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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/95-2

10:35 a.m., November 27, 2019

2. Cyprus—2019 Article IV Consultation

Documents: SM/19/252 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; SM/19/253; and Correction 1

Staff: Tuladhar, EUR; Gonzalez Miranda, SPR

Length: 52 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Tivane (AE), Temporary
	K. Carvalho da Silveira (AF), Temporary
	J. Di Tata (AG)
N. Ray (AP)	
	F. Antunes (BR), Temporary
	Z. Huang (CC), Temporary
	P. Moreno (CE)
L. Levonian (CO)	
	Endlich (EC)
	P. Rozan (FF)
	K. Merk (GR)
	Y. Indraratna (IN)
	F. Spadafora (IT), Temporary
	M. Shimada (JA), Temporary
	M. El Qorchi (MD)
	M. Merhi (MI), Temporary
	R. Doornbosch (NE)
	M. Bernatavicius (NO), Temporary
	A. Tolstikov (RU), Temporary
	R. Alkhareif (SA)
A. Mahasandana (ST)	
P. Inderbinen (SZ)	
	D. Andreicut (UK), Temporary
	P. Pollard (US), Temporary

G. Bauche, Acting Secretary
P. Cirillo, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: R. Rueffer. European Department: P. Gerson, X. Liu, H. Takizawa, A. Tuladhar. Finance Department: J. Okwuokei. Legal Department: R. Berkhout, G. Poh. Monetary and Capital Markets Department: M. Narita. Strategy, Policy, and Review Department: M. Gonzalez Miranda, K. Wang. Alternate Executive Director: M. Psalidopoulos (IT). Senior Advisors to Executive Directors: M.Gilliot (FF), J. Shin (AP).

Advisors to Executive Directors: S. Belhaj (MD), E. Boukpessi (AF), I. Fragin (GR), A. Grohovsky (US), J. Hanson (NE), P. Mooney (CO), A. Srisongkram (ST), A. Urbanowska (SZ), D. Vogel (AG), J. Montero (CE).

2. CYPRUS—2019 ARTICLE IV CONSULTATION

Mr. Doornbosch and Mr. Cools submitted the following statement:

On behalf of the Cypriot authorities, we would like to thank staff for the in-depth discussions in Nicosia in September and the insightful staff report. Six years after the start of the EFF program, Cyprus is turning the page.

Cyprus has gone through a significant internal adjustment process which has drastically improved its cost competitiveness. Private and public debt levels are today on a downward path. Yearly GDP growth has averaged 4,6 percent over the last four years, and the government is recording solid primary surpluses. Unemployment has halved since 2014, and banks have significantly reduced their NPL levels. As a result of these macro-economic developments, Cyprus' sovereign rating was upgraded in 2018 to investment grade and is now assigned a stable or positive outlook.

In September 2019, the authorities signaled their intention to reimburse the remaining 570 million SDR of Fund credit, as the Fund credit borrowing cost currently exceeds the market rate of the Republic of Cyprus' bonds, as demonstrated by the recent issuances of 15- and 30- year Eurobonds at historically low rates.

While Cyprus is turning the page, the authorities are keenly aware of the risks ahead. They therefore remain particularly committed to expenditure restraint and further NPL reduction. They also agree that sustained efforts will be needed to improve Cyprus' competitiveness beyond cost competitiveness. Staff is rightfully recalibrating its advice towards more long-term structural issues to unlock Cyprus' growth potential.

Outlook

While real GDP is expected to remain robust in 2019 and beyond, driven by investment and private consumption, it is expected to ease to 3,2 percent in 2019 and 2.9 percent in 2020. The growth slowdown is due to the deterioration in the external environment, mainly reflecting the barriers imposed in international trade and uncertainty related to Brexit, which adversely affect external demand. Private consumption is expected to register a deceleration, reflecting - inter alia - the projected acceleration in loan repayments and the impact of changes in various social contributions, including the recent introduction of contributions towards the new General

Healthcare System. The foreseen deceleration in investment emanates from the gradual completion of construction projects. These projects include foreign-financed ones and relate to ongoing tourism-related projects (marinas and casino), residential construction, renewable energy sources and education.

Risks to the outlook are tilted to the downside, due to slowing global growth and the expected decline in contribution of construction to GDP growth. Headline HICP inflation in 2018 was 0,8 percent, and is expected to remain sluggish, despite the projected high growth rate. One explanation for the weak inflationary pressures is that, despite the strong employment growth, there is still significant slack in the labor market, restricting wage and unit labor cost growth. In addition, technological change may lower production costs and increase competition which may in turn constrain profit margins of firms, weighing on price growth.

Public Finances

Public finances are expected to return to nominal surpluses in 2019, after recording a temporary deficit of 4,4 percent of GDP in 2018, which reflected the one-off support measures related to the sale of the Cyprus Cooperative Bank. Cyprus is expected to record a primary surplus of about 6.2 percent of GDP in 2019 and will continue to record solid primary surpluses on the forecast horizon. As a result, Cyprus’ public debt is on a firm downward trajectory. Despite spending pressures, the broad political consensus for spending restraint continues to hold. The authorities have capped expenditure growth to nominal medium-term economic growth, as reflected in the medium-term budget plan for 2020-22.

Financial Sector

Since last year’s Article IV report, there has been continued significant progress in reducing NPLs, among others, as a result of the €2.6 billion sale of NPLs by Bank of Cyprus. However, despite significant progress, the level of NPLs is still very high compared to euro area average and efforts to reduce them need to continue.

In this light, Cyprus’ two largest banks, holding around 70 percent of NPLs, plan to further offload NPLs, bringing their levels to below 10 percent of total loans, by the end of 2021. Strong investor appetite for NPLs has been fostered by the 2018 legislative changes strengthening Cyprus’ foreclosure, insolvency and sales of loan laws. The recent parliamentary efforts to increase the role of the Ombudsman in debt work outs, which could potentially lengthen the duration of the judicial process, have been deferred to the Supreme Court. These efforts have arguably not affected investor appetite.

In relation to sales of NPLs, the restructuring of loans remains a significant challenge, as these loans are no longer recorded in the banking system but remain part of private debt and therefore continue to constitute a burden for the economy.

Staff rightly points out that the NPL workout by credit acquiring companies, including the public asset management company, is progressing. In addition to the 2018 legislative changes, four factors are contributing to a speedier debt work-out. First, the Estia burden sharing mechanism for distressed primary residence mortgage loans is currently being rolled out, after receipt of the first applications last September. Second, the electronic foreclosure mechanism (e-auction) will be launched soon. Third, additional judges to deal with the NPL backlog are being recruited. Finally, recovering real estate prices are helping banks to offload real estate they have onboarded as part of debt to asset swaps.

Banking profitability in Cyprus has been considerably affected by the need to hold provisions against NPLs. However, profitability issues stem from other sources as well. Staff's analysis on how increased digitization could improve bank profitability has been particularly appreciated. Strengthened efforts will be needed to enhance financial service digitalization. In this light, the digitalization transformation strategies by Cyprus' banks are an important development.

The authorities also remain committed to further strengthening AML/CFT compliance. Since the last Article IV report, they have strengthened the regulation of shell companies and the oversight of the Citizenship Investment Program ('CIP').

External Sector

The revision of National Accounts Data and External Statistics, as part of a five-year benchmark revision, has led to an upward revision of the current account balance by, on average, 1.6 percent of GDP for the period 2008-2018. This has led to a requalification by staff of Cyprus' external position from 'weaker than' to 'moderately weaker than implied by medium-term fundamentals and desirable policies. The authorities consider the external sector developments affecting Cyprus to be in line with the fundamentals of the Cyprus economy. The projected current account deficit, while expected to narrow, is considered to be at a sustainable level, in line with the overall domestic economic growth momentum. Finally, the authorities appreciated the technical exchange with staff on the application of the EBA Lite model.

Competitiveness

The Selected Issues Paper provides a good insight in Cyprus' export competitiveness and helps to understand the key determinants of service exports and to set the right policies accordingly. While key recommendations, such as diversifying export markets and enhancing productivity, are not easy to implement in a small island economy reliant on services, the authorities remain fully committed to structural reform efforts to unlock Cyprus' growth potential. The 2019 Cyprus Competitiveness Report commissioned by the Cyprus Economy and Competitiveness Council highlights policy areas for further improvement, such as addressing low labor productivity, promoting entrepreneurship, improving business linkages and connectivity, and improving access to finance.

