria of Estia ('house'), the burden-sharing scheme intended to strengthen the resolution of a sensitive segment of the NPL portfolio. At the time of writing, the eligibility criteria of the Estia scheme are being finalized. The authorities would like to underline, however, that at €20 million, the net total maximum annual fiscal cost of Estia is manageable. Moreover, Estia is expected to facilitate NPL resolution, and has helped fostering political and societal buy-in for the NPL resolution legislative package approved in July 2018.

Structural Reforms

While Cyprus is sticking to a prudent fiscal policy and reducing its financial sector contingent liabilities, it has at the same time engaged in an impressive array of structural reforms. In 2019, the long awaited National Health Service will be rolled out. The judicial system will be strengthened, with the expected creation of a Commercial Court, and with additional judges being hired to address a backlog in legacy cases, including NPL cases. A local government reform is on the drawing board, and a legislative proposal to enhance the governance of the Central Bank of Cyprus has been submitted. The concomitance of these reforms demonstrates the willingness of the authorities to modernize further the Cypriot state and economy. At the same time, the authorities are dealing with the fallout of regional conflicts, with Cyprus facing one of highest levels of asylum applications in the EU.

As Cyprus is engaged on many fronts, it is inevitable that some reforms take more time than expected to move from the drawing board to the implementation stage. Thus, it is important to take a long-term perspective when analyzing the country's reform efforts. The authorities in particular agree that the problems of issuance and transfer of title deeds needs to be addressed and that judicial reform needs to be further pursued, as well as measures to ease doing business in Cyprus.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank the staff for the reports and Mr. De Lannoy and Mr. Cools for their helpful buff statement.

We are pleased to read from Mr. De Lannoy and Mr. Cools' statement that the recent upgrade of Cyprus' debt-to-investment grade is interpreted by the authorities as "an invitation to deepen the many structural reforms that Cyprus has embarked upon". Indeed, structural reforms are essential to address the many challenges and risks the country will have to face in the short and medium term. We would like to mention three of them related to growth, fiscal, and financial dimensions, which are deeply enrooted.

We are encouraged by the rapid recovery of the Cypriot economy which will exceed 4 percent in 2018 and 2019, as also happened in the previous couple of years. The staff report notes that growth has been supported by tourism and professional services, as well construction and real estate. Could staff elaborate further on the current sources of growth for the country compared to those observed a decade ago; for instance, compared to the situation in 2007, when the staff report at that time (Article IV consultation) underscored that "Cyprus is well placed to emerge as a gateway to the East and a hub of business operations in the region" and that "the thriving Cypriot economy is testimony to the government's implementation of reforms and pursuit of prudent policies, in line with Fund advice". Meanwhile, we note from the buff statement that foreign residential real estate investment related to the Citizenship by Investment (CbI) scheme is being strengthened in order to continue to ensure compatibility with AML/CFT standards. We fully share the staff's comment that ensuring inclusive growth is crucial, not just for equity, but also for the sustainability of the recovery.

The public debt-to-GDP level, surpassing 100 percent this year, entails a critical vulnerability; therefore, we fully share the staff's recommendation to maintain a strict spending discipline to ensure a firmly declining debt path. We are encouraged by the important decline of the public debt ratio, projected in the baseline scenario of the Debt Sustainability Analysis. Could staff elaborate on the economic, political, and social feasibility of keeping a primary fiscal surplus of 5 percent of GDP in the medium term, which seems very far from the historic performance of Cyprus, at least during the past decade. At the same time, we wonder whether assuming zero contingent liabilities in the baseline scenario is plausible, given risks in the financial system and the recent resolution experience.

The Selected Issues chapter brings about a helpful perspective on the risks posed by non-performing loans (NPLs) and rightly underlines that their resolution would allow the country to minimize its dependence on external financing sources by restoring domestic credit channels. NPL indicators, at 30 percent of total loans and 85 percent of GDP, eloquently illustrate the situation and the need to urgently solve this issue. Clearly, the authorities have started to take important measures, although, as pointed out in the staff report, some of them imply a “high cost to the public purse”, leading us back to the comments of the previous paragraph on fiscal issues. At the same time, we are encouraged by the staff’s assessment that some policies and reforms enhance the toolkit available to borrowers and creditors to address NPLs on a durable basis. We would like to have a further explanation on the incentives and expected functioning of the proposed Estia.

With these comments, we wish Cyprus and its people every success in their future endeavors.

Mr. Meyer submitted the following statement:

We thank staff for their insightful report and selected issues paper in the context of Cyprus’ Article IV consultation. We also thank Mr. De Lannoy and Mr. Cools for their informative buff statement.

Solid government policies and favorable external conditions triggered a strong rebound of the Cypriot economy. Most economic flows show an impressive rebalancing, but important vulnerabilities remain, inter alia linked to high public and private indebtedness as well as a high stock of NPLs. We consider that government policies, such as sizable primary budgetary surpluses and new legislation to incentivize NPL reduction, can be effective instruments in strengthening resilience. For the structural readjustment of the economy to be successful in the long run, however, additional policy efforts will be needed, aiming to reduce debt levels, foster productivity, safeguard cost competitiveness and to further reduce NPLs, on a permanent basis.

Macroeconomic Developments

Cyprus enjoys strong cyclical growth that is boosted by foreign funded investments. Favorable external demand conditions and an effective government policy to attract foreign financing into the residential construction sector lifted GDP growth significantly above its potential. Accordingly, most macroeconomic indicators show an impressive improvement: the unemployment rate almost halved since 2015 and the output gap practically

closed from around -7 percent of potential GDP in the same period. At the same time, as staff points out, the current account deficit has widened substantially and is expected to remain large over the medium term. In the context of still high public and private indebtedness, we also share staff's concerns regarding the increased exposure of the Cypriot economy to foreign funding, especially in the construction sector.

Fiscal Policies

We commend the authorities for maintaining a strong fiscal position and for their commitment to swiftly reducing public debt, but also note the increased exposure to contingent liabilities. Fiscal performance has again outperformed expectations and is projected to be compliant with European fiscal rules. We welcome the remarkable improvement of the general government headline surplus in recent years and the significant reduction of public debt in 2017. At the same time, we agree with staff that banking support measures related to the previously government-owned Cyprus Cooperative Bank (CCB) were costly for the public budget and increased the exposure to explicit contingent liabilities. We note that these measures are likely to also negatively weigh on the general government balance in 2018. Moreover, we note that staff foresees a slight weakening of the structural primary balance in 2019 on account of new expansionary measures (e.g. lowering of the interest levy, a gradual reversal of public wage cuts and additional expenditure under the Estia scheme) as well as possible cost-overruns in health expenditures following the rollout of the National Health System starting in 2019. We agree with staff that maintaining the strict spending discipline of previous years will be instrumental to firmly anchor public debt on a downward-sloping path.

Financial Market Policies

Banks have ample liquidity, but challenges with regard to asset quality and profitability remain. Both the NPL stock and ratio have declined significantly in 2018, although the NPL ratio remains the second highest in the euro area. Much of this reduction was achieved through sales, write-offs and, provisionally, the removal of CCB's sizable NPL portfolio from the banking sector. However, the high NPLs stock will likely continue to weigh heavily on banks' profitability and the overall soundness of the Cypriot banking sector.

The July 2018 legislative package on insolvency, foreclosure and the sale of loans is welcome and – if steadfastly implemented – could be

instrumental in curtailing strategic borrower defaults. In this context, the recently amended Estia scheme could also help tackling legacy NPLs, but its design needs to be better targeted in order to address moral hazard concerns. The authorities should carefully monitor all the outstanding risks and issues stemming from the scheme in order to improve the payment discipline among strategic defaulters.

An appropriate governance framework and supervision of the Cooperative Asset Management Company (CAMC) – a residual entity from the sale of CCB – must be put in place. The organization and the governance of the Cooperative Asset Management Company are yet to be fully defined. Being a credit-acquiring company established under national law, the CAMC is supervised by the Central Bank of Cyprus (CBC). We thus agree with staff that it is urgent for CBC to strengthen the regulatory and supervisory framework for such companies.

Structural Policies

We agree with staff on the need to renew the reform momentum, particularly with regard to the judicial system, public sector governance and active labor market policies. It is crucial to accelerate the judicial reform to strengthen legal enforcement of commercial claims and shorten court procedures, including by establishing a commercial court, by reforming the civil procedure rules and by introducing an e-justice system. Building on the progress already made, as mentioned in the buff statement, we encourage the authorities to continue strengthening the AML/CFT procedures of the Citizenship by Investment scheme. We also agree on the importance of strengthening public sector governance and government effectiveness, including through an improved monitoring of the governance of state-owned enterprises and local governments. We further believe that the report would have benefited from discussing the benefits of restarting the authorities' privatization plan, the reform of the electricity market and the creation of a reliable system for the issuance and transfer of title deeds. These measures could have a direct effect on the cost-competitiveness of the Cypriot economy and facilitate trade flows and investment conditions.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for their well-written set of reports and Mr. De Lannoy and Mr. Cools for their informative buff statement. We broadly share staff conclusions and policy recommendations and would like to make the following comments.

We welcome the progress made by Cyprus since the 2012-13 crisis. In this regard, we note the recovery of GDP to pre-crisis levels, the gains in employment, and the achievement of a healthy fiscal primary surplus. The country remains, however, confronted with important crisis legacies, including high NPLs, private and public sectors debt overhang, and weak credit growth. We are encouraged by the authorities' efforts to address these legacies, including through the recent approval of a legislative package to reduce vulnerabilities and catalyze NPL resolution.

We agree that further private and public balance sheet repair should remain the key policy priority. The Selected Issue paper underscores the challenges in reducing NPL overhang and restoring credit financing and points to the limited effectiveness of early legislative reforms because of weaknesses in the legal framework and lack of enforcement. Against this background, we welcome recent actions to address this vulnerability to financial stability by strengthening the legal framework for NPL resolution. We note, however, from ¶14 that staff continues to express concerns about some weaknesses in the legal framework for foreclosure and weak enforcement and support their call for steadfast implementation of the enhanced framework and timely enforcement.

We encourage the authorities to remain vigilant about the contingent liabilities related to the sale of the Cyprus Cooperative Bank (CCB). The resolution of the CCB and the creation of the Asset Management Company (AMC) are welcome developments toward addressing the NPL vulnerability. However, this transaction has contributed to reverse the recent declining trend in the public debt to GDP ratio and we also note from footnote 18 that the fiscal impact of the inclusion of the AMC in the fiscal accounts remains uncertain. We therefore encourage the authorities to closely monitor the potential impacts of the CCB resolution, strengthen the supervisory and governance framework of the AMC, and address the moral hazard concerns related to the implementation of the Estia subsidy scheme. While still on the CCB, could staff clarify the content of footnote 9?

With these remarks, we wish the authorities all the success.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the reports and Mr. De Lannoy and Mr. Cools for their informative buff statement.

Cyprus is recovering strongly, with growth rates of above 4 percent achieved since 2016. Buoyed by services and foreign investment in the construction sector, growth is expected to remain robust at 4.1 percent in 2018-19 but projected to decelerate thereafter towards its potential rate. Inflation is projected to be stable while the unemployment rate is expected to moderate significantly until 2020 on the back of demand growth led by investments. However, the overall macro fundamentals suggest a mixed picture. While both general government and primary fiscal balances are positive and supportive of debt stabilization, we note that the CAD is large and will remain so due to elevated construction imports, slowdown of growth in trading partners and the persistence of a positive credit gap created prior to the crisis, which keeps domestic absorption at higher level. Staff has assessed Cyprus's external position as weaker than implied by fundamentals despite competitive labor costs and real exchange rate.

We note that Cyprus's economic outlook is clouded by several downside risks; slow pace of resolution of NPLs, contingent liabilities risk to debt, tightening of global financial conditions, rising protectionism, slower growth in the euro area and Brexit.

In the fiscal sector, the primary balance is expected to strengthen further in 2018 on the back of improved revenues while the structural primary balance is projected to strengthen going forward. We are encouraged to note that staffs' baseline projections suggest a decline in public debt to 70 percent in the medium-term. This positive assessment of debt dynamics is nevertheless subject to downside risks ranging from uncertainty about court decisions on public wage cuts, higher spending on health system, lower economic growth and possible realization of contingent liabilities. Could staff comment on their assessment about the materialization of these risks and their impact on debt trajectory? Going forward, reining in public spending through limits on wage growth, control on the cost of health services and implementing public financial management reforms would strengthen fiscal resilience. We welcome the authorities' commitment to keeping spending in control and the proposal for actuarial assessment of national health services.

The large overhang of private and household sector debt posited against high level of NPLs in the banking system despite write-downs, repayments and debt-to-asset swaps poses risks to financial stability. To facilitate the resolution of impaired assets, we encourage the authorities to strengthen mechanisms for foreclosures, enforcement of debt recovery and insolvency processes while incentivizing other means of NPL reduction such as sustainable restructuring and/or their sale to professional investors. As

indicated in the SI paper, addressing NPLs is imperative for reviving the delivery of cost affordable bank credit, which remains limited as a source of funding for long-term economic growth. We welcome the adoption of the legislative amendments aimed at strengthening the legal framework for NPL resolution as well as the extension of the scope of tax exemptions for NPL repayments and the gamut of other measures for resolving bad debts. However, we believe that it would be prudent to review the subsidy scheme proposed to encourage NPL repayments and assess its future impact on the fiscal position. Could staff elaborate on the likely effectiveness of the subsidy scheme for reducing NPLs and its impact on the debt and fiscal deficit going forward? As advised by staff, judicial reforms which support the process of recovery and collection of loans are needed to implement the legislative agenda effectively.

We support staff advice about streamlining the governance, operational and supervisory structure for the state AMC as well as for other newly established AMCs. Like staff, we also believe that the state AMC should be limited to managing CCB assets, while a sunset clause should be prescribed to minimize fiscal costs going forward. We note that the property market, barring the luxury segment, is stable and support the staff suggestion for its close monitoring and the use of macroprudential and other countercyclical tools, if necessary, to mitigate risks. In this context we are encouraged to note that the authorities have placed limits and diligence procedures on the Citizenship by Investment Scheme(CbI) which would limit unsustainable demand and pricing pressures for the luxury property segment.

Structural reforms focused on improving competitiveness and the business climate require improvements in judicial procedures for enforcing commercial claims and reducing delays in resolving foreclosure and insolvency cases. The introduction, inter alia, of a dedicated commercial court with specialized judges, reform of the civil procedure code and reduction in case backlogs would enhance investor confidence. We encourage the authorities to improve public sector effectiveness by raising fiscal and public-sector efficiency and governance by way of public sector financial management. Besides strengthening central bank autonomy, mitigation of existing AML/CFT risks should be addressed by implementing preventive measures, enhancing transparency of beneficial ownerships, international cooperation and unbiased investigations. To ensure inclusive growth we encourage the authorities to bolster ALMPs and support economic diversification while enhancing educational and skill building opportunities. We are appreciative of the authorities for taking multipronged actions to implement structural reforms to increase the efficiency of the government and

that of the legal system which is necessary for a favorable business climate. Could staff comment on the effectiveness of ALMPs implemented by the authorities so far in reducing the unemployment rate?

We wish the authorities the best and all success in future endeavors.

Mr. Fanizza and Mr. Spadafora submitted the following statement:

We thank staff for a set of informative reports and Mr. De Lannoy and Mr. Cools for their candid buff statement. We associate ourselves with Mr. Meyer's statement and offer some additional comments for emphasis.

A strong macroeconomic performance and a favorable short-term outlook have led to upgrades of Cyprus' sovereign rating to investment grade. Nevertheless, Cyprus needs to make further progress in tackling legacy issues – most notably a large debt overhang in both the public and private sector – as they may hamper growth over the longer term.

In particular, despite significant declines since end-2014, banks' non-performing loans (NPLs) remain high, affecting banks' profitability through high provisioning needs and limiting banks' capacity to adequately extend credit to the economy. Besides, high NPLs pose risks to public finances, as shown by the resolution of the Cyprus Cooperative Bank, which has raised the public debt-to-GDP ratio by about 15 percentage points.

Against this background, we welcome the new legislation adopted last July to facilitate NPLs' disposal, improve payment discipline, address distorted incentives for debt restructuring, and discourage strategic defaults. What explains the high rate of redefault on restructured loans?

The effectiveness of the recently approved amendments to the foreclosure and insolvency legal frameworks rely heavily on reforming the judicial process. We thus encourage the authorities to make progress in adopting the measures needed to strengthening collateral execution, in order to speed up NPL recovery. As well documented by staff in the useful SIP, maintaining a sustained rate of growth in the longer-term rests on the ability to restore the bank credit channel: the alternative sources of financing currently at work may be insufficient and subject to risks and undesirable side effects.

On the subsidy scheme Estia, we acknowledged Messrs. De Lannoy's and Cools' emphasis on the importance of gaining political and societal buy-in for a more resolute approach to collateral enforcement and, more

generally, NPL resolution. At the same time, we fully support the staff's call for ensuring effective eligibility criteria that foster payment discipline in a durable way.

Finally, we welcome the authorities' commitment to further advancing the structural reform agenda with a view to diversifying the country's economy and raising long-run potential growth.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its set of reports and Mr. De Lannoy and Mr. Cools for their useful buff statement, which was a very good complement to staff's reports. We associate ourselves with Mr. Meyer's statement and would like to add some further comments for emphasis.

The Cypriot economy is recovering strongly after the severe dislocation caused by the 2012–2013 banking crisis, supported by broad-based demand growth and a strong pickup in employment, which allowed for the recovery of its pre-crisis GDP levels already in 2017. However, crisis legacies—in the form of high NPLs and public and private sector leverage, as well as deteriorated inclusiveness indicators—continue to weigh on the economy. Our reading of both the staff's report and the buff is that the authorities are taking good advantage of this window of opportunity to step up the deleveraging strategy and the reduction of NPLs, through the implementation of several forceful measures. This, notwithstanding, we concur with staff that there remains some work to be done, particularly in the area of business environment by strengthening institutions, such as the court system.

We commend the authorities for the approval of a comprehensive package of amendments to strengthen the legal framework for NPL resolution—as described in paragraph 13—which is an important step forward towards improving payment discipline. This is essential for sustainable deleveraging and a well-functioning market economy. We call on the authorities to address remaining shortcomings in the areas of issuance and transfer of title deeds, and in the implementation of a governance, operational and supervisory structure for the state-owned asset management company. Regarding the subsidy scheme (Estia) for low income borrowers, staff proposes to better calibrate it to the individual borrower's repayment capacity and to tighten its eligibility criteria. In view of the subsidy details spelled out in footnote 13, what type of calibration does staff have in mind?

We concur with staff that fiscal performance has been strong recently, as attested by the remarkable improvement of the general government headline surplus in recent years and the significant reduction of public debt over the last two years. We commend the authorities for their commitment to fiscal discipline over the medium term. Regarding external accounts, the current account deficit is expected to remain large over the medium term. From a macroeconomic perspective, this imbalance is driven by the extremely low private saving rate, especially for households. In this latter case, the saving rate has been negative since 2013, which has led households to draw down their assets to sustain consumption. Could staff comment on how it envisages the correction of this low private saving going forward?

Finally, we share staff's view that structural institutional reforms are key for improving competitiveness, the investment climate and long-run potential growth. Priority should be given to the reform of the judicial process and to the strengthening of the governance and autonomy of the Central Bank of Cyprus. However, we also note with concern that the Cypriot economy scores poorly in terms of wealth and income inequality and in at-risk-of-poverty rates, but there is barely any mention of this in the report. Could staff comment on the authorities' strategy to address these inequality problems?

Mr. Tan and Ms. Rauqueue submitted the following statement:

We thank staff for the informative reports and Messrs. De Lannoy and Cools for their concise buff statement. Cyprus's recent bout of strong economic growth and fiscal surpluses is commendable. While further efforts are required to sustain the recovery and ensure higher and more inclusive medium-term growth, we share the thrust of staff's assessment and would like to offer the following comments for emphasis.

A multi-pronged approach to resolving still-high NPLs is central to financial system stability. High provisioning requirements for the high level of NPLs along with reduced net interest margins have weighed on banks' profitability, which could undermine adequate NPL resolution. As such, improving operational efficiency, strengthening risk management and collateral execution are needed to improve the profitability of banks, with specific consideration for the increased redefault rate for restructured loans. While the recently amended legal tools and frameworks should help with more timely NPL resolution, we agree with staff that implementation will be key for incentivizing payment discipline. Resolving NPLs decisively will also help stimulate new bank lending, support investment and therefore sustain

longer-term growth. In staff's baseline scenario, zero recovery from NPLs in the public asset management company (AMC) is assumed. Could staff elaborate on how their recommendations to improve the governance, operational and supervisory structure for the AMC could potentially alter this conservative NPL recovery assumption?

Strict spending discipline serves as a valuable anchor for fiscal policy. Unfunded SOE liabilities, the rollout of the National Health System and the rising wage bill represent notable public spending pressures and potential sources of arrears. The sharp rise in public debt under the contingent liability shock scenario further demonstrates the need to carefully monitor and manage these potential fiscal risks. In this light, the authorities' commitment to cap the wage bill and expenditure growth below the medium-term growth rate will help with placing debt on a downward trajectory. As revenues have surprised on the upside, these gains should be used to further reduce debt as the authorities guard against pro-cyclical spending.

Reforms to institutional frameworks and administrative capacity are essential for boosting investment and growth prospects. As highlighted by staff, resolving the issuance and transfer of title deeds and pursuing key judicial reforms are crucial for improving the business environment, securing access to finance and raising investment. In addition, strengthening the management and governance of SOEs remain important priorities for improving service delivery and reducing fiscal risks. To ensure inclusive growth, we agree with staff's recommendation on addressing high youth unemployment and skills mismatch.

Mr. Ray and Ms. Park submitted the following statement:

We thank staff for their detailed report and Mr. De Lannoy and Mr. Cools for their informative buff statement. The sustained upswing in Cyprus is a welcome development but should not reduce the impetus to address lingering vulnerabilities. Important progress has been made in addressing bank balance sheet weakness, which has been reflected in the upgrade of Cyprus' sovereign credit rating. We agree with the staff's analysis and policy recommendations and see it as critical that the authorities make further progress in addressing financial system legacy issues while maintaining prudent fiscal policy.

Continued efforts to address bank balance sheet weaknesses and restore a sustainable payments culture are necessary to restore the financial sector's capacity to support the economy. We welcome the progress that has

been made in 2018, including adoption of amendments to strengthen the framework for insolvency and foreclosure and the resolution of Cyprus Cooperative Bank (CCB). While there has been a significant step down in non-performing loans (NPLs), the NPL ratio remains one of the highest in Europe and more progress is needed. As highlighted by the useful Selected Issues paper, a sustainable reduction in NPLs needs to do more than just remove NPLs from bank balance sheets; weak payment discipline also needs to be addressed. To achieve this, we agree that it will be critical to ensure consistent implementation of new insolvency and foreclosure laws to discourage strategic defaults and encourage loan workouts. The mandate for the new state-owned asset management company should support payment discipline and maximize loan recovery. While noting the role of the Estia subsidy scheme in maintaining political support for financial sector reforms, we agree that this scheme could be better targeted to vulnerable borrowers and welcome the commitment by the authorities to consider tightening the eligibility criteria.

Prudent fiscal policy is necessary to rebuild fiscal space. We note staff's assessment that while debt is on a downward trajectory in the forecast period, the potential for realization of contingent liabilities associated with banking sector weaknesses remains high—as highlighted by the impact of the CCB resolution on debt in 2018. The agreement between staff and authorities on the need to maintain strict spending discipline and avoid procyclical policies is welcome, as is the broad agreement to limit wage bill growth, monitor spending on the new public health insurance scheme and minimize fiscal costs of the new asset management company.

Structural reforms are needed to increase productivity and support diversification into higher value-added sectors to achieve more sustainable medium-term growth. We agree with staff that priority areas include increasing judicial efficiency, essential to the enforcement of the new foreclosure and insolvency legal frameworks and to help support access to finance, and stronger public sector governance. The citizenship by investment scheme should remain under close scrutiny, given potential for capital inflows to boost construction activity in the luxury segment to unsustainable levels and to ensure adherence to AML/CFT standards.

Mr. Mahlinza and Mr. Ismail submitted the following statement:

We thank staff for the informative set of reports and Mr. De Lannoy and Mr. Cools for their insightful buff statement.

The Cypriot economy has continued its strong recovery from the 2012–13 crisis underpinned by buoyant service and construction sectors and robust domestic demand. The notable progress in the bank reforms and improved fiscal performance have culminated in an upgraded sovereign rating and enhanced investor confidence. Notwithstanding these significant developments, addressing risks posed by the high non-performing loans (NPLs) and debt overhang is crucial to entrench financial stability and bolster inclusive growth. We broadly agree with staff's analysis and policy recommendations and provide the following comments for emphasis.