Continued improvement of public sector efficiency is also key to enhance Cyprus' competitiveness. Two ongoing far-reaching reforms are noteworthy here. The local governance reform on the one hand will increase professionalism and fiscal responsibility. The reform of the judiciary on the other hand, with increased specialization and capacity, will strengthen the business climate and legal certainty.

Mr. Moreno submitted the following statement:

We thank staff for its insightful report and selected issues paper in the context of the Cypriot Article IV consultation. We also thank Mr. Doornbosch and Mr. Cools for their informative buff statement.

We commend the authorities for using the rapid economic growth that Cyprus experienced following the crisis for achieving a remarkable fiscal adjustment and for improving the asset quality of banks and NPL reduction. However, significant stock imbalances remain, such as high levels of private, public and external debt and the still considerable stock of NPLs, which is putting pressure on the profitability of banks and their ability to finance the private sector. We share staff's recommendations on the need to boost growth potential, secure financial stability, and to improve the efficiency of public spending and the quality and governance of public services.

Macroeconomic Developments

Growth performance in recent years has been robust and the outlook remains favorable albeit with downside risks. Cyprus' strong cyclical growth, driven by foreign-funded investments and private consumption, is slowing down. Solid growth is likely to continue during the next quarters, but low productivity growth and a weakening of external demand— which is partly structural due to increasing competition for tourism services from neighboring countries—weigh on medium-term growth prospects. We agree that risks to the growth outlook are tilted to the downside and mainly stem from still high private and public debt, the high reliance of investment on foreign funding, and the potential unwinding of key reforms in the financial and fiscal sectors. Sustaining robust growth levels over the medium-term and increasing the country's resilience to adverse shocks would require renewing the structural reform momentum and following appropriate policies to enhance resilience in the banking system.

Fiscal Policies

Fiscal performance is expected to remain strong in the near term, but the efficiency of public spending needs to be improved. Buoyant tax revenues on the back of strong economic growth, combined with overall prudent expenditure management, have helped generate large primary fiscal surpluses since 2015. Budget surpluses are set to outperform expectations in 2019, following the temporary deficit recorded in 2018 due to government support measures related to the sale of the Cyprus Cooperative Bank (CCB). Like staff, we welcome the marked improvement in the structural balance in recent years. The projected budgetary surpluses will support the continued decline in the public debt-to-GDP ratio. At the same time, staff expects the structural deficit to gradually deteriorate. Areas of inefficient public spending and contingent liabilities create downside risks to the budget. We thus agree with staff that the government should continue to resist pressure to unwind key reforms and expenditure growth should be firmly controlled in order to maintain a declining public debt path, especially as the high level of debt makes Cyprus vulnerable to financial markets and growth shocks.

Financial Sector Policies

We welcome recent progress in reducing NPLs, but further actions are needed to continue to tackle the considerable risks surrounding the banking system. Banks continue to have ample liquidity, but their asset quality remains poor. The stock of NPLs in the banking system remains elevated, with the

NPL ratio still the second highest in the euro area, though it remains well provisioned. The provisioning of NPLs is adding pressure on the profitability of the banking sector, which remains low in a context of low interest rates, poor asset quality, and persistently high operating costs. Therefore, it is key that the authorities continue to facilitate the reduction of non-performing loans including by setting up an effective governance structure of the state-owned asset management company, taking steps to improve payment discipline and strengthening the supervision of credit acquiring companies. Further, it will be important that the authorities strengthen the supervision capacities in the non-bank financial sector, including by fully integrating the insurance and pension funds supervisors.

A potential reversal of reforms to the foreclosure framework would risk hindering ongoing NPL resolution efforts and creating risks for financial stability. The amendments to the foreclosure framework, if implemented, would backtrack on key elements of the reform adopted in July 2018, which was an important step towards improving financial stability and payment discipline through a more effective enforcement of claims and NPL workout. We note that these amendments were referred to the Supreme Court, which is expected to decide on their constitutionality in the spring of 2020. In the meantime, the foreclosure framework as adopted last year remains currently in place. While we commend the recent roll-out of the ESTIA burden sharing scheme, we are concerned about its ability to act as a catalyst for the relief of indebted. Rigorously enforcing compliance with the eligibility criteria and swiftly triggering foreclosure procedures upon defaulting borrowers are crucial for its underlying success.

Efforts to effectively tackle AML/CFT risks remain a priority. We share staff’s views that effectively mitigating existing inherent AML/CFT risks could avert shocks to confidence as well as investment and the soundness of the banking system, and we support continued efforts to this aim as a matter of priority.

Structural policies

We stress the need to renew the overall structural reform drive to boost growth potential and ensure resilience and inclusiveness. Among the structural reforms efforts, we would highlight: (i) addressing inefficiencies in the justice system are key to ensure the effective implementation of the insolvency and foreclosure frameworks and improve the business environment—such objective would also be served well by ensuring a reliable and transparent solution to issue and transfer title deeds, as well as to resolve persistent backlogs; (ii) the importance of strengthening public sector governance and government effectiveness, including through an improved monitoring of the governance of state-owned enterprises and rolling out the planned local government reform; (iii) complete reforms aimed at increasing the effectiveness of public employment services and reinforce outreach and activation support for young population, including delivering on the reform of the education and training system to reduce skill mismatches and improve inclusiveness; (iv) focus investment-related economic policy on sustainable transport, environment, including energy efficiency and renewable energy, digital skills, and research and innovation.

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

We thank staff for an informative set of reports and Mr. Doornbosch and Mr. Cools for their candid buff statement. We associate ourselves with Mr. Moreno's statement and offer some additional comments for emphasis.

Amid a strengthened recovery, robust labor market, strong fiscal performance and broadly favorable economic outlook, Cyprus should keep addressing key legacy issues – notably still high debt in the private sector – while tackling weak productivity dynamic to boost medium-term potential growth.

We welcome the significant progress in reducing the stock of NPLs in the banking sector, mainly through portfolio sales to Credit Acquiring Companies (CACs) and the Cyprus Asset Management Company (CAMC). However, further efforts are needed to improve NPL resolution and debt workouts with a view to avoiding negative impacts on the banks' capital position and profitability; banks also need to improve operational efficiency, including through deeper digitalization of financial services, and reverse the rising cost-to-income ratios, seizing the fact that competition from domestic fintech companies is still low.

We share staff's concerns that the recent proposed amendments to the foreclosure framework risks weakening borrowers' incentives to enter loan restructurings, restore payment discipline and avoid strategic defaults. Ensuring the legal certainty of the regulation to facilitate debt workouts takes on a distinctive importance, including for fostering the development of an effective market for NPLs in Cyprus. Given the concentration of NPLs in the two largest banks, what are in staff's view the incentives to develop an NPL market?

We support staff's call for expediting the strengthening of the governance and autonomy of the Central Bank of Cyprus, enhancing the regulation and supervision of CACs and finalizing the governance, operational structure and business plan of CAMC.

Access to financing due to high borrowing costs has been cited as the single most problematic factor for doing business (Paragraph 27). This is somewhat puzzling in a context where interest rates on new loans have been lowered, liquidity is excessive (Paragraph 15) and slow credit growth arises primarily from weak demand for loans (while recognizing that deleveraging by banks may be constraining their lending operations). Staff's comments are welcome.

We welcome the authorities' commitment to maintaining fiscal discipline, mitigating AML/CFT risks and advancing the structural reforms agenda – notably the national digital strategy – along the priorities outlined by staff; reforms of the judicial system are instrumental in fostering faster debt workouts and support financial stability.

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

We thank staff for their reports and Messrs. Doornbosch and Cools for their helpful buff statement. The Cypriot economy continues to recover from the nadir of the crisis. The services and construction sectors are growing, bank balance sheets are strengthening, and the level of unemployment continues to fall. Nevertheless, vulnerabilities remain in the form of high NPLs and low productivity growth. We broadly agree with the thrust of staff's assessment and offer the following comments for emphasis.

We commend the authorities for the strong fiscal performance but note that challenges remain given the elevated levels of public debt. We concur with staff that growth in the wage bill should be maintained below nominal GDP growth and welcome the authorities' commitment in this regard. Public spending priorities could better support structural reform efforts to achieve more inclusive medium-term growth. Public financial management of SOEs and Local Government units should be strengthened. We encourage authorities to maintain efforts to modernize tax administration through the enactment of a new tax procedure code and IT system.