Strengthening financial stability and resilience is vital to bolster long term growth. We are encouraged by the recent sale of the Cyprus Cooperative Bank (CCB) and the approval of a legislative package aimed at reinforcing NPL resolution and addressing the remaining vulnerabilities in the financial sector. Nevertheless, reinvigorating efforts towards completing the judicial reforms and supervisory and governance framework for credit-acquiring firms is warranted. This will further strengthen loan recovery and reduce fiscal costs. While the fiscal costs of the Estia subsidy scheme are deemed manageable, further tightening of the scheme's eligibility criteria is critical to avoid any moral hazard. In this context, we would appreciate staff's comments on how to improve the targeting and eligibility of the Estia subsidy scheme.

Further fiscal consolidation is key to sustain the declining path of public debt. To this end, containing expenditure increases in line with medium term economic growth and maintaining the rise in the wage bill within the rate of nominal GDP growth would help preserve debt sustainability and create fiscal space for growth-enhancing spending. We also see room for improvement in public financial management (PFM) through strengthening internal controls and monitoring of risks stemming from local governments and state-owned enterprises (SOEs). Further, the authorities' plan to launch a National Health System (NHS) is a welcome step. However, the fiscal risks emanating from the new system should be closely monitored.

We encourage the authorities to scale up efforts towards improving the business environment, strengthening competitiveness, and eliminating structural bottlenecks to inclusive growth. To improve the investment climate, reform priorities should be geared towards the advancement of judicial reforms and enhancement of corporate governance and efficiency of SOEs. We also view as important sustaining efforts to strengthen the independence and governance of the Central Bank of Cyprus (CBC) and wonder how the proposed additional Executive Committee would relate with the existing

CBC's Board and other Executive Departments. Staff comments are welcome. Finally, policies to foster economic diversification and reduce skills mismatch and youth unemployment would be crucial to bolster broad-based growth.

Mr. Saito and Mr. Komura submitted the following statement:

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Cools for the informative statement. We welcome that growth is expected to remain strong at around 4.2 percent in the near-term, largely driven by foreign-financed investments, including through the Citizenship by Investment scheme (CbI). However, the Cypriot economy faces several challenges. Notably, legacies from the banking crisis, including its extremely high level of non-performing loans (NPLs), continue to weigh on the economy. In addition, downside risks to the economy call for attention. For example, staff points out high dependence on the construction sector, particularly financed through the CbI. In this regard, the Cyprus authorities have recently taken several measures to boost residential investments, including the reduction of property taxes and the introduction of the CbI while its due diligence procedure has been strengthened. Does staff consider that the surges of foreign-financed investments in residential properties mostly reflect strong residential demands or are largely driven by speculative purposes?

Financial Sector

Vulnerabilities in the financial sector still pose a main challenge in the Cypriot economy. NPLs are among the highest in European countries while significantly declining from 161 percent of GDP (48 percent of loans) in 2014 to 84 percent of GDP (39 percent of loans) in 2018 Q2. In addition, a high cost structure with excess staffing levels and large branch networks, together with narrow interest margins, weigh on profitability of banks. Therefore, we agree with staff that repairing bank balance sheets by lowering operational costs and strengthening collateral execution for NPL recovery is key to improve financial stability.

In particular, steady decline in NPLs is a top priority to preserve financial stability. In this regard, we commend that the authorities have taken several important steps. For example, the assets (primarily performing loans) and all customer deposit of the Cyprus Cooperative Bank (CCB) were sold to Hellenic Bank. In this regard, staff recommends Cyprus of putting in place a governance, operational and supervisory structure for a government-owned Asset Management Company (AMC) which deals with the bulk of the remaining NPLs of CCB. Could staff elaborate more on its current structure?

In particular, we are interested in whether the AMC has adequate size, expertise, and incentive of staff to better deal with NPLs recovery. Furthermore, the Parliament adopted a package of amendments to strengthen the legal framework for NPL resolution. We agree with staff that steadfast implementation of the enhanced frameworks will be necessary to facilitate NPLs resolution process. Regarding the proposed Estia scheme, we see merits to better target to reduce moral hazard and avoid benefitting rich debtors while minimizing fiscal costs.

Fiscal Policy

We commend the authorities for strong fiscal performance. The general government primary balance has significantly improved and is expected to reach greater than 5 percent of GDP in the near-term. Given the still-high level of public debt, 95.7 percent of GDP in 2017, maintaining fiscal discipline, while preserving necessary expenditure, is imperative in Cyprus. In this regard, it is welcoming that the buff statement shows the authorities' firm commitment to keep expenditure growth below the medium-term GDP growth rate.

Structural Reforms

Steady structural reforms, including institutional reforms, are warranted to improve business climate. We agree with staff on the priorities, including judicial reforms, public sector governance reforms, and AML/CFT reforms. On the last one, staff mentions that AML/CFT risks could have macro-critical impacts in Cyprus. Is staff of the view that the authorities have speedily tackled these risks? In particular, does staff consider that Cyprus can obtain a better evaluation from the upcoming MONEYVAL AML/CFT assessment by conducting necessary reforms timely?

Mr. Ostros and Mr. Gade submitted the following statement:

We thank staff for their reports and Mr. De Lannoy and Mr. Cools for their helpful buff statement. The Cypriot economy is recovering strongly, and fiscal policy has been put on a strong footing to ensure public debt to GDP is placed on a downward path. Also, the authorities have made progress in tackling crisis legacies, but challenges remain with the still exceptionally high level of non-performing loans (NPLs) and the need for judicial reform to strengthen the legal framework for foreclosure and legal enforcement. The focus of staff's report is rightly so on these challenges and we broadly share

staff's analysis and the staff appraisal. We associate ourselves with Mr. Meyer's statement and make the following points for emphasis.

The economy is recovering strongly, but the reliance on foreign investments into construction activity come with the risk of economic volatility ahead. We welcome the strong recovery of the Cypriot economy, which is aiding a reduction in the imbalances that had built-up in the pre-crisis years, but also creates an opportune environment to address remaining challenges. Investments in construction have been a key driver of growth in recent years. Given the notorious volatility of construction activity, we encourage the authorities to implement a reform agenda aimed at further improving the business climate and broadening the growth base. As construction activity is foreign-financed, in part due to the Citizen by Investment scheme, we encourage the authorities to continue strengthening the AML/CFT procedures, as well as we more broadly encourage the authorities to consider policies to calibrate the investment cycle.

Fiscal policy is on a much stronger path with substantial surplus, but risks from increased spending pressure and contingent liabilities need to be managed carefully. The primary balance has been brought to an impressive likely 5.1 percent of GDP this year, which is contributing substantially to public debt-sustainability. Going forward, we take positive note of fiscal policy projected with a broadly neutral stance in view of the closed output gap. Irrespective of still low core inflation, a prudent fiscal policy should become increasingly contractionary as the output gap moves into positive territory. In this vein, we also take positive note of the authorities' view on the need to maintain strict spending discipline and avoid pro-cyclical policies. Continuing to build fiscal buffers is especially important given the still looming contingent liabilities from the banking sector as well as key risks from wage bill spending pressures, including ongoing court cases, and unfunded liabilities of SOEs.

The high level of NPLs remains a key challenge for the economy, and while progress has been made, the still exceptionally high level calls for continued reform efforts. We appreciated staff's focus on the challenges of the stock of NPLs for the Cypriot economy – both in last years' Article IV report and in the Selected Issues Paper (SIP) this year. While progress has been made, a remaining stock of 84 percent of GDP is exceptionally high. While there is a net outflow of NPLs, we also take note of the still significant inflow from performing to non-performing loans – perhaps due to stricter lending standards. For the existing stock of NPLs, we support staff's assessment on the need to complete the regulatory and supervisory framework for the

newly-licensed credit-acquiring companies and the governance of the Asset Management Company. To continue addressing the remaining stock, and to mitigate the risks from new NPLs - should the cycle turn - we encourage the authorities to improve in particular the legal framework and legal enforcement via a reform of the judicial system.

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for well-written papers and Mr. De Lannoy and Mr. Cools for their helpful buff statement. Cyprus' economic recovery remains strong, underpinned by domestic consumption and foreign investment inflows. In 2018 real GDP has returned to its pre-crisis peak in 2011. The authorities' strong commitment to sound fiscal policies and structural reforms is commendable. We also welcome recent progress in addressing weaknesses in financial sector regulation and reducing NPLs. As we broadly agree with the staff appraisal and recommendations, we will make several comments for emphasis.

Up to now Cyprus was able to achieve strong creditless recovery, supported by external inflows, self-financing, and unpaid debt service obligations. Going forward these sources of financing may not be sustainable and repairing banks' balance sheets should remain a priority. In this regard, we welcome recent steps in reducing still large NPLs overhang, including the sale of the Cyprus Cooperative Bank (CCB) and adoption of the legislative package to strengthen the legal framework for NPLs resolution. The legislative package provides an opportunity to substantially improve payment discipline and speed up the NPL workout, and it should be fully enforced. It is also essential to strengthen the governance and supervision over the newly-established state-owned asset management company (AMC) as well as private credit-acquiring companies.

Continued strong fiscal performance is essential for reducing risks associated with still very high public debt and possible deterioration of external financing conditions. We note that the sale of the CCB, while reducing the NPL level in the economy, resulted in a substantial one-time increase of the public debt. The authorities are well-advised to maintain strict spending discipline to firmly put public debt on a declining path. Limiting public expenditure growth could be achieved by keeping the pace of wage bill expansion below nominal GDP growth and a hiring freeze in public sector. The authorities should strengthen the eligibility criteria of 'Estia' subsidy scheme for mortgage restructuring. Possible windfall revenues, including from

the NPLs recovery by the AMC should be saved to bring forward the reduction of the public debt.

We welcome the authorities' commitment to further advance structural reforms. Progress achieved in strengthening the financial sector legislation brought to the forefront the need to address the inefficiencies in the judicial system. We note the authorities' efforts to strengthen institutional framework in this area, including plans for creation of a Commercial court, reform of the Civil Procedure Code, and increasing the number of judges to address the backlog in legacy NPL cases. We also welcome the efforts to improve the central bank governance and further strengthen the AML/CFT framework.

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

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Cypriot economy is improving, as recently indicated by its return to investment grade status, but further measures are necessary to address a heavy debt load and the critical legacy problem from the crisis – large non-performing loans (NPLs). The authorities are committed to addressing risks and fiscal performance has notably been strong; however, additional structural reforms will also be needed to lower risks, especially as spending could rise in response to spillovers from the health and financial sectors. We agree with the general thrust of the report and offer the following comments.

Financial Sector

We welcome the discussion of NPLs throughout the report, which we view as the main challenge the Cypriot economy faces. We appreciate the authorities' recent steps to address vulnerabilities, including the sale of assets and customer deposits of Cyprus Cooperative Bank (CCB) and the amendments to strengthen the legal framework for NPL resolution. However, further efforts are still needed, and we particularly agree with staff's recommendations related to the governance and operations of the new Asset Management Company and Estia scheme, which needs better calibration. We also welcome the SIP that explores the NPL challenge for households. NPLs in Cyprus are relatively larger than any other EU member and resolution of household NPLs will help stabilize the economy and further lower household gross debt, which although declining in recent years remains high at 102 percent of GDP. We also welcome continued efforts to address AML/CFT risks.

Fiscal Outlook

Additionally, vulnerabilities in the financial sector pose risks to the fiscal outlook and the broader economic expansion. We agree that strict fiscal discipline should be maintained in order to continue a large primary surplus over the medium term and ensure debt continues on a downward path. The increase in public debt due to support for the CCB transaction highlights that fiscal policy requires constant attention as progress can easily reverse, and we welcome the authorities' commitment to keeping expenditure growth below the medium-term GDP growth rate.

Structural Reforms

In order to sustain Cyprus's economic expansion and maintain fiscal prudence, a number of structural reforms are also needed. We welcome the authorities' commitment to judicial and court reforms as well as efforts to improve local government and partially privatize some state-owned enterprises.

Mr. Just and Mr. Hagara submitted the following statement:

We thank staff for the report, and Messrs. De Lannoy and Cools for their informative buff statement. The cyclical recovery of Cyprus' economy has continued on a swift pace towards the pre-crisis peak level, driven by strong, foreign-funded investment in the construction sector. In addition, the authorities' welcome reform efforts resulted in a rating upgrade to investment grade. Nevertheless, important crisis legacies and vulnerabilities are still to be addressed, including a deeply indebted private sector with a very high level of non-performing loans (NPLs) and elevated public debt. In this vein, the pressure to reform has not abated and the authorities continue to face a significant list of reforms that need to be implemented. We share thrust of the staff appraisal and broadly associate ourselves with the statement by Mr. Meyer. We would like to add the following comments for emphasis.

The stock of NPLs is still high and, together with elevated private debt, is the main vulnerability for the Cypriot banking sector, as well as the economy overall. The sale of the Cyprus Cooperative Bank (CCB) was an important step in stabilizing the banking sector. In turn, the CCB's substantial NPL stock was removed from the banking sector, which contributed to a considerable reduction of the overall NPL ratio in 2018. Despite that, the NPL ratio remains among the highest in the EU and the authorities need to intensify their efforts to reduce it. A legislative package adopted by the Parliament in

July, including amendments to foreclosure, insolvency, sales of loans, and securitization laws, is a step in right direction to facilitate NPL resolution. At the same time, the proposed ESTIA scheme can support borrowers' payment discipline, but needs to be monitored for eventual moral hazard issues and further adjusted, if needed. Following the CCB's sale, a major portion of its NPL portfolio was transferred to a newly created Cooperative Asset Management Company (CAMC). To maximize loan recovery and minimize fiscal costs, the CAMC's independent governance and transparency should be ensured.

The effective implementation of the AML/CFT framework is also important. We agree with staff that full compliance with the AML/CFT requirements needs to be ensured, including with regard to the Citizenship-by-Investment (CbI) scheme to maintain its integrity. We wonder whether staff assesses the authorities' response to the Cyprus Development Bank's violation of the AML requirements between 2014 and 2016 as sufficient and satisfactory.

Continued strict fiscal discipline is needed against the increasingly strong cyclical position and high public debt. We commend the authorities for sustaining a strong primary structural fiscal balance. Nevertheless, public debt remains elevated, with negative risks from contingent liabilities, particularly in the banking sector. With the economy being fairly advanced in the cycle, it does not need further stimulus from the fiscal policy, and we encourage the authorities to fully concentrate on maintaining the fiscal discipline to put public debt firmly on a declining path. Containing expenditure growth, including the public wage bill, and checking for the fiscal impact of the recent healthcare reform, are key in that regard.

We also encourage the authorities to reaccelerate the structural reform agenda. A judicial reform, including establishing of the commercial court and measures to increase the efficiency of courts more broadly, is needed to reinforce the impact of recent amendments to the foreclosure and insolvency frameworks, while title deeds issuance and the transfer system should be improved. Furthermore, the privatization program should be restarted to increase competition and economic efficiency, and also to reduce exposure to contingent liability risks.

Mr. Beblawi and Ms. Merhi submitted the following statement:

We thank staff for the interesting reports and Mr. De Lannoy and Mr. Cools for their insightful buff statement. The Cypriot economy has

achieved an impressive turnaround since the 2012-13 banking crisis, due to prudent macroeconomic policies and progress on structural reforms. GDP growth has been robust and expected to remain above 4 percent, unemployment is rapidly declining, while large fiscal primary surpluses are putting public debt on a declining path. Notwithstanding this strong economic performance, crisis legacy issues, mainly a high nonperforming loans ratio, remain and continue to weigh on the banking sector. We concur with staff assessment that going forward, elevated financial sector vulnerabilities due to delays in NPL resolution and the high dependence on the construction sector, supported by possibly-volatile capital flows which could be induced by a sharp tightening of global financial conditions, pose risks to this outlook. We would like to highlight the following issues:

Addressing NPLs to lower borrowing costs and reviving credit supply will be important to support longer-term growth, as elaborated in the informative SIP. We welcome the recent legal amendments aimed at reducing vulnerabilities and catalyzing NPL resolution. Notwithstanding this progress, addressing the high levels of NPLs, at 30 percent of total loans and 85 percent of GDP, remains a critical issue, especially that the pace of NPL reduction has been slow despite several years of robust GDP growth. We therefore agree with staff that steadfast implementation of the enhanced frameworks will be key to facilitate this process and ensure timely enforcement. These new frameworks should be supplemented by additional structural reforms aimed at strengthening institutions.

We commend the authorities for putting public finances on a healthy footing, with large primary surpluses contributing to the reversal of the upward trend of the debt-to-GDP ratio. We concur with staff that fiscal discipline should be maintained, and we see merit in staff recommendation to cap overall spending growth in order to protect against procyclical fiscal pressures. Keeping the increase in the public wage bill envelope within the rate of nominal GDP growth will be particularly important in this regard. Moreover, the transition to public insurance in the health sector will need to be carefully managed. We welcome the authorities' commitment to keeping expenditure growth below the medium-term GDP growth rate, as well as containing risks to the budget from contingent liabilities from NPLs as elaborated in the report.

With these comments, we wish the Cypriot authorities all the best in their reform efforts.

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for their candid set of reports and Mr. De Lannoy and Mr. Cools for their informative buff statement.

Cyprus's robust recovery is welcome, but additional efforts are needed to make it more sustainable. Growth remains strong, primarily driven by high foreign investments in the construction sector and continued strength in tourism and professional services, but important vulnerabilities remain. The crisis legacies, linked to high public and private debt, as well as a large NPL stock, weigh on the sustainability of the current growth momentum. Vigorous efforts to reduce the NPL overhang and restore credit financing, supplemented by enhanced structural reforms, are key to increase the country's resilience to future shocks.

Fiscal performance is set to remain robust, on an account of strong revenue collection and prudent expenditure management. Public debt is expected to decline under the baseline scenario. However, strict spending discipline should be maintained to firmly anchor debt on a downward path. Downside risks stemming from an increased public wage bill, additional spending under the Estia scheme, and possible health care expenditures – as a consequence of the planned NHS launch – should be closely monitored. In this context, we urge the authorities to build fiscal buffers to counter the risks of procyclical policies, inter alia by capping the rate of spending by medium-term output growth.

Advancing structural reforms is essential to improve competitiveness and make the economy more flexible and resilient to shocks. We welcome the authorities' commitment to undertake long-overdue judicial reforms to address administrative inefficiencies, in particular by improving the efficiency of the courts and strengthening the enforcement of commercial claims. This would improve access to financing and investment. We also agree with the importance of strengthening public sector governance, yet more efforts to mitigate AML/CFT risks are warranted. In this regard, we would like to ask how staff assess the integrity risks associated with the Citizenship by Investment (CbI) scheme and its compliance with AML/CFT standards? Furthermore, addressing high youth unemployment and diversifying the economy into high-skill service sectors would ensure inclusive and sustainable long-term growth.

Additional efforts aimed at reducing the private debt overhang, accelerating NPL resolution and improving payment discipline are critical.

Notwithstanding the economic rebound and stronger investor sentiment, NPLs remain elevated. We welcome the authorities' recent legislative actions aimed at strengthening the insolvency and foreclosure regime. However, a further clean-up of banks' balance sheets will be essential to restore their profitability and improve cost-income ratios. As highlighted in the Selected Issues Paper, we concur with staff that lowering borrowing costs and reviving the credit supply by further reducing the NPL overhang will be crucial to support long-term growth.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents and Mr. De Lannoy and Mr. Cools for their informative buff statement. We largely share staff's appraisal of the favorable macroeconomic projections for Cyprus reflecting a continuing robust economic growth fueled by strong domestic demand, and particularly investment. We also salute the remarkable efforts made by the authorities to promote sound and contracyclical policies to public finances and sanitize the banking sector. As growth is gradually expected to reach its potential over the medium-term, we concur with staff's main conclusions that this current recovery period must therefore be made the most of, to address remaining structural rigidities. Labor market's functioning is not optimal as unemployment is still high and skill mismatches may prevent the most vulnerable workers (the youth and long-term unemployed) to find a job. Likewise, public sector governance should be strengthened to better control risks arising from local governments and public bodies' management. We associated ourselves with Mr. Meyer's gray and would like to make a few additional comments.

Macroeconomic Outlook

The outlook remains very encouraging with growth driven by private and public consumption, foreign investment in residential properties and health and tourism infrastructure. We salute the efforts of the authorities to put public finances on a sounder and more sustainable footing and to close the output gap, reflected in a slight rise in inflation. Going forward, we concur with staff that Cyprus remains exposed to internal vulnerabilities and rising external risks mainly related to a widening current account deficit, a weak external position and a credit growth constrained by ongoing households and non-financial corporations deleveraging and a still high level of non-performing loans (NPLs).

Fiscal Policy

We welcome the authorities' efforts to improve the public primary balance surplus and curb the public debt ratio although the latter remains high and above most European countries. We acknowledge that fiscal costs of Cyprus Cooperative Bank's assets sale (€3.5 billion, 17 percent of GDP) have already been booked in public debt. We support the spending discipline of the authorities as public debt needs to be put on a declining path. In line with staff's DSA, we believe that contingent liabilities in the banking sector, including those related to the sale of the CCB, as well as growth slowdown could undermine debt sustainability. The estimation of a reduction in public debt under the baseline scenario, from 106 percent of GDP in 2018 to below 70 percent of GDP by 2023 should indeed rely on the most conservative assumption. As a matter of fact, combined macro-fiscal shocks (growth and interest rate and primary balance shocks) would cause public debt to peak at 107 percent of GDP in 2020 increasing gross financing needs to 14 percent of GDP that year.

Banking Sector

We fully share staff's analysis on the need to further reform et restructure the banking sector to reduce NPLs on a durable basis. We encourage the authorities to proceed with the sanitization of the banks' portfolios, through the sales of loans law and the adoption of a law on securitization or the defeasance structure (CAMC) created to oversee the sales of NPLs to credit-acquiring companies. These welcomed steps require however an adequate and upgraded regulatory and supervisory framework by ensuring a greater judicial efficiency, accountable and more transparent government agencies and, the operational independence of the Central Bank. Looking ahead, as growth is heavily dependent on foreign financing, diversification of banking activities into higher-value-added sectors like luxury residential development warrant cautious policies from the supervisory authorities to mitigate credit exposure to non-resident counterparts. We would like to have staff's view on this respect and the recommendations needed to mitigate risks arising from non-residents, especially in the property market.

Finally, we note that inherent AML/CFT risks could have a macro-critical impact and need to be addressed by adequate mitigating legislation. We would insist on the importance of the compliance with AML/CFT standards and more specifically as regards the CbI scheme. As pinpointed in the report, compliance and supervision of the sectors concerned should be ensured.

Ms. Levonian, Ms. McKiernan and Mr. Feerick submitted the following statement:

We thank staff for their reports and Messrs. De Lannoy and Cools for their helpful buff statement. The Cypriot economy continues to recover strongly from the low point of the crisis and this is reflected across a number of metrics, including public finances, unemployment and the banking sector. Nevertheless, legacy issues continue to cloud the outlook and the present conjuncture provides an opportunity to build on this progress. We broadly agree with the thrust of staff's assessment and offer the following comments for emphasis.

Commitment to prudent fiscal policy has been commendable and we encourage the authorities to continue in this vein. Cyprus has recorded substantial primary surpluses over recent years, which has contributed to the rapid fall in the debt ratio. While there is a slight weakening in the structural primary surplus in the short term, it is expected to remain sizeable over the medium term. Coupled with favorable automatic debt dynamics, the structural primary surpluses will contribute to ensuring that debt remains on a firm downward trajectory. In terms of specific policy advice, we agree with staff that maintaining strict expenditure discipline will be important.

Progress is being made in repairing the banking sector, but there remains much to be done. Cypriot NPLs remain elevated despite the notable reduction over recent years and it is clear that this will continue to weigh on the health of the banking sector. In this regard, we welcome the July 2018 legislative package on insolvency, foreclosure and the sale of loans, which could play a central role in addressing strategic defaulters. Relatedly, the recently amended Estia scheme could assist in this regard but its design could be better targeted to address moral hazard concerns. The Cypriot authorities have made some significant improvements in the AML/CFT architecture, particularly with regard to the Citizenship by Investment scheme. Nevertheless, given the importance of the banking sector to the economy, we encourage further strengthening of the framework.

We agree with staff on the need to progress the structural reform agenda to improve competitiveness and the investment climate, and bolster long-run potential growth. A key structural roadblock identified by staff relates to reform of the judicial system for which a suite of useful recommendations have been outlined and are worthy of consideration by the authorities. On the labor market, we welcome the significant improvement in recent years – evident in the halving of the unemployment rate to just over

7 percent – but also note that challenges remain in certain sectors, notably amongst youth unemployment and the potential for hysteresis of older workers to set in. As such, we agree with staff that further actions in the ALMP space have the potential to deliver results.

Mr. Daïri and Mr. Sassanpour submitted the following statement:

We thank staff for well-written papers and Mr. De Lannoy and Mr. Cools for their informative buff statement. We concur with the thrust of the staff appraisal and stress a few key issues.