Progress in repairing the banking sector is continuing, but a number of challenges remain in this regard. We welcome the positive impact of the 2018 amendments to the foreclosure and insolvency framework, which enhances the toolkit to deal with NPLs. However, we note recent amendments to this framework that may lead to uncertainty and encourage the authorities to be vigilant in ensuring that the pace of NPL resolution is not impeded by these measures. We encourage the authorities to closely monitor real estate market developments and agree with staff that tailored macroprudential measures should be introduced, if warranted. We welcome the ongoing improvements in the AML/CFT architecture. Progress should continue in this area, particularly in terms of preparing for the forthcoming MONEYVAL report.

We agree with staff that ensuring that growth is inclusive is key to making it sustainable and we welcome the indicators that show income inequality and the gender gap in Cyprus are comparable to those of European peers. Like staff, we encourage the authorities to build on efforts to reform public sector governance. Approval of the pending legislation to reform the civil service and strengthen the governance of the CBC is critical in this regard. We welcome the analysis in the Selected Issues Paper around the promotion of export competitiveness and agree with the conclusions, particularly the need for policies to encourage greater investment in R&D and technological diffusion. Finally, did staff carry out any analysis on the issue of climate change?

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

We thank staff for the report and Messrs. Doornbosch and Cools for their informative statement. The issues concerning Cyprus' present macroeconomic conditions do not fundamentally differ from those discussed during the last review conducted in November of 2018. The economy continues to enjoy a strong post-crisis recovery, albeit at a slower pace amidst domestic constraints and the synchronized external slowdown. Despite the good progress, persisting legacy problems, such as elevated public and private debt and non-performing loans (NPL) ratios, remain a drag to private sector credit and investment and a significant risk to the outlook.

Cyprus' financial soundness indicators have gradually improved over time, yet further efforts are necessary to achieve a healthier, more stable, and growth supportive banking system. Local NPLs went from its peak of nearly 48 percent in 2014 to about 30 percent in 2018, still a very high level in spite of the authorities' commitment and consistent approach to tackle the issue. The Capital Adequacy ratio has also improved, but bank profitability persists under pressure, and improvements on this front will require further efforts to diversify revenues, rationalize operational costs and improve the use of digital solutions. Moving forward, continued debt overhang, difficulties in debt workouts, and the sustainability of the companies acquiring bad credit (CACs) remain critical challenges. Given such challenges and risks, we welcome the Central Bank of Cyprus' strengthening supervision and regulation of CACs, as well as the authorities' reforms aimed at maximizing recovery of the Cyprus Asset Management Company, encapsulating risks of moral-hazard and further facilitating NPL reduction.

As underlined by staff, Cyprus' fiscal performance is to remain strong for the foreseeable future. Mr. Doornbosch and Mr. Cools highlighted in their statement that the authorities disciplined fiscal management approach has established a positive trend on the primary balance of an average of 5 percent for the forecast horizon staring in 2019. At such pace, and assuming no surprises stemming from the NPL cleanup efforts, the general government debt is projected to decline from about 95 percent of GDP to a much healthier 64 percent in 2024. We agree with staff and the authorities in prioritizing public investment and human-capital expenditure, while containing the growth of the still high wage bill.

We encourage the authorities to press ahead with reforms. As agreed by the authorities and staff, reforms should focus on productivity and competitiveness, as well as on public sector governance. On the former, economic diversification and potential growth-enhancing investment, and on the latter, judicial, insolvency framework, civil service, SOE, and Central Bank's autonomy and governance, are some of the key issues at hand. We wish the authorities success in the implementation of the reform agenda and look forward to assessing progress in the next article IV review.

Mr. Inderbinen 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. Robust GDP growth is underpinned by strong private consumption and foreign-financed investment; however, risks are tilted to the downside. Domestically, persistent crisis legacies in the financial sector weigh on investments and growth. Externally, the euro area slowdown, rising protectionism, and global trade tensions could further lower exports and widen the current account deficit. Vigorous efforts to reduce the NPL overhang and restore credit provision, supplemented by productivity-enhancing structural reforms, will be key to increase the country's resilience to future shocks.

Fiscal structural reforms are needed to maintain the fiscal stance. We commend the authorities for their prudent expenditure management and improved revenue collection that attest to their continued commitment to fiscal targets. As a result, projected budgetary surpluses are expected to support the decline in debt-to-GDP. Nevertheless, strict spending discipline should be maintained going forward. Avoiding procyclicality and enhancing efficiency of public spending should be priorities. We concur with staff that downside risks, particularly those stemming from contingent liabilities in the banking sector and state-owned bodies, should be closely monitored. Given the benefits of further strengthening PFM, has staff discussed the possibility of conducting a Fiscal Transparency Evaluation?

Further efforts are needed to address the elevated NPL stock and the private debt overhang. We welcome the significant progress made in offloading a large portion of NPLs in 2018; however, their successful work outside the banking sector is still needed. In this context, close monitoring and strengthened supervision of credit acquiring companies is warranted. We note from the buff that the authorities do not expect investor demand for impaired assets to be affected by the recent changes to the foreclosure framework, currently under review by the Supreme Court. Has staff engaged on contingency planning with the authorities in case the legislation came into force? Also, can staff comment on the effectiveness of the 2018 TA by LEG on the legal framework for NPL resolution?

Productivity-enhancing structural reforms are key to boost potential growth. Lagging productivity growth, inefficient government administration, and a weak business environment are key impediments to sustainable and inclusive growth. We concur with staff that priority should be given to judicial reforms, lowering the cost of doing business, and strengthening the governance of state-owned enterprises. The figure in paragraph 28 of the report lists corruption as one of the problematic factors for doing business. Could staff comment on the authorities' efforts to address this? We welcome new measures introduced by the authorities to tighten the Cyprus Investment Program (CIP) scheme, yet more efforts to mitigate AML/CFT risks are warranted. Also, policies to support greater market diversification, facilitate more competition, and strengthen technological change would promote a healthy exports sector, as highlighted in the Selected Issues Paper.

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

We thank staff for the interesting reports and Mr. Doornbosch and Mr. Cools for their insightful buff statement. The Cypriot economy continues to grow at a robust rate, while large fiscal primary surpluses have put public debt on a declining path. Important progress has been made in addressing domestic and external stability risks, which has helped Cyprus regain its investment grade status. Notwithstanding these positive developments, the authorities should continue their efforts in addressing crisis legacies, namely the private sector debt overhang with NPLs, which remain among the highest in Europe, while maintaining prudent fiscal policy. We concur with staff that going forward, elevated financial sector vulnerabilities, due to delays in NPL resolution and realization of contingent liabilities from publicly supported schemes, in addition to global financial conditions uncertainties, pose risks to the outlook. Policy discussions rightly focused on how to reduce these vulnerabilities and reinvigorate medium-term growth potential. We would like to highlight the following issues:

While asset quality has improved in the banking sector, profitability remains week. Banks should continue to maintain adequate provisioning coverage and build capital buffers to insulate against potential further losses from NPLs. Continued efforts to address the persistently high level of NPLs, in order to revive credit supply, will be important to support longer-term growth. We welcome, in this regard, the recent legal amendments to the foreclosure and insolvency legislation. We agree with staff that steadfast implementation of the amended legal tools to lower NPLs and the debt overhang will be key to facilitate this process and ensure timely enforcement. Continued strengthening of the Credit Acquiring Companies and close data monitoring will also be important. We look forward to the finalization of the state subsidy scheme for restructuring and repayment of NPLs (Estia), collateralized by primary homes, which could benefit NPLs worth up to €2 billion or 10 percent of GDP. In this regard, we concur with staff that any additional new scheme should be well-targeted. We would be interested to learn whether the scheme is still expected to have a fiscal cost of around 4 percent of GDP? Could staff also share their views on why the take-up rate has been lower than expected so far?

We commend the authorities for maintaining a strong fiscal position, with large primary surpluses contributing to the reversal of the upward trend of the debt-to-GDP ratio. We also welcome their plan to save any windfall revenues toward public debt reduction. Maintaining strict spending discipline and improving the efficiency of public spending is crucial to reduce risks to debt sustainability and strengthen inclusive medium-term growth. Keeping the increase in the public wage bill envelope within the rate of nominal GDP growth will be particularly important in this regard. We encourage the authorities to remain vigilant about containing risks to the budget from contingent liabilities from SOEs. Measures to enhance the governance of

SOEs, as well as financial management controls at the local government level, could help contain these risks, while improving public efficiency.

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

Mr. Merk and Mr. Fragin submitted the following statement:

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

We broadly agree with staff's assessment and policy recommendations. The ongoing economic recovery in Cyprus is encouraging. Growth remains strong amidst subdued inflation. Unemployment is declining, and the necessary clean-up of balance sheets is continuing. However, the external position (current account) has deteriorated and public and private debt levels remain high. Going forward, staff projects a relatively benign economic outlook, although downside risks remain substantial, notably including the reversal of hard-won reforms and fiscal efforts. In this challenging environment, we call on the authorities to stay their course and build on the progress achieved so far in entrenching macroeconomic stability and dealing with crisis legacies, pursuing stability-oriented macroeconomic policies and advancing key structural reforms to strengthen productivity. We associate ourselves with Mr. Moreno's statement and would like to provide the following additional remarks.

We take positive note of the evolution of public debt under staff's baseline projections. At the same time, the adverse scenario vividly shows potential consequences and debt sustainability risks in the event of inadequate fiscal policies. We thus call on the authorities to exercise resolute spending restraint – including on the wage bill – and advance fiscal structural reforms to rein in remaining contingency risks in order to secure adequately large fiscal surpluses well into the medium term.

The substantial private debt overhang and still elevated NPLs continue to pose major risks to financial stability. Swift, high-quality deleveraging and NPL resolution thus remain of the essence. In this regard, we call on the authorities to continue working towards more effective foreclosure and insolvency frameworks and ensuring their strict implementation. We second staff's call for strengthening the oversight of Credit Acquiring Companies and support close monitoring of the Estia scheme to prevent potential opportunistic behaviour and moral hazard.

We take note that staff deems AML/CFT compliance risks macro-critical. Against this background, we strongly encourage the authorities to quickly close remaining gaps and ensure full compliance with established AML/CFT standards, including in the context of the country's "citizenship-by-investment" program.

Ms. Mahasandana, Mr. Ray, Mr. Harada, Mr. Shin, Mr. Shimada and Mr. Srisongkram submitted the following joint statement:

We thank staff for their comprehensive report and Mr. Doornbosch and Mr. Cools for their insightful statement. We welcome the good progress made in addressing domestic and external stability risk arising from legacies of the financial crisis. Having said that, vulnerabilities remain, especially in the financial sector with still high NPLs, low bank profitability, and debt overhang weighing on productive investment. Further efforts are needed to address these issues and to maintain the impetus, while resisting growing political pressures to unwind some key reforms. We broadly agree with the staff appraisal and would like to focus on a few points on emphasis.

NPL resolution and sustainable debt workouts should be prioritized. The NPL ratio in Cyprus has been declining, but it is still high compared with European peers. While we welcome the 2018 amendments to the related laws as they enhance the toolkit to address NPL, we note staff's concern that recent amendments to the foreclosure framework involving the Financial Ombudsman could impede further NPL reduction. We would like staff to elaborate more on the likely impact if the recent amendment comes into effect after the review by the Supreme Court, and how the authority should mitigate the impact and proceed NPL reductions.

At the same time, close monitoring on Credit Acquiring Companies (CACs) and the housing market is necessary to avoid unintended accumulation of financial vulnerabilities. While CACs play an important role in promoting NPL reduction, close monitoring based on data under strengthened oversight framework is necessary to avoid CACs from posing new risks to financial stability, given that a large volume of NPL (about 50 percent of GDP) are currently held by CACs. Potential impacts on the housing market through banks' and CACs' real estate holdings by foreclosure should also be monitored closely. We also encourage the authorities to finalize and implement their plans to enhance governance and performance of the state-owned CAMC so as to assist in the NPL reduction efforts.

Low bank profitability should be addressed to enhance financial resilience. Besides the high NPL ratio as legacy of financial crisis, Cypriot banks are suffering from low profitability caused by prolonged low interest rate environment and overbanking. In this regard, we welcome staff's analysis on the impact of digitalization on banks in the Selected Issue Paper. In the digitalization era, it is essential for the banks to adapt their business models. We encourage the authorities to support these transformations of banking business model through appropriate advice and supervision. Aside from digitalization, could staff elaborate more on how banks in Cyprus could diversify their revenue sources and rationalize operational costs?

Fiscal prudence is also key to restoring public debt sustainability. Maintaining a large primary surplus of around 5 percent in coming years could be challenging, but is essential to put the public debt on firm downward trajectory. We concur with staff that wage bill growth, which remains high by international standards, needs to be maintained below nominal GDP growth to free up fiscal space for more productive spending. We also note the potential for additional fiscal costs associated with government guarantees to public entities and rental subsidy under the Estia scheme.

Productivity enhancing structural reforms will be key to bolstering medium-term growth potential. While Cyprus maintains its cost effectiveness, low productivity growth is a bottle neck for its medium-term growth. The authorities need to encourage investment in digitalization, innovation and skilled human capital. Mitigating AML/CFT risks is also crucial to avoid macro critical impacts, including on foreign corresponding banking relationships.

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

We thank staff for the comprehensive set of reports and Mr. Doornbosch and Mr. Cools for their helpful buff statement. We associate ourselves with Mr. Moreno's gray and generally concur with staff's appraisal, while adding the following issues for emphasis.

The economic growth remains robust but sustaining it in the long term will require continuous implementation of wide-ranging structural reforms. The large private, public, and external debt overhangs weigh on productive investments. Therefore, we strongly agree with staff, that key policy priorities should be the reduction of private and public debt underpinned by effective functioning of foreclosure and insolvency frameworks. We also concur on the need to accelerate judicial reforms and to complete institutional reforms, such as more effective governance of SOEs and public administration. Further efforts to effectively tackle AML/CFT risks should also remain a priority.

We commend the authorities for their strong fiscal performance after the crisis. However, in the context of still-high level of public debt and vulnerabilities stemming from contingent liabilities pertaining to the banking system, spending should be firmly controlled to ensure a declining debt path. We positively note, that, according to the BUFF statement, the broad political consensus for spending restraint continues to hold. Maintaining a primary surplus above 4 percent of GDP over the medium term will be crucial to strengthen confidence and keep debt firmly on a durable downward path.

The NPL ratio remains exceptionally high, constraining credit and investment growth. Following a strong reduction in NPLs in 2018, the NPL stock declined only marginally in 2019 and mostly relied on loan sales. We concur with staff that further decisive progress in NPL resolution is vital. We note, however, that the recent amendments to the foreclosure framework approved by Parliament backtracks on key elements of the reform adopted in July 2018 and could hinder ongoing NPL resolution efforts.

Cyprus is lagging its EU peers in the area of digital transformation and technology adoption. There is a need to step up efforts in promoting technology adoption in the public sector through e-government projects, which could also stimulate private-sector innovation activities. Higher reliance on digital solutions could also be an opportunity for Cyprus's banking sector, which suffers from low profitability and operational inefficiency.

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

We thank staff for the well-written reports and Mr. Doornbosch and Mr. Cools for the helpful buff statement. The economic growth in Cyprus continues to be robust, following a rapid recovery from the global financial crisis. Great progress has been made in fiscal adjustment, NPL reduction, and competitiveness improvement for the past years. Going forward, more should be done to continue the NPL resolution, ensure the debt sustainability, and improve the productivity growth. We agree with the thrust of staff's appraisal and limit ourselves to the following comments for emphasis.

We take positive note that the NPL ratio declined by more than 10 percent since the end of 2017. In order to further reduce the NPL in a timely and orderly manner, we agree with staff that it is important to improve the foreclosure and insolvency framework, promote the development of the

NPL market, and strengthen the oversight of credit acquiring companies and the asset management company. Regarding the subsidy scheme for NPL restructuring and repayment to primary homeowners (Estia), we concur with staff that it should be transparent, well-targeted, and cost-efficient. The profitability of the banking sector remains under pressure. We encourage the authorities to support the digital transformation of banks, in order to streamline banks' operational cost, and improve the productivity of the overall banking sector.