The recovery of the Cypriot economy since the 2012-13 crisis has been indeed impressive. Growth has been strong with a momentum that is likely to be sustained in near term. Price and wage pressures have been mute, despite high international energy prices, significant gains in employment and the closing of the output gap. Export competitiveness has been preserved and the current account deficits appear manageable. These favorable developments have been reflected in a recent sovereign rating upgrade. The key macro-critical issues facing Cyprus are continued financial sector vulnerabilities related to crisis legacies—notably the pace of progress in NPL resolution—high stocks of public and private debt, and the sustainability of foreign-financed construction boom through the citizenship by investment (CbI) scheme. The hardening of global financial conditions, global trade conflicts, and the anticipated moderation of growth in the euro area pose additional risks.

Cyprus' strong economic performance has been accompanied by sizable recurrent primary fiscal surpluses reflecting strong revenue performance and expenditure containment. The public debt ratio declined in tandem but remained among the highest in the EU, even excluding Cyprus' contingent liabilities of the banking sector. Going forward, it is imperative to put the debt ratio firmly on a downward path by continuing to run primary surpluses, at a time when expenditure pressures are anticipated from the unwinding of crisis-era wage freeze and higher public health expenditures following the National Health System rollout. In this connection, we welcome the authorities' commitment to maintain strict expenditure discipline and keep the wage bill growth below nominal GDP growth, closely monitor the new health system, use potential dividends from assets sales to pay down debt, and strengthen public financial management.

Crisis legacies continue to weigh on the banking system and remain a source of financial vulnerability. While the stock of NPLs has been reduced

considerably in the past four years due to restructuring, repayments, write-offs, and transfers to the new CAMC, it is still by far the highest in the euro area in relation to GDP. The July 2018 legislative measures strengthened the insolvency and foreclosure framework for resolution of NPLs, but the current judicial system and legal framework is not fully supportive and needs to be fortified, including by establishing dedicated commercial courts staffed by trained judges to speed up the process and clear the backlog. We also note that redefault rate in restructured loans is increasing, and we agree with staff that banks might need specific regulatory guidelines to deal with it. The Estia subsidy scheme could also be better targeted to avoid moral hazard and help intended beneficiaries in servicing their debt.

One of the key structural challenges outside the financial sector is to address the high youth unemployment—notwithstanding the recent favorable developments—through active labor market policies, improvements in education, and by reducing skill mismatch. Attracting FDI requires improvements in ease of doing business, particularly in the area of reinforcement of contracts. The CbI scheme has been successful in attracting foreign investment and supporting growth, but a close monitoring of its impact on the housing market is warranted. The high dependence of growth on foreign capital also merits continuous evaluation. We welcome the recent strengthening of due diligence procedure for the CbI scheme to ensure its compatibility with the AML/CFT standards, as underscored by Mr. De Lannoy and Mr. Cools.

We wish the authorities continued success.

Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the reports and Mr. de Lannoy and Mr. Cools for their statement. Since the last Board discussion of Cyprus Post-Program Monitoring (PPM) in early June, the Cypriot economy has continued its gradual recovery, but not without new challenges. We commend the authorities for their continued efforts to strengthen macroeconomic and financial sustainability, which have been increasingly recognized by market participants and rating agencies, as reflected by the recent sovereign rating upgrades to investment grade status.

Recent developments in the banking sector are positive, but their full and effective implementation remain uncertain. We welcome the approval of the legislative package to improve the foreclosure and insolvency frameworks, as well as the completion of the restructuring process and sale of Cyprus

Cooperative Bank (CCB). Both developments are fundamental to address the legacies of the banking crisis, but implementation risks have not been eliminated. We expect that the new foreclosure and insolvency frameworks will give more traction to the process of banks' balance sheet repair, particularly regarding a more resolute NPL reduction.

The restructuring of CCB came at a high fiscal cost. According to Box 1, the fiscal impact of the CCB deal reached 17 percent of GDP, and costs can rise further. As a result, public debt is expected to temporarily spike to 106.1 percent of GDP this year. We take note of staff's projections that the public debt ratio is expected to resume the downward trend in 2019 and reach less than 70 percent of GDP by 2023, thanks to continuing large primary surpluses and robust GDP growth.

The authorities should spare no efforts in strengthening the governance and oversight structure of the newly created Asset Management Company (AMC). We take note of staff's views that potential dividend upsides from the AMC exist over the long-run, but the company undoubtedly entails significant medium-term fiscal risks considering the intrinsic difficulties of recovering a portfolio of aged, devalued, and fragmented NPLs. Further, we concur with staff that the AMC should be ring-fenced from political interference.

The economy's medium-term growth outlook remains positive. To further reduce macroeconomic and financial vulnerabilities, the authorities should seize the current favorable environment to deepen reforms, notably regarding the judicial system, public administration, and AML/CFT framework. That said, we agree with Messrs. de Lannoy and Cools that it is important to take a long-term perspective when analyzing the country's reform efforts amid actions on many different fronts.

Mr. Jin and Mr. Fan submitted the following statement:

We thank staff for the comprehensive reports and Messrs. De Lannoy and Cools for the informative buff statement. It is good to note the strong recovery in Cyprus and the progress in tackling crisis legacies. Meanwhile, more needs to be done to address the stubbornly high debt level and promote the reduction of remaining NPLs and implementation of structural reforms. We broadly share staff's recommendations and would like to limit our comment as follows.

Efforts to further reduce NPLs in an orderly and timely manner is critical. We commend the authorities for their significant reduction of NPLs,

as well as their two steps to reduce vulnerabilities and catalyze NPL resolution, including the assets sales of CCB and adoption of package of amendments to strengthen the legal framework for NPL resolution. However, with almost two-thirds of the restructuring loans having already been restructured at least once, we see strong merit in the concrete implementation of these amendments, and encourage the authorities to enhance the governance, operational, and supervisory structure for the state-owned AMC to guarantee the orderly restructuring of NPLs. We welcome the proposed subsidy scheme called Estia to encourage distressed borrowers to begin servicing their loans and would like to emphasize the importance of avoiding moral hazard for strategic defaults. We welcome staff's introduction on Cyprus's main policy measures to maintain its role as an important offshore financial service center, and its typical funding source, investment target, and main customers in this industry. Meanwhile, we also welcome staff's elaboration on the implication of recent international rules and best practices in AML/CFT to Cyprus.

Continuous efforts in addressing the high debt level are still critical. We commend the strong fiscal performance, especially the revenue overperformance driven by VAT collection. However, the debt only declined slightly and the risk to debt sustainability remains high. Although the public debt is projected to be on a rapid downward path in the baseline according to the DSA, the reduction is vulnerable to macro-fiscal shock. To maintain a steady fiscal position and keep debt on the planned downward path, we support staff that a strict control on the spending discipline should be maintained, and the wage bill envelope should be kept within the rate of nominal GDP growth. Meanwhile, careful management is warranted to realize the long-term neutrality of national health insurance and mitigate the temporary shock to spending in the near term. We welcome staff's elaboration on the share of public sector in the Cypriot economy and its implications for debt reduction.

Structural reforms should continue to facilitate NPL and debt reduction, further enhance the investment climate, and bolster productivity. The judicial reform and commercial claims enforcement, as well as the strengthening of other institutional frameworks such as insolvency service and professionals, are critical in the implementation of the amendment of legal systems of NPL resolution. Meanwhile, efforts are needed in addressing persistent delays with issuance and transfer of title deeds. Also, we welcome the improvement of central bank governance and autonomy. The excess dependence on the construction sector supported mainly by the Citizenship by Investment scheme (Cbi) projects may not be sustainable, but more

importantly, it may bring risks to the property market. We would appreciate if staff could introduce both the number and composition of immigrants as well as the amount of capital inflow under the Cbi project. Furthermore, we would like to hear staff's elaboration on the opinion of other EU countries on the impact of this projects to the EU, and whether the EU has set any quota on this project.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. De Lannoy and Mr. Cools for their buff statement. We associate ourselves with the statement by Mr. Meyer.

The strong performance of the Cypriot economy continues, and the outlook remains favourable, but challenges remain - most notably high private and public debt, NPLs and low productivity growth. The current growth dynamic benefits from the supportive external environment and the economic expansion has continued at a robust pace which has helped increase employment and supported private sector deleveraging. Employment increased across most sectors and unemployment has fallen rapidly (while remaining above the pre-crisis level), but youth unemployment remains high. Investment has been boosted significantly by the Citizenship-by-Investment (Cbi) program that has attracted foreign investment primarily in real estate (which, given this is a relatively low productivity sector, may weigh on the prospects for long-term potential growth) and is expected to increase further because of the pipeline of ongoing and new construction projects in residential properties, education, health and tourism infrastructure. Staff expect some deceleration of growth toward potential by 2021 and also note that their estimated medium-term potential growth rate is conditional on the implementation of structural reforms and an acceleration of NPL resolution. The currently very favorable economic environment should, therefore, be used to reinvigorate the structural reform agenda.

Budget execution in 2018 has been strong and the public debt-to-GDP ratio is expected to return to a downward trajectory in 2019 – however, fiscal policy is procyclical. Fiscal performance improved because of strong revenue collection (in particular VAT) and prudent expenditure management. Staff project sustained high primary surpluses of about 5 percent of GDP for the years ahead. Moreover, they expect that – following the upward impact of the CCB transaction in 2018 although its exact statistical classification remains to be determined – the public debt-to-GDP ratio is expected to resume

declining - by 38 p.p. to 68.1 percent of GDP by 2023. The CCB sale has also resulted in substantial contingent liabilities for the state in relation to the Asset Protection Schemes (APSs). The final fiscal costs to the government will depend on the actual proceeds from the NPL workout by the residual entity and the potential losses under the APSs. Staff forecast that the fiscal structural balance will weaken slightly next year on account of new expansionary measures (most notably a reduction of the interest levy, a reversal of public wage cuts implemented under the program and additional expenditure under the Estia scheme) as well as possible cost-overruns in health expenditures following the rollout of the National Health System starting in 2019. We share Staff's assessment of a (mildly) expansionary fiscal stance which is procyclical as the positive output gap is expected to further increase over the coming years. This is despite high public debt and still sizeable contingent financial sector liabilities. In this context, we agree with Staff that strict spending discipline should be maintained to firmly anchor the public debt-to-GDP ratio on a downward-sloping path.

We agree with Staff on the need to renew the reform momentum and on the structural reform priorities, in particular, judiciary reform, public sector governance and ALMPs. It is crucial to accelerate the judicial reform with a view to strengthen legal enforcement of commercial claims and shorten court procedures, including by establishing a commercial court, by reforming the civil procedure rules and by introducing an e-justice system. Other priorities include a more forceful implementation of the government's plan to streamline business procedures. We also agree with the importance of strengthening public sector governance and government effectiveness, including through an improved monitoring of the governance of state-owned enterprises and local governments. Staff, however, do not discuss the benefits of restarting the authorities' privatization plan nor the reform of the electricity market. These measures could have a direct effect on the cost-competitiveness of the Cypriot economy and facilitate trade flows and investment conditions.

While the sale of the government-owned Cyprus Cooperative Bank (CCB) to Hellenic Bank (HB) and the adoption of the legislative package to strengthen NPL resolution have improved depositor confidence, helped consolidate the banking system and reduced financial sector vulnerabilities, we agree with Staff that improving the payment culture and the steadfast implementation of the recently amended foreclosure and bankruptcy frameworks is necessary to achieve a further reduction in NPLs. The Cypriot banking sector continues to be under pressure because of low interest income, the potential need for additional provisions in the context of high NPLs, and high operating costs due to oversized branch networks—even after recent

large-scale branch closures by HB. The NPL ratio, albeit declining, remains the second highest in the euro area. In this context, the approval of the recent legislative package on NPL resolution, particularly the amendments to the foreclosure and insolvency frameworks are welcome but will now need to be swiftly and fully implemented. Moreover, the legislative package will need to be complemented by reforms of the judiciary and the system for issuing and transferring title deeds. While the recent revision of the eligibility criteria for the Estia scheme, which has helped build a political consensus in favour of the CCB sale and the amendments of the foreclosure and insolvency frameworks, is welcome, the revised scheme continues to raise moral hazard and social fairness concerns. The creation of a governance framework for the wind-down institution (the Cooperative Asset Management Company – CAMC – the residual entity from the sale of the CCB) has been delayed and major challenges lie ahead. The key challenge will be to ensure actual operational independence of the wind-down entity from political interference. The sole objective of the entity should be to divest its assets with a view to maximise the returns to the state.

The Acting Chair (Mr. Zhang) made the following statement:

Cyprus experienced a large banking crisis a few years ago. After that, Cyprus entered a program with the Fund and its troika partners, the European Central Bank (ECB) and the European Stability Mechanism (ESM). This is part of the solution, and there are some efforts in terms of the bail-ins on the retail deposit. Since then, the economy has made a remarkable turnaround, underpinned by generally prudent economic policies and also aided by the favorable external environment.

In 2016, Cyprus exited the Fund program, and now it is under the post-program monitoring (PPM) until somewhere in the middle of the next year.

Mr. Meyer made the following statement:

I thank the staff for the report and Mr. De Lannoy for his buff statement. I would like to make some remarks for my European colleagues.

We take positive note of a strong rebound of the Cypriot economy since the crisis, based on effective government policies and also favorable external conditions. We commend the authorities for the overall improvement in macroeconomic indicators such as growth and unemployment. The sizeable primary fiscal surplus, as well as the authorities' policy initiatives to

incentivize NPL reduction, are important instruments in strengthening resilience.

At the same time, as pointed out by the staff and reflected in many gray statements, structural challenges remain and require continued policy efforts. On the positive side, regulatory capital ratios more than doubled since 2011-2012. That is good. On the other hand, NPLs, which peaked at 47.5 percent in 2014, stood still at 42.5 percent at 2017. Recently we have seen a substantial reduction, and that is important. Debt to GDP, still stands around 100 percent, and that is concerning as well.

Against that background, we note the government's budget increased exposure to contingent liabilities and agree with the staff that maintaining the strict spending discipline of previous years will be instrumental to firmly anchor public debt on a downward-sloping path. Additional efforts will also be necessary to continue reducing NPLs on a permanent basis. As suggested by the staff and many Directors, the recently amended Estia scheme could help tackle legacy NPLs, but it is important that its design be better targeted to address moral hazard concerns. More broadly, we agree with the staff on the need to foster productivity and to renew the reform momentum, particularly with regard to the judicial system, public sector governance, and active labor market policies. With this, I wish the authorities much success in their endeavors.

Mr. Tan made the following statement:

I thank the staff for the insightful report, which I found easy to read and comprehend, and also to Mr. De Lannoy and Mr. Cools for the clear and concise buff statement. We are largely on the same page on many of the issues raised in the report. I would echo most, if not all, the comments raised in the gray statements, particularly the point that many Directors have touched on—the large stock of NPLs in the banking sector and the commendable efforts made to reduce the overhang while noting that more needs to be done. We reiterated the same in our gray statement, so I will not plan to repeat that. The staff has also drafted a helpful selected issues paper on the challenges faced by Cyprus and the associated policy implications.

I will just add a short take on the broader issue regarding the NPLs. If one looks at what underlies the attention we have all given to this issue, one will get the common understanding that banks can be both a source of stability or vulnerability to a member's financial system and, in turn, its real economy. Past crises have also taught us that one of the key contributing factors to

weaknesses in the banking system is often the lack of adequate processes for underwriting loans and monitoring their continued performance. The financial landscape is fast evolving, and new risks such as cyber and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) risks are relevant, too, but in the case of Cyprus, it remains topical for our discussion.

At the end of the day, the authorities should also bear in mind that it is about encouraging banks to adopt better risk management, especially credit risk management. We need to be cautious that the NPL will impact the restructuring, which is important for the reasons given in the papers. It is not a substitute for the banks keeping their house in order—i.e., the policy discussion with the authorities should go beyond and cover how banks can maintain sound credit underwriting and prudent lending practices to avoid severe asset quality issues in the first place, and how banks can actively review and manage problem loans at an early stage to ensure that their credit portfolios remain resilient to vulnerabilities in the external environment.

The bad news is that sustainability of asset quality—and correspondingly, poor allocation of credit—will undermine the prospects of sustained economic growth for Cyprus. The good news is that as the staff has noted, the inflows into NPLs seem to be on a declining trend, reflecting stricter lending standards, so we probably need not lose sleep at this stage. But to be safe, we encourage the staff to continue to work with the authorities from both ends, not just on the legacy stock issue of NPL resolution, but also on the forward-looking flow issue, by paying equal attention to responsible lending on the part of the banks and responsible borrowing on the part of the customers.

Mr. Trabinski made the following statement:

We thank the staff for the insightful set of papers and Mr. De Lannoy and Mr. Cools for their candid buff statement. We broadly agree with the analysis and would like to raise two additional points.

Cyprus's economy is experiencing robust growth, driven mainly by foreign finance investment. However, important crisis legacy problems are still to be resolved, including a heavily indebted private and public sector and very high NPLs stocks. Therefore, we stress the need to maintain strong spending discipline and rebuild fiscal buffers, thereby putting debt on a downward path.

Second, we note the authorities' initiative for establishing the subsidy scheme Estia, which is intended to support troubled borrowers. However, to be consistent with my previous remarks, the scheme's fiscal cost should not be neglected. In addition, given its ongoing finalization, moral hazard risks associated with strategic defaulters should be addressed, as also suggested by Mr. Meyer. We encourage the authorities to put in place strict eligibility criteria and also closely monitor the launch of the scheme.

Finally, we encourage the authorities to further strengthen the AML/CFT framework, building upon the outcomes of the upcoming AML/CFT assessment. With this, we wish the authorities all the best in their endeavors.

Mr. Just made the following statement:

We fully agree with the Acting Chair's opening remarks, that the economic turnaround has been remarkable, but there are significant deficiencies, and I would like to associate myself with Mr. Meyer, both on the positive and negative side.

The authorities have made substantial strides in addressing the NPL program. Contrary to some of the other recent euro area member country Article IV reports, the staff did not make any reference to the ECB's guidance on NPLs; and maybe the staff could comment on how the framework put in place by the authorities to incentivize NPL output reduction compares with these ECB clients.

Second, we appreciate the staff's answers to the various AML questions. Our sense is that progress has been made, but there are still significant gaps before we can call the AML regime efficient. We therefore wonder whether AML should be included in the risk assessment matrix. Equally, Cyprus has been affected by some of the sanctions against Russia, and we wonder whether there could be additional risks of possible sanctions that may have a negative impact on Cyprus.

The staff representative from the European Department (Ms. Tuladhar), in response to questions and comments from Executive Directors, made the following statement:¹

I would like to touch on some of the policy questions Directors raised. Several Directors raised the question of the Estia NPL subsidy scheme. I

¹ Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

wanted to first provide an update. The cabinet recently approved a tighter set of eligibility criteria for the scheme. In particular, the income criteria now take into consideration the household size, and the thresholds now range from EUR 20,000 to EUR 60,000 compared to the EUR 50,000 we mentioned in the staff report. Similarly, the net wealth criterion was also revised down from 125 percent of the value of the primary residence, down to 85 percent, up to a ceiling of EUR 250,000. These proposals have now been submitted to DigiComp, and a decision is expected late next week.

While we welcome this tightening, the staff's view is that there is scope for further improvement in the targeting of this scheme, and this is all the more pertinent given the ongoing concerns raised about the fairness, the fiscal cost, as well as the moral hazard risks inherent in the scheme.

Speaking of risks, several Directors also asked about the treatment of the fiscal risks, as well as the financial sector contingent liabilities in particular. We have noted that as far as the financial sector is concerned, the main risk arises from the asset protection schemes that were issued in the context of the Cyprus Cooperative Bank (CCB) resolution. These have not been included in the baseline because independent estimates considered the risk as low, as the underlying portfolio comprises mainly performing loans. On the Cyprus Asset Management Company, the fiscal costs were already recognized when the government bond was issued, so any risk now mainly is on the upside.

We would note, however, that there are other non-financial risks that remain quite high. As the ongoing budget debate suggests, these risks include unwinding of some of the crisis area measures, such as through court decisions on wages and pensions, expansion of the Estia scheme to other borrowers, as well as tax breaks. The staff does recognize that these pressures can become more pronounced under very strong new revenue performance. Nevertheless, the authorities have indicated their very firm commitment to contain these spending pressures to keep it within the medium-term GDP growth rate, which is in keeping with their track record. With elections not on the horizon until 2021 and GDP growth expected to remain above potential, the staff assesses the strong fiscal performance will continue but advised they maintain a strong fiscal discipline against these risks.

Mr. De Lannoy made the following concluding statement:

I thank Directors for their gray statements and interventions. We greatly appreciate the attention the Board pays to developments in Cyprus, and I will convey their messages to the authorities.

Cyprus is expected to continue to record solid primary surpluses as the authorities remain committed to strict spending discipline in line with the staff report. Except for the spike this year due to the CCB transaction, public debt is on a firm downward trajectory and is expected to fall below 70 percent by 2023.

Let me touch upon three topics: first, the CCB transaction; second, NPLs; and third, structural reforms.

First, with regard to the CCB transaction, there is no doubt that this deal was necessary to stem the deposit outflows witnessed earlier this year. The deal has stabilized the financial sector and has removed a large part of NPLs off the banking books. As such, it also contributed to the recent upgrades of Cyprus' sovereign ratings to investment grade.

Second, Directors have rightly pointed out that the remaining NPL overhang is the number one challenge for Cyprus. While NPLs have come down from 161 percent of GDP in 2014 to 84 percent of GDP in the second quarter of this year, they are still too high. Looking ahead, NPLs are expected to further decrease as international investors are taking an interest in Cypriot NPLs. This investor interest has been spurred by the July legislative package designed to facilitate foreclosure. Investor interest has also been stimulated by the Estia burden-sharing scheme. The scheme has been designed as a tool to incentivize nonperforming vulnerable debtors to make good on the loans collateralized by their primary residence. It is an instrument to reduce NPL levels to a manageable annual cost of EUR 20 million per year.

Some Directors have raised legitimate moral hazard concerns. This is a fair point, and this is precisely why the authorities have decided to sharpen the eligibility criteria of the scheme. As a large portion NPLs are now in the process of being moved off the balance sheets of the banks, the Central Bank of Cyprus is putting in place the necessary supervisory tools to supervise the newly licensed credit-acquiring companies in line with staff's recommendations. These new tools will also be used for supervising the Cyprus Asset Management Company.

Third, let me now move from post-crisis management to a longer-term perspective. As we noted in our gray statement, Cyprus is using the positive economic climate to reform its institutions and its economy. This genuine dedication to reform is clear when one speaks to the authorities. Being engaged on so many fronts at the same time—judicial reform, local governance reform, the rollout of the national health system—while dealing with the aftermath of a financial crisis and a migration crisis at the same time, is an important political challenge.

Let me focus on judicial reform, as this is key to reduce NPLs. This is a work in progress, with a commercial court being set up and dozens of new judges being hired to deal with the judicial backlog, including on NPL cases. But much more has been done and is ongoing.

Some Directors have touched upon AML/CFT issues. I would like to highlight the four-layer AML scrutiny put in place of applicants for the Citizenship by Investment scheme. Other Directors have talked about the need to closely monitor the labor market. Whereas general unemployment and youth unemployment have come down drastically, the authorities agree that challenges remain regarding skills mismatches, and that issues of inequality deserve further attention, as one Director rightly highlighted.

I will stop here but not before thanking the new mission chief, Ms. Tuladhar, and her entire team on behalf of the authorities. The authorities continue to appreciate the constructive and collaborative engagement with the Fund, and they look forward to welcoming the staff again in March.

The Acting Chair (Mr. Zhang) noted that Cyprus is an Article VII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong post-crisis economic recovery, which has supported large fiscal surpluses and lowered the unemployment rate. Directors also welcomed the recent reforms undertaken to address key vulnerabilities in the banking sector, including the resolution of a large systemic state-owned bank. Directors observed, however, that private and public debt remain large while NPL ratios are still among the highest in Europe. They encouraged the authorities to make further efforts to address these legacy problems and strengthen economic growth over the medium term.

Directors emphasized the importance of further measures to facilitate a steady decline in NPLs on a durable basis. They called for steadfast implementation of the amended legislative framework on foreclosure, insolvency, sale of loans, and securitization, supplemented by a strengthening of the court system and removal of uncertainties related to title deeds. Directors also stressed the need to enhance the governance and supervisory framework for the recently-established asset management company. They recommended that to limit moral hazard, the proposed *Estia* scheme aimed at encouraging distressed borrowers to begin servicing their loans be better targeted and based on appropriate assessment of borrowers' capacity to repay.

Directors highlighted the need for banks to continue efforts to strengthen their balance sheets. They urged banks to diversify income sources and consolidate operations to improve cost-income ratios and better position themselves against increased competition. Directors recommended strengthening regulatory guidance on loan restructuring and exercising vigilance over bank lending policies, the adequacy of provisioning, and debt-to-asset swap policies.