The fiscal surplus helped to put the public debt level on a downward trend. But the risks to debt sustainability remains high, given the high vulnerability to macro and fiscal shocks and the non-negligible contingent liabilities. We are comforted by Mr. Doornbosch and Mr. Cools' buff statement that there is broad political consensus for spending constraint and the expenditure growth will be capped at nominal medium-term economic growth for 2020-22. We see merit in staff's suggestion to improve the efficiency of educational and health spending. We encourage the authorities to continue strengthening the public finance management, including improving the governance of SOEs.

Structural reforms should continue to boost medium-term growth potential. We note with concern that as a regional financial center, the export of financial service in Cyprus is slowing down, driven by a low productivity growth and sluggish external demand. Considering that the UK is one of the top destinations of Cyprus' financial service export, could staff shed light on how the Brexit would impact the financial service export to UK, and whether some UK based financial service firms would relocate to Cyprus? Given the relatively low level of spending in R&D, we see merit in staff's suggestion of encouraging more investment in innovation, but also underscore the importance of facilitating technology diffusion through international trade and investment, which is crucial for small economies like Cyprus.

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

Mr. Sylla and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for the set of comprehensive papers and Mr. Doornbosch and Mr. Cools for their helpful buff statement.

The Cypriot authorities made notable progress in addressing legacies of the 2012-13 financial crisis and implementing policies that have supported the economic recovery. We note that real GDP growth reached 3.3 percent in the first half of 2019 on the back of strong private consumption. The economic expansion has pushed down the unemployment rate to 6.5 percent in second quarter of 2019 from 7.3 percent in 2018, while inflation remained low. We praise the authorities for their robust fiscal performance. We are encouraged by the Government's plan to reimburse some external creditors, including the Fund as indicated by Mr. Doornbosch and Mr. Cools buff statement. Notwithstanding the broadly favorable outlook, risks to the outlook remain skewed to the downside stemming notably from political pressure to reverse reforms, and high levels of non-performing loans (NPLs) and debt, including from the private sector. Looking ahead, we encourage the authorities to sustain their efforts and discipline to entrench macroeconomic stability, reduce vulnerabilities in the financial sector and bolster productivity and long-term inclusive growth.

We broadly agree with staff's analysis and policy recommendations and will confine our remarks to the following issues.

A prudent fiscal stance remains necessary to ensure public debt sustainability. We appreciate the authorities' commitment to using any unforeseen revenue gains to reduce public debt and preserving rigorous spending in line with medium-term budget plan for 2020-22. We acknowledge the current pressure to revert the wage cuts made during the crisis. However, given that the wage bill remains elevated, it is important that its growth is kept below nominal GDP growth rate to maintain public debt on a downward trajectory. It is reassuring to note that the NHS, the national insurance system, has a global budget and various mechanism to keep expenditures in check. Nevertheless, vigilance is still needed to contain and mitigate fiscal risks. Could staff comment on the status of the launch of the NHS initially planned for June 2019 and whether this has led to a temporary increase in the fiscal outlay so far? Steps to reform local governments and SOEs should proceed swiftly.

Further strengthening bank' balance sheets and proceeding with NPL resolution are paramount to safeguarding financial stability. The financial soundness indicators point to improvements in the banking sector. We note, however, that new regulatory requirements from ECB, EU Directives and IFRS9, combined with a low interest rate environment are weighing on banks' profitability and could exacerbate the losses associated with NPL workouts. To mitigate these potential losses, we encourage the authorities to take the necessary steps to enhance provisioning and buffers. Ensuring adequate incentives and regulatory framework are in place to improve competitiveness and operational efficiency of banks while leveraging the use of innovative technology would be also helpful. Could staff comment on measures that are being considered by the authorities to use of technologies to improve banks' efficiency? Could staff also elaborate on the current regulatory landscape for fintech in Cyprus? At the same time, we concur that the authorities should ensure that obstacles to the smooth functioning of the NPL resolution toolkit are removed. Particular attention should be paid to enhancing the oversight framework for Credit Acquiring Companies (CACs) as these companies hold about 50 percent of GDP in NPLs. In addition, the authorities should closely monitor potential macro-financial risks emanating from the real estate held by these companies. To complement the debt workout initiatives, we encourage the authorities to also expedite the completion of the governance and operationalization of the state-owned Cyprus Asset Management Company (CAMC).

Finally, we concur that tackling structural bottlenecks will be essential to raise productivity and competitiveness, enhance governance and boost medium-term inclusive growth. We agree that policy priorities should be given to education, R&D and innovative technologies in order to increase productivity, competitiveness and address the skills mismatches and high youth unemployment. The implementation of national digital strategy, creation of research centers and a new ministerial entity for innovation and digital policy, together with planned development of equity funding for SMEs are steps in the right direction. We encourage the authorities to advance public sector governance reforms, including approval of pending legislations related to civil service reform, court of appeals and governance of the Central Bank of Cyprus. On financial integrity, there is a need to further strengthen the AML/CFT legal and supervisory frameworks and address the identified gaps going forward, in preparation for the upcoming MONEYVAL AML/CFT assessment.

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

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

Cyprus' sustained efforts to advance its reform agenda over the years has helped to tackle legacy challenges from the global financial crisis, improve macroeconomic fundamentals, and create conditions to support long-term growth. However, rising external headwinds, including mounting protectionist policies, the potential adverse impact of a disorderly Brexit, as well as a faster-than-expected slowdown in euro area growth, could significantly weigh on the near-term growth prospects. Against this background, we encourage the authorities to continue advancing structural reforms to enhance financial sector resilience, including by fostering NPLs resolution and private sector deleveraging; preserving fiscal sustainability; and supporting supply-side policies needed to enhance competitiveness and productivity. We broadly concur with the policy priorities outlined in the staff report and thank Messrs. Doornbosch and Cools for their informative buff statement.

A strong commitment to preserve a prudent fiscal stance complemented by efforts to address debt sustainability risks is essential to entrench macroeconomic stability. We welcome the authorities' commitment to preserve large primary fiscal surpluses over the forecast horizon by capping expenditure growth to nominal GDP growth and improving expenditure efficiency. While these steps could assist in further reducing debt vulnerability risks, it is equally important to rebalance expenditure towards growth-enhancing investments – such as improving physical and human capital, creating conditions to bolster private sector development, and promoting the services sector. In this connection, we encourage stepped up efforts to contain the wage bill growth, carefully monitoring fiscal risks that could emanate from the New General Healthcare System (NHS) and state-owned enterprises (SOEs) and advancing local government reforms. Similarly, the invigoration of revenue-enhancing measures, including modernization of the tax administration is important to address competitiveness challenges faced by the Cypriot economy.

Buttressing financial sector resilience through continued efforts to deleverage and strengthen bank's liquidity buffers is essential to support financial stability. While considerable progress has been made to improve the banks' balance sheets and deploy a vast array of NPL reduction solutions, including loan restructuring, foreclosures, and full settlements, further efforts are warranted to ensure a sustained decline in NPLs. We note that the potential need for further provisioning as banks seeks to lower NPLs to single digits by 2020 could divert considerable resources to support credit and investment growth. In view of the large share of NPL holdings in the balance sheets of Credit Acquiring Companies (CACs), we agree with staff that stepped up efforts to continue reinforcing the supervisory and oversight framework of CACs is crucial to buttress financial stability. In addition, closely monitoring macro-financial risks from property market developments and appropriately deploying macro-prudential measures as needed, while ensuring effective mitigation of AML/CFT compliance risks ought to be given primacy going forward.

Finally, rebooting structural reform priorities is paramount to speedily address bottlenecks to productivity and competitiveness. We appreciate the thorough discussion about the Cyprus's export competitiveness challenges as well as the policy priorities outlined in the SPIs. We underscore the need to implement more forcefully, a wide range of structural measures to lift productivity growth in the services sectors, which account for 75 percent of Cyprus' exports, including through policies aimed at diversifying markets for services exports, incentivizing investments in research and development and technological diffusion, as well as policies to bolster ICT infrastructure and human capital development. Furthermore, complementary measures to strengthen public sector governance would help catalyze competitiveness of the economy and support private sector development.

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

We thank staff for well-written papers and Mr. Doornbosch and Mr. Cools for their helpful buff statement. Cyprus' growth, while gradually slowing, remains among the strongest in Europe. We welcome the authorities' commitment to sound fiscal policies and structural reforms, as well as continued progress in addressing weaknesses in financial sector regulation and reducing NPLs. As we broadly agree with the staff appraisal, we will make a few comments for emphasis.

We agree that continued strong fiscal performance is needed for reducing risks associated with still very high public debt and possible deterioration of external financing conditions. 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. There is also some scope for improving efficiency of educational and health care spending.

Financial sector vulnerabilities remain a substantial drag on Cyprus' economic performance. In this regard, repairing banks' balance sheets and restoring their profitability remains a priority. The adoption of 2018 amendments to the foreclosure and insolvency legislation have strengthened the legal framework for NPLs resolution. It is essential to preserve the effectiveness of this mechanism and to limit excessive lengthiness of foreclosure procedures. It is important to enhance the supervision of the Cyprus Asset Management Company, as well as private credit-acquiring companies. The authorities should also strengthen the eligibility criteria of 'Estia' subsidy scheme for mortgage restructuring to minimize moral hazard risks.

We welcome the authorities' commitment to implementation of productivity-enhancing structural reforms, which are key to boost potential growth. We concur with staff that investment in digitalization, innovation and skilled human capital are needed to improve competitiveness. Progress achieved in strengthening the financial sector legislation brought to the forefront the need to address remaining inefficiencies in the judicial system, including reform of the civil procedure code, and increasing the number of judges to address the backlog in legacy NPL cases. The authorities should also tackle the AML/CFT risks and further strengthen their AML/CFT framework.

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

Mr. Rozan and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents and Mr. Doornbosch and Mr. Cools for their informative buff statement. We command the Cypriot authorities for their success in reducing internal and external imbalances while mitigating risks to debt sustainability and avoiding procyclical policies. The downsizing of the banking sector and continued fiscal consolidation efforts have been paramount in this regard and have helped support the country's sound economic expansion. We welcome the authorities' endeavor to ensure fiscal sustainability, strengthen financial sector policies and implement structural reforms in a context of still favorable financing conditions. Nevertheless, growth is projected to slowly decrease and reach its potential level by 2020.The build-up of external risks is likely to put further strain on foreign demand. Consequently, we encourage the authorities to capitalize on the reform momentum to enhance the efficiency of public spending, strengthen the financial sector and address structural impediments to investment, so as to lower unemployment. We associate ourselves with Mr. Moreno's statement and would like to add a few remarks for emphasis.

Outlook and risks

Despite a favorable economic outlook, the balance of risks is titled to the downside including the delay in the resolution of NPLs, debt sustainability concerns and potential exposure to a sharper-than-expected external shocks in a context of Euro area economic slowdown and uncertainty over Brexit scenarios. Financial markets' confidence could also be adversely affected by the realization of contingent liabilities as well as negative outcomes of the AML-CFT assessment. Energy investment are encouraging signals to support potential growth

Fiscal policy

The large and continued fiscal surplus is comforting and we encourage the authorities to keep up with their efforts to continue with the declining path in public debt. Despite its economic expansion, Cyprus remains exposed to debt sustainability risks. We thank staff for the very useful DSA, which clearly emphasizes the significant vulnerability to shocks including a combination of macro-fiscal and contingent liabilities arising from both the banking sector and the public and para-public sectors, which could result in large spike in gross financing needs if they were to materialize. We recognize that containing the above-mentioned risks while addressing important structural fiscal challenges arising from an ageing population and costs related to the new National Health System (NHS) is not an easy task. Thus, we concur with staff on the importance of spending containment. The reform of local governments, by deferring more responsibilities to them could also contribute to better expenditure control at the local level. On inflation and fiscal outturns, we note that headline and core inflation were mostly subdued in 2019. Given domestic demand's strong contribution to growth, could staff clarify the impact of low inflation rate on both medium-term growth and fiscal consolation objectives?

Banking sector

Efforts to consolidate the banking sector and improve asset quality are encouraging and should be maintained to further reduce NPL ratios and increase banks' profitability. While progress has been made to accelerate NPL resolution including through the Estia scheme, staff's comments on the pace of NPL reduction necessary to reduce the NPL ratios to single digits by 2020 would be interesting. In line with staff's recommendations, we also encourage the authorities to proceed further with institutional reforms including the enhancement of the governance of the CBC, the review of the civil procedure rules and the reduction in delays in adjudication of commercial claims.

Structural reforms

Greater manufacturing diversification and higher investment in technological innovation and R&D could boost Cyprus' external competitiveness while reducing the current account deficit. The country needs to move ahead from the banking crisis and enhance its productivity growth by addressing the remaining economic inefficiencies and promote greater market competition. Priority should be given to removing unnecessary administrative burden, provide higher legal certainty regarding the enforcement of contracts, reducing skills mismatches and accelerate the pace of the digital transformation. The promotion of a more business-friendly environment lies in the robustness of the judicial system and we encourage the authorities to complete the ongoing reform, introduce an e-justice system and modernize the system of issuance and transfer of legal forms such as title deeds. On the latter, we agree that accelerating the transposition of the EU Services Directive would contribute to attract capital flows and spur innovation. We would be interested in staff providing more details on the actions planned to enhance the country's connectivity that would translate into greater geographical diversification.

Lastly, the weight of financial services in the country's economy and attractiveness warrants all the more a robust AML-CFT framework as underscored in the Risk Assessment Matrix in Annex VIII. We urge the authorities to bridge the remaining gaps regarding in particular preventive measures, transparency, identification of beneficial ownership of companies and trusts, as well as to reinforce their cooperation at the international level. We look forward for the results of the upcoming Moneyval AML-CFT assessment.

Mr. Just and Ms. Endlich submitted the following statement:

We thank staff for their report, and Messrs. Doornbosch and Cools for their informative buff statement. Cyprus has experienced a strong economic rebound after the crisis. However, the reform momentum has slowed and needs to be reinvigorated, as considerable vulnerabilities remain in the financial sector, and weak productivity growth and political pressure to revoke key reform measures weigh on future growth performance. We share the thrust of the staff appraisal and broadly associate ourselves with the statement by Mr. Moreno. We would like to emphasize the following points.

We welcome Cyprus' strong path of fiscal consolidation. The primary budget surpluses have been remarkable so far, also compared to other crisis-affected countries of the EU, and the projected budgetary surpluses will further support the decline in the public debt-to-GDP ratio. However, we note that favorable macroeconomic conditions and external influences played a major role, rather than domestic structural reforms. As Cyprus continues to face significant fiscal legacy risks, we caution against reversing the legislation implemented during the crisis, and encourage the authorities to keep the volume and structure of public spending under control.

The banking sector still faces significant challenges with respect to the high stock of NPLs and low profitability. Improvements in the foreclosure framework, the transfer of two large NPL portfolios to Credit Acquiring Companies (CACs) and the Cyprus Asset Management Company (CAMC), as well as the introduction of the state subsidy scheme Estia for the restructuring and repayment of NPLs collateralized by primary homes have reduced the NPL ratio considerably to 31 percent of loans as of May 2019. However, recent amendments to the foreclosure framework have created uncertainties which might negatively affect NPL sales. We encourage the authorities to keep a stable, clear, and effective legal framework in place, including the foreclosures law. In addition, as the NPL ratio remains the second largest in the euro area, a further reduction of NPLs is needed, although we are comforted that around half of the NPLs have been provisioned and the remainder is mostly backed by collateral. Could staff provide more details on the composition of the collaterals and their recoverability? Furthermore, given the high value of assets being held by CACs, we consider strengthening the oversight framework for CACs and their close monitoring as highly important due to potential negative spillovers and impacts on the banking sector. In addition, the finalization of the governance and operational structure of the state-owned CAMC, including the adoption of an appropriate sunset clause, should secure operational independence, accountability, and transparency.

A “low-for-long” interest rate environment will reinforce the profitability challenges of the banking sector. Credit demand remains low due to a continuing debt overhang of the private sector reducing income, while structural factors such as the substantial share of non-income generating assets, or the rigid and high cost structure weigh on the business model. We therefore welcome the ongoing consolidation in the banking sector, as well as through reducing overstaffing and the size of the branch network, but consider further efforts as necessary to address excess capacity. We consider investments in digitalization as an opportunity to enhance efficiency and increase profitability in the banking sector, as financial service digitalization in Cyprus is at a low level compared with digital frontier countries. Could staff elaborate on the role of Fintech to increase financial service digitalization?