Directors welcomed Cyprus's robust fiscal performance and emphasized that strict spending discipline should be maintained. They cautioned against relying on transitory revenues from cyclical gains and one-off measures to finance permanent spending initiatives, and took positive note of the authorities' commitment to cap expenditure increases, including the public wage bill, in line with the medium-term GDP growth rate, in order to create room for growth-enhancing spending. Directors noted that the transition to public insurance in the health sector should be carefully managed. They agreed that fiscal structural reforms are needed, and recommended strengthening public financial management, monitoring risks from local governments and the state-owned sector, and improving the corporate governance of commercial state-owned enterprises.

Directors stressed the need to undertake institutional reforms and further enhance the investment climate and raise medium-term growth potential. They agreed that reforms to increase the efficiency of the courts, speed up the enforcement of commercial claims, and clear the backlog of cases should continue. They also recommended expediting legislation to strengthen the governance and autonomy of the Central Bank of Cyprus and encouraged further efforts to mitigate AML/CFT risks. Directors noted that active labor market policies and investment in higher value-added sectors can help reduce high youth unemployment and skills mismatch, thereby promoting more inclusive growth.

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

APPROVAL: September 10, 2019

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Regarding external accounts, the current account deficit is expected to remain large over the medium term. From a macroeconomic perspective, this imbalance is driven by the extremely low private saving rate, especially for households. In this latter case, the saving rate has been negative since 2013, which has led households to draw down their assets to sustain consumption. Could staff comment on how it envisages the correction of this low private saving going forward?***
 - The investment boom and associated construction-related imports are expected to dissipate over the medium term, contributing to an improvement in the current account balance.
 - As discussed in the SIP, net wealth in a median Cypriot household decreased by 40 percent between 2009–10 and 2014. Since 2014, the savings rate of households has been around -4 percent of GDP, as households have continued to draw down on their still-large stock of assets to finance consumption. However, households are expected to eventually start rebuilding their net asset position as incomes rise with the economic recovery and interest rates normalize, which should lead to a higher savings rate.
 - Servicing of debt owed by households is expected to improve, which would decrease domestic absorption and raise the current account. The recent legislative amendments all enhance the toolkit available to borrowers and creditors to address NPLs on a durable basis. Steadfast implementation—along with structural reforms aimed at strengthening institutions, especially the court system, and removing uncertainties related to title deeds—is expected to improve payment discipline and prospects for NPL workouts.
2. Over time, an associated improvement in the negative net international investment position (NIIP) would help to bring down the primary income deficit, providing further support for the current account.
3. ***Does staff consider that the surges of foreign-financed investments in residential properties mostly reflect strong residential demands or are largely driven by speculative purposes?***

- Staff's view is that foreign-financed investments in residential properties reflect both (i) residential demand, including for second home and holiday home, and (ii) speculative demand as real estate prices started to recover after a drop by 30 percent since 2014. A part of these investments, particularly in the luxury segment, are through the citizenship-by-investment scheme.

Fiscal Policy

4. *Could staff elaborate on the economic, political, and social feasibility of keeping a primary fiscal surplus of 5 percent of GDP in the medium term, which seems very far from the historic performance of Cyprus, at least during the past decade. At the same time, we wonder whether assuming zero contingent liabilities in the baseline scenario is plausible, given risks in the financial system and the recent resolution experience.*
 - While the primary fiscal surplus of 5 percent of GDP projected over the medium term is large compared with Cyprus's historical performance and other country experiences, the assessment of sustainability should take into account country-specific factors. The large primary surplus is underpinned by robust economic growth, with output projected to remain above potential over the medium term. Once the positive output gap eventually closes, the primary balance should decline somewhat. The large primary balance also reflects the structural adjustment that was undertaken during and after the 2012–13 financial crisis, including through a reduction of unsustainably high expenditure and increases in social contribution rates. The authorities remain firmly committed to maintaining spending discipline. That said, there are risks to the fiscal balance arising from expenditure pressure, as discussed in the staff report.
 - Regarding contingent liabilities, staff's baseline scenario is based on assumptions that staff believe are most likely to realize. More specifically, the government's financial sector exposure comes from Asset Protection Schemes, which mainly cover collateralized, performing loans; independent analysts estimate the unexpected losses to be capped at €155 million. The AMC is not a source of contingent liabilities as the government has already recognized the debt when placing domestic bonds. Any positive cash flows in excess of operational expenses in the AMC will be used to reduce public debt going forward and thus offer a potential upside risk. Hence, while the realization of contingent liabilities from the banking sector is not assumed in the baseline, staff has highlighted it as one of key risks to debt sustainability and its quantitative impact is assessed in detail in Annex IV.
5. *We are encouraged to note that staffs' baseline projections suggest a decline in public debt to 70 percent in the medium-term. This positive assessment of debt*

dynamics is nevertheless subject to downside risks ranging from uncertainty about court decisions on public wage cuts, higher spending on health system, lower economic growth and possible realization of contingent liabilities. Could staff comment on their assessment about the materialization of these risks and their impact on debt trajectory?

- There are pending court cases on the legality of public wage and pension cuts that were implemented during the financial crisis. The latest budget document suggests that the annual savings from the measures amounted to some 1¼–1½ percent of GDP each year in 2016–17. The measure has been in place since 2012 and cumulative savings from the measure—and the potential fiscal impact of a court decision against the government—are significant. Absent offsetting policy measures, the primary balance would be lower. Staff does not have sufficient information about the likelihood of this risk materializing, but the reversal of the wage cuts beginning in 2018 might reduce the likelihood of such court decision.
 - There is no quantitative assessment of higher-than-projected spending on the health system. Key near-term risk is that a large shift of healthcare demand from public healthcare providers to private providers leads to a larger budget deficit due to difficulty in adjusting the cost structure of the former in the short run. As discussed in Annex VII, however, this risk is mitigated by capacity constraints of private healthcare providers that limit additional spending and the global budget cap. A key risk over the medium to long term is that higher demand for healthcare service could outstrip increases in taxes for financing the health system.
 - The quantitative assessment of lower economic growth and possible realization of contingent liabilities is provided in Annex IV.
6. *We welcome staff's elaboration on the share of public sector in the Cypriot economy and its implications for debt reduction.*

- In Cyprus, state-owned enterprises are composed of three categories: Extra-Budgetary Funds (EBFs), Semi-Government Organizations (SGOs), and public corporations (PCs).
- Both SGOs and EBFs are non-commercial SOEs and part of the general government. EBFs are typically special accounts managed by government ministries or agencies and do not have their own boards or employees. SGOs have their own boards and employees and implement government policies autonomously. Their combined size measured by the expenditure-to-GDP ratio is small at 2½ percent of GDP and their impact on the general government fiscal balance is limited.

- PCs are commercial SOEs and are large by European standards. They play an important role in the energy, telecom, and water sectors in Cyprus. The liabilities of nonfinancial PCs stood at 13 percent of GDP at end-2016. PCs are not included in the general government accounts.
- SOEs could affect the pace of debt reduction. Outstanding loans of SOEs explicitly guaranteed by the government are estimated to stand at close to 5 percent of GDP at end-March 2018. More broadly, the liabilities of SOEs, including pension obligations, could form implicit contingent liabilities for the government even if they are not explicitly guaranteed.

Financial Sector

7. *Staff recommends Cyprus of putting in place a governance, operational and supervisory structure for a government-owned Asset Management Company (AMC) which deals with the bulk of the remaining NPLs of CCB. Could staff elaborate more on its current structure? In particular, we are interested in whether the AMC has adequate size, expertise, and incentive of staff to better deal with NPLs recovery.*
 8. *Staff's baseline scenario, zero recovery from NPLs in the public asset management company (AMC) is assumed. Could staff elaborate on how their recommendations to improve the governance, operational and supervisory structure for the AMC could potentially alter this conservative NPL recovery assumption?*
- Improved governance, operational and supervisory structure is key to maximize the recovery from NPLs in the AMC. Appropriate governance structure helps ensure that the board and management of the AMC are incentivized to maximize recovery of the NPLs, without negative spillovers to financial stability. Strong governance would help ensure independence and operational efficiency. In this regard, the AMC Blueprint drafted by the EC/ECB provides a useful reference (see 2nd PPM Report, June 2018). Given the large amount of sensitive, difficult-to-recover NPLs owed by households and SMEs, it will be important that the newly created AMC is insulated from political interference so as to signal a clear break with the weak practices of the past.
 - The Cyprus Asset Management Company (Kepides) is currently established as a subsidiary of Sepides, the remainder of CCB. Debt servicing is currently provided by a private debt servicer (Altamira Asset Management). An external consultant has been hired to provide advice to the authorities on the governance structure of CAMC, including the selection criteria for the board members and its financial plan.

9. *While still on the CCB, could staff clarify the content of footnote 9?*

- With the aim of addressing the troubled bank and reducing NPLs in a more resolute and effective manner, country authorities agreed to undertake several commitments with the European Commission, which can be broadly grouped according to the following three pillars.
- **Sale of assets and liabilities to the acquiring bank.** Within 15 months (i) the sold assets and liabilities are fully integrated into the business of the acquiring bank; (ii) all employees are onboarded into the bank and up to 1,200 of them are retained after this period; (iii) up to 72 branches are rented out to the bank with the option of being taken over afterwards; and (iv) all other branches are shut down.
- **Residual entity/AMC.** The residual entity left behind after the sale of asset and liabilities to the acquiring bank: (i) gives up its banking license or reduce its scope to allow the management of assets within its perimeter; (ii) limits its activity to maximize the proceeds from the management and disposal of the assets; (iii) transfers the daily management of the assets to a fully private servicing company; and (iv) has the right to transfer the entire asset portfolio to any other state-owned AMC.
- **Legal framework.** Within well specified timeframes Cyprus takes actions to: (i) amend foreclosure legislation to allow for the effective enforcement of claims; (ii) establish an electronic auction system for properties subject to foreclosure; (iii) amend legislation related to the sale of loans; (iv) improve the efficiency and effectiveness of the insolvency service and regulate the profession of the insolvency practitioners; and (v) undertake a reform of the judicial process, in order to increase the efficiency in handling NPLs.
- A Monitoring Trustee will be appointed to monitor the full compliance with the commitments undertaken.

10. *Could staff elaborate on the likely effectiveness of the subsidy scheme for reducing NPLs and its impact on the debt and fiscal deficit going forward?*

- The effectiveness of the subsidy scheme will depend on several factors: (i) the take-up rate, which will determine the number of actual beneficiaries and viable restructurings; (ii) the ability to screen out strategic defaulters and pursue restructurings more aggressively by leveraging on the credible threat of the enhanced foreclosure framework ; which, in turn, will be a function of (iii) the strengthening of the legal framework for NPL resolution and the broader reform of the judiciary with the aim of discouraging borrowers from pursuing a hold-out strategy.

- It is estimated that NPLs with a total value of €3.4 billion could potentially benefit from the scheme. The authorities expect the cost of the scheme to the state, in case of full take-up, to amount to €815 million (4 percent of GDP) over a 25-year period, or approximately €33 million (0.2 percent of GDP) on an annual basis.
- 11. *We would like to have a further explanation on the incentives and expected functioning of the proposed Estia.***
- The design features of the ESTIA scheme offer strong incentives for sustainable debt restructuring by banks and durable debt service by borrowers by encouraging burden sharing among banks, borrowers and the government in the following way: (i) banks, through a cash enhancement from the government, manage to restructure loans while avoiding foreclosure procedures; in cases that may involve borrowers' strategic behavior or their complete lack of repayment capacity, banks may now feel more willing to foreclose collateral as there might be less reputational risks from engaging in foreclosure; (ii) eligible borrowers receive relief on their loan installments, while being able to retain the property, as long as they meet their obligations on a more manageable restructured loan; and (iii) the government may achieve a significant reduction in difficult-to-handle NPLs at a relatively moderate fiscal cost, while mitigating financial stability risks and avoiding the socio-economic repercussions of mass repossessions.
 - The operational details of ESTIA are being finalized. Pending approval by DGCOMP, the scheme is expected to be launched in early 2019. Borrowers will submit application forms along with required documentation to their bank. The banks will review and forward all documents to a designated government agency with a recommendation on the eligibility of the borrower. The government agency, in turn, will assess the application and grant the final approval or rejection. If the borrower is assessed to be eligible, a standardized restructuring solution will be offered by the bank and the borrower will receive an annual state subsidy amounting to one third of his/her installment, provided that the obligations on the remaining two-thirds of the installment are met. In the case of defaulting borrowers, the subsidy is discontinued, and the bank promptly initiates the foreclosure procedure.
- 12. *Regarding the subsidy scheme (Estia) for low income borrowers, staff proposes to better calibrate it to the individual borrower's repayment capacity and to tighten its eligibility criteria. In view of the subsidy details spelled out in footnote 13, what type of calibration does staff have in mind?***
- 13. *In this context, we would appreciate staff's comments on how to improve the targeting and eligibility of the Estia subsidy scheme.***

- Staff envisage a scheme where state support, subject to all relevant eligibility criteria, would fill only the residual between the assessed collateral value and the borrower's repayment capacity, as opposed to a fixed one-third of the borrower's obligations. The objective of such calibration is to maximize the efficient use of fiscal resources, while avoiding over-compensation of borrowers. Excess fiscal room could be saved and/or used to expand the scope of the scheme.
- Moreover, while still under discussion, all key eligibility parameters go well beyond thresholds warranted in a scheme aimed at supporting vulnerable borrowers and could be tightened accordingly. In particular, allowing a net household wealth, excluding primary residence, of up to 125 percent of the market value of the primary residence significantly exceed levels established under the Personal Insolvency Law, and undermines the potential for repayment through disposal of the borrower's other assets. Even under the newly-revised criteria, this threshold remains generous.

14. *What explains the high rate of redefault on restructured loans?*

- The high redefault rate on restructured loans underscores the limited effectiveness of the foreclosure framework and might also reflect banks reluctance to enter into a more durable restructuring process.
- Restructuring without a credible threat of foreclosure has led to a high redefault rate. The foreclosure process has been ineffective and slow and viewed as socially unacceptable, discouraging banks from pursuing defaulters more aggressively, which in turn has undermined payment discipline.
- Banks are reluctant to engage in a more durable restructuring, partly due to difficulties in verifying financial disclosure information or as write-downs could weigh on their capital. As a result, debt service obligations of renegotiated loans might have been still large relative to repayment capacity for a certain group of borrowers. Survey data indeed indicate repayment capacity is still low for some households in Cyprus (See the accompanying SIP).

15. *Looking ahead, as growth is heavily dependent on foreign financing, diversification of banking activities into higher-value-added sectors like luxury residential development warrant cautious policies from the supervisory authorities to mitigate credit exposure to non-resident counterparts. We would like to have staff's view on this respect and the recommendations needed to mitigate risks arising from non-residents, especially in the property market.*

- While activity in the luxury segment of the residential property market has expanded rapidly, so far, construction projects have been mainly foreign-financed or financed

through pre-sales. This has limited the degree of intermediation through the domestic banking system and thus the risks to financial stability. However, if signs were to emerge that construction in the luxury market is becoming more reliant on domestic credit, then staff is of the view that tightening bank lending standards and raising macroprudential capital requirements would be appropriate.

16. *We welcome staff's introduction on Cyprus's main policy measures to maintain its role as an important offshore financial service center, and its typical funding source, investment target, and main customers in this industry.*

- Credit institutions continue to comprise the bulk of Cyprus's financial sector even after their downsizing since the crisis, with total assets of around 400 percent of GDP in 2017. They are mostly funded through deposits, more than two-thirds of which reflect resident deposits. The investment fund sector has grown rapidly, with total assets more than doubling over the last decade, although they remain just under 25 percent of GDP. Cypriot investment firms have also experienced rapid growth, with total assets amounting to 60 percent of GDP as of end-2016 for the firms providing investment services. As for insurance companies, total assets amounted to 20 percent of GDP in 2017. Apart from this activity, Cyprus hosts financial company Special Purpose Entities (SPEs), which belong to an international group and channel funds between related nonresident entities on behalf of their nonresident parent company. Financial SPEs are foreign-financed and their financial assets are matched in size by their financial liabilities.
- As highlighted in Figure 8 of the staff report, according to selected investment climate metrics, Cyprus performs well relative to other offshore financial centers in areas such as perceptions of rule of law and of government effectiveness, however, there is scope for it to improve on these fronts relative to euro area peers. On the other hand, enforcing contracts in Cyprus takes nearly double the time that it does on average in other OFCs and elsewhere in the euro area. Institutional reforms to increase the efficiency of courts, clear the backlog of cases, and speed up enforcement of commercial claims would enhance the investment climate. Effectively mitigating existing inherent AML/CFT risks is another key priority, as their materialization could have a macro-critical impact (e.g., CBR pressures).

Structural Reforms

17. *Could staff elaborate further on the current sources of growth for the country compared to those observed a decade ago; for instance, compared to the situation in 2007, when the staff report at that time (Article IV consultation) underscored that "Cyprus is well placed to emerge as a gateway to the East and a hub of business operations in the region" and that "the thriving Cypriot economy is*

testimony to the government's implementation of reforms and pursuit of prudent policies, in line with Fund advice".

- Tourism, professional services and construction were and still are the main drivers of growth. On a positive note, construction activity is not as reliant on credit expansion from domestic banks as it was during 2004-08, while the tourism season has been extended well beyond the summer months and is offered to a more geographically diversified tourist base.
- Opportunities for Cyprus to emerge as a business regional hub are still intact. The country's strategic position, a highly educated population, and technical competences in the legal and accounting fields are all potentially relevant factors. However, as noted already ten years ago, success requires safeguarding external competitiveness and confronting medium-term challenges, including greater diversification of the economy towards higher value-added activities. In contrast, during 2008–13, the country continued building up unsustainable imbalances. Surging imports and an erosion of external competitiveness resulting from wage growth that exceeded productivity growth led to a wide current account deficit, while foreign inflows fueled a housing boom and a large increase in private sector indebtedness, eventually leading to a collapse of an outsized banking system.
- Going forward, for the country to be able to reduce its vulnerabilities and to attract investment away from its traditional sectors, it will be critical to complete private and public balance sheet repair and to implement structural reforms, especially in the judiciary and public administration.

18. *We also view as important sustaining efforts to strengthen the independence and governance of the Central Bank of Cyprus (CBC) and wonder how the proposed additional Executive Committee would relate with the existing CBC's Board and other Executive Departments. Staff comments are welcome.*

- The proposed executive committee would comprise the governor, the deputy governor and two executive directors, whereas the composition of the board of directors would remain as it is, consisting of the governor, the deputy governor, two executive directors and five non-executive directors.
- The executive committee would be responsible for the day-to-day activities of the CBC and the management of the CBC's business, whereas the board of directors would be responsible for the CBC's strategy, internal procedures and framework for the CBC as well as broader oversight of the CBC administration. Other tasks of the executive committee would include: (i) implementing policy decisions taken by the ECB and the SRB; (ii) implementing the CBC's tasks including the supervision of

authorized credit institutions and the macroprudential supervision of the financial system; (iii) overseeing payment, clearing and settlement systems; and (iv) submitting recommendations to the board with respect to the CBC's strategy.

- The introduction of the Executive Committee, whose mandate will be clearly separate from that of the CBC Board, will strengthen checks and balances and the governance of the CBC.

19. *Could staff comment on the effectiveness of ALMPs implemented by the authorities so far in reducing the unemployment rate?*

- The authorities' strategy has primarily aimed at reducing unemployment via stronger economic growth, while providing a temporary safety net to those in need through the Guaranteed Minimum Income (GMI). Some specific ALMPs have targeted the youth as well as other vulnerable groups, such as the long-term unemployed, GMI beneficiaries and persons with disabilities, with evaluation of the effectiveness of the ALMP schemes performed on a scheme-by-scheme basis upon completion. Evidence so far indicates that activation results were mixed, with ALMPs targeting the youth being more successful than those addressed at vulnerable groups. A more general assessment on the impact of ALMPs on the activation of the unemployed is still not conclusive, as a fully-fledged monitoring and evaluation system only became operational beginning of 2018.

20. *Staff mentions that AML/CFT risks could have macro-critical impacts in Cyprus. Is staff of the view that the authorities have speedily tackled these risks? In particular, does staff consider that Cyprus can obtain a better evaluation from the upcoming MONEYVAL AML/CFT assessment by conducting necessary reforms timely?*

21. *We wonder whether staff assesses the authorities' response to the Cyprus Development Bank's violation of the AML requirements between 2014 and 2016 as sufficient and satisfactory.*

22. *We would like to ask how staff assess the integrity risks associated with the Citizenship by Investment (CbI) scheme and its compliance with AML/CFT standards?*

23. *We also welcome staff's elaboration on the implication of recent international rules and best practices in AML/CFT to Cyprus.*

- The current international AML/CFT standard, as last revised in 2012, strengthened requirements in several areas. Additionally, the current FATF assessment

methodology (adopted in 2013) shifts the focus from technical compliance (i.e., are the laws in place) to an assessment of effectiveness (i.e., is the system generating results in line with the country's risks). Although improvements have been made since 2012, staff's current assessment is that important AML/CFT risks remain, such as in relation to the absence of a common EU-wide AML/CFT supervisory framework, and gaps in preventive measures, transparency of beneficial ownership, international cooperation, financial intelligence and investigations. The implication for Cyprus is that each of these AML/CFT risks could have a macro-critical impact, amplified by a possible negative MONEYVAL assessment (which could for example lead to a FATF listing).

- Cyprus' AML/CFT assessment by MONEYVAL has already commenced and the on-site mission for the assessment is scheduled for May 2019. Technical changes that would improve technical compliance ratings can be made up-to-the last day of the on-site mission and where appropriate authorities should indeed make such reforms. That said, the effective implementation of policy and regulatory changes may take longer and may not be in time to positively impact on the ratings and assessment of effectiveness. Even so, staff encourages reforms as the aim of these is to address the inherent AML/CFT risks because of their possible macro-critical impact, and not just to improve the ratings for this particular assessment.
 - The MONEYVAL assessment will include an assessment of the effectiveness of AML/CFT supervision of banks. Enforcement of AML/CFT rules by supervisors and sanctions in case of non-compliance, such as in the case of Cyprus Development Bank, are not necessarily a weakness, but staff views these as an indicator that a part of the AML/CFT system is producing results. The assessment will indicate if supervisory enforcement actions (in Cyprus and by other countries against Cyprus' banks) are in line with Cyprus' risks and context. Likewise, the MONEYVAL assessment will also assess if the Citizenship by Investment (Cbi) scheme effectively mitigates relevant AML/CFT risks (such as those related to politically-exposed-persons, compliance with customer due diligence, beneficial ownership and other AML/CFT requirements by banks, lawyers, accountants, real estate businesses and trust & company service providers). Available information (such as Cbi application forms) are insufficient to conclude that this is indeed the case.
- 24. *We would appreciate if staff could introduce both the number and composition of immigrants as well as the amount of capital inflow under the Cbi project. Furthermore, we would like to hear staff's elaboration on the opinion of other EU countries on the impact of this projects to the EU, and whether the EU has set any quota on this project.***

- Publicly available data on the CBI scheme is limited. It is estimated that 3,336 naturalizations were processed through the CBI scheme over 2008–2017 (European Parliamentary Research Service). Press reports have estimated that, in 2017, the government issued passports to 503 applicants and 510 additional passports to members of their family (Cyprus Mail). Separately, Eurostat publishes statistics for all persons naturalized in individual member states, which is not limited to those granted citizenship through the CBI scheme: among the roughly 3,400 previous non-EU citizens receiving citizenship in Cyprus in 2016, 34 percent were from Russia, 9 percent were from Ukraine, 8 percent were from China, 5 percent were from Moldova, and 4 percent were from Lebanon.
- Beginning this year, the Cypriot government established a limit on the annual number of naturalizations of investors under the scheme to 700. In addition, the authorities created a registry of the program’s approved service providers, participation in which requires adherence to a Code of Conduct.
- A recent report by the European Parliamentary Research Service (“Citizenship by Investment (CBI) and Residency by Investment (RBI) schemes in the EU: State of play, issues and impacts,” by Amandine Scherrer and Elodie Thirion) recalled that the European Parliament has called “on the [European] Commission to assess the various citizenship schemes in light of European values and the letter and spirit of EU legislation and practice and to issue recommendations in order to prevent such schemes from undermining the values that the EU has been built upon, as well as guidelines for access to EU citizenship via national schemes.” Guidelines for Member States regarding their CBI and RBI schemes are expected to be published soon.

25. *Cypriot economy scores poorly in terms of wealth and income inequality and in at-risk-of-poverty rates, but there is barely any mention of this in the report. Could staff comment on the authorities’ strategy to address these inequality problems?*

- An important reform of the welfare system has unified previously fragmented public-assistance benefits under a single Guaranteed Minimum Income (GMI), bringing Cyprus in line with best practices in Europe. The reform has improved both coverage and adequacy of public assistance, reducing the Gini coefficient for household disposable income from 34.8 in 2013 to 32.1 in 2015.
- However, wealth and income inequalities remain relatively high by European standards, reflecting the relatively larger impact of the 2013–14 crisis on the non-banking private sector, both in terms of employment and wages. Regressive tax policies such as the abolition of the immovable property tax and strategic default among borrowers have also likely contributed to growing wealth inequalities in recent years.