We appreciate the efforts to strengthen AML/CFT compliance and consider the effective implementation of AML/CFT measures as highly important. The authorities have taken a welcome stronger stance on AML/CFT of late. We also take positive note of the cap on the number of citizenships granted under the Cyprus Investment Program (CIP) scheme, as well as the lengthening of the required periods for holding investments. As there is evidence that the CIP has contributed to an overreliance on construction investment and has negatively affected housing affordability in some coastal areas, we would appreciate staff's comments whether stricter CIP controls could dampen house price increases in specific segments.

Structural reforms need to address institutional challenges and encourage investment in digitalization and innovation. Amending the Central Bank of Cyprus (CBC) legislation will strengthen the CBC's autonomy and fully align its governance with Eurosystem. We encourage the authorities to fully and timely implement the government digital strategy, which includes the adoption of modern technology in the civil service, justice, and the health care systems.

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

We thank staff for their well-focused set of reports and Mr. Doornbosch and Mr. Cools for their helpful buff statement. We broadly share staff appraisal and would like to make the following remarks.

We take positive note that growth is gradually moving to a more sustainable path, but risks remain tilted to the downside. While the pace of post-crisis recovery is encouraging, the economy remains exposed to high non-performing loans, private debt overhang, and elevated public debt. Also, banks' low profitability constrains credit and investment growth, while longer-term economic growth potential is hindered by weak productivity growth. In this context, we share staff's view on the need for continued sound financial sector policies and structural reforms, focused on enhancing efficiency and productivity.

Maintaining fiscal discipline would help in mitigating debt sustainability risks. In addition, we agree with staff that spending efficiency needs to improve while public spending prioritization should support structural reforms efforts to help achieve faster and more inclusive medium-term growth. These efforts should be pursued in parallel with measures to contain fiscal risks arising from SOEs, particularly through continued improvement in SOEs' public financial management and governance.

It is important to continue repairing banks' balance sheets to help address the legacy challenges. In this context, we support prioritizing a well-functioning NPL resolution toolkit through restructuring, foreclosure, and insolvency. Also, we welcome the framework for electronic auctions and progress of judiciary reforms aimed at reducing backlogs of collateral execution and incentives for debt workouts. In this context, we agree with staff that close monitoring of the state-subsidy scheme, Estia, is important to prevent potential moral hazard and to allow timely reassessment of borrower eligibility. We also welcome the authorities' commitment to further strengthen the AML/CFT compliance to help mitigate associated risks.

Finally, we encourage the authorities to further advance structural reforms to strengthen potential growth. Priority areas include addressing low labor productivity and promoting entrepreneurship, connectivity, and access to finance. Also, policies to support greater market diversification, competition, and technology adoption are needed to enhance competitiveness. Furthermore, the authorities' strategy to improve investment in ICT infrastructure, STEM training, and research and development innovation are welcome. On technology, we welcome the authorities' digital strategy, which focuses on promoting innovation and the digital transformation of public and private sectors as highlighted in Box 1.

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

Mr. Bhalla and Mr. Goyal submitted the following statement:

We thank staff for the informative report and selected issues paper, and Mr. Doornbosch and Mr. Cools for the helpful buff statement.

After a long phase of rapid growth, Cyprus economy is settling down to a more sustainable level. Notwithstanding slowing of net exports, economy is being supported by domestic demand with strong investment and steady consumption growth. Growth was also facilitated by reforms that brought about reduction in non-performing loans, strengthened bank balance sheets and improved fiscal parameters. However, level of NPL is still one of the highest in Europe and debt levels also remained high. Going forward, there is downside risk to the sustainability of reform process under increasing political pressure that may increase financial and fiscal vulnerability. Moreover, global demand slowdown and sluggish productivity growth are other challenges before the economy.

While NPL resolutions have helped banking sector consolidation, need to maintain adequate capital buffers against potential losses as NPL ratios are to be lowered further is bringing pressure on the profitability. We agree with the staff suggestion that banks' efficiency needs to be improved by rationalizing operational costs and adopting digitalization solutions. Similarly, we agree that holdings of repossessed properties by the banks and other financial entities need to be closely monitored to guard against excessive liquidity mismatch risks.

We agree with the staff that the reversal of fiscal reforms poses a significant downside risk to the economy that would slow down the primary surplus and pace of debt reduction. Thus, government spending should be appropriately prioritized. Growth in wages should be maintained below the GDP growth and spending on education and technological innovations should be encouraged to enhance growth potential. We support the ongoing efforts towards improving tax administration.

Notwithstanding accommodating monetary policy stance and robust domestic demand contributed both by investment and consumption expenditure, credit pickup has stayed weak. Is it the reflection of a fall in banking assets with transfer of two large NPL portfolios to credit acquiring companies, or there are some other specific reasons? Staff may like to comment.

Cyprus economy is affected by twin problems: inadequate diversification of its economy particularly the export sector and weak productivity growth. These require major focus on structural reforms. There is a need to invest in new technologies, skill upgradation labour force, to address government inefficiencies and remove financing constraints.

AML/ CFT risks are macro critical and need to be mitigated by addressing gaps related to transparency and beneficial ownership of companies and trusts and by augmenting financial intelligence and investigations. We note authorities are making efforts in this regard for instance regulations are being implemented to clarify the definition of shell companies.

We wish the authorities every success in future endeavors.

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

The Cypriot economy continues to improve, although growth is gradually slowing. The authorities have made solid progress helping the economy recover from the crisis. While their efforts are commendable, vulnerabilities persist and the authorities will need to continue pushing ahead through the inevitable reform fatigue. We generally agree with the thrust of the staff report and offer the following comments for emphasis.

Financial Sector

Resolving legacy financial sector issues remains the top priority in Cyprus. The authorities have made significant progress in sharply lowering NPLs although they remain comparatively high. We welcome the authorities' efforts to strengthen supervision of Credit Acquiring Companies, given that they now hold around 50 percent of GDP in NPLs. Further progress will be needed, however, including renewed efforts to improve the foreclosure framework and prevent potential backsliding. Furthermore, the low take-up of the Estia scheme may limit the effectiveness of the scheme for reducing NPLs. Staff comment on the impact of the scheme going forward, along with prospects of finalizing the governance and operational structure of the Cyprus Asset Management Company to speed up debt workouts, would be welcome.

Bank profitability also continues to be an issue. The turn to net profits last year was largely due to lower provisioning, while operating profits declined. Noting that non-resident banking services are declining and domestic competitive pressures are rising, is there scope for domestic mergers of Cyprus' smaller banks?

Fiscal Outlook

Fiscal performance remains strong. Given the spike in debt levels during the crisis, we welcome the authorities' ambition to bring debt down to sustainable levels. While understanding the desire to move quickly, the goal of achieving a 31 percentage point decline in debt-to-GDP over the next five years is extraordinary. If growth can continue at its current pace then the adjustment path may be appropriate. However, if growth were to slow, we wonder whether some increased priority spending on pro-growth areas, such as much-needed R&D and technology investment, would be warranted. Additionally, could staff comment on the potential fiscal impact from an unfavorable ruling by the Supreme Court on the wage bill, as well as the prospects for the constitutional amendment mentioned on page 15?

Structural Reforms

Finally, we note that lagging productivity is one of the key impediments to higher growth. We thought the section on structural reforms in the report was well-detailed, with a good focus on ICT and technology needs; quicker contract enforcement and debt workouts; and reforming the public sector. Enhancing growth would assist the authorities in their ambitious fiscal consolidation plans while also improving long-run sustainability.

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

We would like to thank Messrs. Doornbosch and Cools for their informative buff statement, and Staff for their report, which we view as balanced. We broadly agree with Staff and share many of the main findings, in particular those related to the need for further tackling issues surrounding the financial sector and ensuring appropriate policy priorities ahead. We also would like to highlight a few items.

Growth performance in recent years has been robust and the outlook remains favourable; however, we wish to echo Staff in that appropriate banking sector policies and reinvigorating the reform momentum could hedge against downside risks. While growth is slightly decelerating on the back of the global economic slowdown, it remains strong, supported by strong domestic demand on account of rising disposable income and large-scale foreign-financed tourism and infrastructure projects. Robust growth is likely to continue during the next quarters, but low productivity growth and a weakening of external demand weigh on medium-term growth prospects. Sustaining robust growth levels over the medium term and increasing the country's resilience to adverse shocks would require renewing the structural reform momentum and following appropriate policies to enhance resilience in the banking system.

We agree with IMF Staff that, notwithstanding the decline in net external debt over recent years, external imbalances remain an issue of concern. The persistently negative current account renders the country vulnerable to a reversal of foreign financing and adds to the still large, albeit declining, external debt burden. In case of a negative confidence shock (e.g. triggered by renewed uncertainty in the financial sector, increasing AML/CFT compliance risks, or negative developments in main funding countries), large external liabilities magnify the impact of higher risk premia on the domestic economy.

Strong fiscal performance has helped increase soundness in public finances, but, like Staff, we view that lingering risks warrant sustained prudence in fiscal management. Buoyant tax revenues on the back of strong economic growth, combined with overall prudent expenditure management, have helped generate large primary fiscal surpluses since 2015. Fiscal discipline, combined with progress in enhancing banking system resilience helped improve Cyprus's public debt situation, while budget execution in 2019 continues to be very strong, with a very sizeable primary surplus. However, a false sense of safety should be avoided in light of short and medium-term fiscal risks (primarily relating to outstanding court decisions and the ongoing health reform) as well as vulnerabilities stemming from still-high (although declining) level of public debt and contingent liabilities pertaining to the banking system and the resolution of a large systemic bank. In view of those vulnerabilities, it is essential to persevere with prudent expenditure management to firmly anchor the public debt-to-GDP ratio on a downward sloping path and solidify investor confidence. In this respect, we concur with IMF Staff that the government should resist pressure to potentially unwind key reforms, as this would risk eroding confidence and increasing the sovereign risk premium.

We support Staff's views on the need to renew the overall structural reform drive to safeguard growth, ensure resilience and support efforts to effectively tackle AML/CFT risks as a priority. Addressing inefficiencies in the justice system are key to ensure the effective implementation of the insolvency and foreclosure frameworks and improve the business environment. Such objective would also be served well by ensuring a reliable and transparent solution to issue and transfer title deeds, as well as to resolve persistent backlogs. 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. We share IMF Staff's views that effectively mitigating existing inherent AML/CFT risks could avert shocks to confidence as well as investment and the soundness of the banking system, and we support continued efforts to this aim as a matter of priority.

We welcome the progress in reducing NPLs but would like to highlight the need for further action in tackling the considerable risks surrounding the banking system. While the decline in the stock of NPLs in the banking system is ongoing, the pace appears to have somewhat moderated compared to previous years and the overall volume remains elevated. At the same time, banking sector profitability remains under pressure in a context of low interest rates, poor asset quality, persistently high operating costs, political resistance towards shifting into fee and commissions-based income models, thus intensifying prevailing strains for the banking system. In view of the still sizeable NPL stock, low imminent prospects for capital-building via organic profitability, moderating economic growth and rather mixed success in restructuring over the past years, we view further decisive progress in NPL resolution as vital and concur with IMF Staff that strengthened supervision of credit acquiring companies is warranted.

We broadly share Staff's views regarding additional financial stability risks related to real estate, the foreclosure framework and the ESTIA borrower subsidy scheme. The real estate market is still supported by strong, albeit decelerating, economic activity, whereas clear signs of overvaluation are not discernible at this stage. However, the presence of potential downward pressures on prices on account of prevailing borrowing constraints of the still highly indebted household sector and prospective sales of the large stock of residential real estate held by large banks and credit acquiring companies could lead to re-adjustments in bank loan portfolios. On the foreclosure framework, recent amendments approved by Parliament in August 2019 constitute a severe backtracking on the reform of the framework adopted in July 2018. While a Supreme Court ruling on its constitutionality is only expected in spring 2020, the revised foreclosure framework, if implemented, can be expected to have adverse effects on progress in NPL resolution and financial stability. Last, there are concerns as to the ability of the borrower subsidy scheme ESTIA to act as a catalyst for the relief of indebted borrowers. Rigorously enforcing compliance with the eligibility criteria and swiftly triggering foreclosure procedures upon defaulting borrowers are crucial for its underlying success.

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

The subject of this session is on Cyprus, 2019 Article IV consultation. Twenty Directors issued 18 grays, and the ECB representative also issued a statement. Thank you.

As you know, Cyprus experienced a large banking crisis during the period of 2012-2013, and, of course, after that the Fund entered into a program with the countries together with the so-called troika partners, including ECB and European Commission. Since then, the pace of the recovery in the country has been more rapid than many of the euro area post-crisis economies. In your grays, you welcomed the improved macroeconomic performance together with the authorities' effort to resolve the legacies from the financial crisis. At the same time, you highlighted that the key areas include maintaining the fiscal discipline, addressing the still-large nonperforming loans (NPL) levels and bank profitability, lending capacity, AML/CFT. There are a wide range of tasks remaining to be tackled, and challenges remain. This discussion of Article IV consultation provides very good opportunities to seek a more effective way forward and to meet these challenges.

Mr. Doornbosch made the following statement:

Before our discussion, I would like to inform the Board that the authorities have not yet given their consent to publication, as they have not yet reached agreement with staff on a deletion to the document, and I would just like to clarify before we have our Board discussion what this relates to.

The sentence that I am referring to is on page 12, and it concerns to Estia, and Estia is the burden-sharing scheme for distressed mortgage borrowers. Staff and the authorities recognize that Estia is an essential tool to help bring down nonperforming loans. It took a while to become operational, but here we are. The first applications have been received in September, but Ms. Pollard and Mr. Grohovsky in their gray point out that the take-up has been unfortunately quite low so far. It important that we are very careful warning for potential or additional or complementary schemes, because if you warn many times for complementary schemes, people start to think there is going to be a complementary scheme, and there is no such plan by the authorities because they are trying to get the uptake of Estia going and make this scheme a success. Therefore, it is important that we are very careful about this. It is also market sensitive in the sense that it immediately affects the pricing of NPLs if there is some discussion of larger haircuts in a future scheme, and that is what the sentence is referring to. The authorities asked for a deletion of the full sentence that reads: Any complementary scheme for vulnerable primary homeowners whose loans are deemed unviable under Estia should ensure further burden sharing such as through larger haircuts by banks. But they also could live with deleting only “such as through larger haircuts by banks”. I think that is important for the Board to be aware of. We are still discussing this with staff and might come to an agreement after the Board meeting, but because of the rules of the transparency policy, it is important to raise it here, and it is also not to say that I will say at the end that we had a very good cooperation and very constructive Article IV consultation, and so it is not related to that. It is just about this specific point. Thank you.

The Acting Chair (Mr. Zhang). Thank you, Mr. Doornbosch. I thought you raised a very important issue. We will have to keep the issue more transparent and follow the transparency policies, and, of course, we will come back on the issues you raised

The staff representative of the European Department (Ms. Tuladhar) made the following statement:[1]

> I will try to address some of the policy issues that were raised, but if you will allow me, let me begin with a few updates. There were several new data released which shows that the staff's projections remain broadly on track. Notably, the flash estimate for the third quarter shows that the GDP growth came in at a robust rate of 3 percent seasonally adjusted, while overall fiscal balance showed a surplus of 4.3 percent of GDP.
>
> As was noted on the buff statement, the authorities have officially notified the Fund of the intention to prepay the outstanding loan of 570 million SDRs. The staff fully supports this as it would lower the financing costs as well as extend the debt maturity profile. Contingent on getting approval from the European Stability Mechanism (ESM), we are expecting the payment to be made sometime in the first quarter of next year.
>
> Turning to policy questions, several Directors raised the issue of the NPL reduction strategy to meet the targets. The NPLs reduction is expected to be achieved through two ways; one, the direct sales to third-party investors, and for the portfolio that has been collateralized by primary homes, which is more difficult to recover, through the subsidy scheme Estia. The authorities are also facilitating additional measures for NPL recovery such as the electronic foreclosure mechanism (e-auction). The decree has been published, and the online platform has gone live.
>
> This raises the question what is the potential impact of the amendments to the foreclosure framework on these efforts. During the mission, the authorities noted that the final amendments that were approved by the Parliament severely limited the scope of loans that would be affected, the perimeter of loans that are subject to these amendments. This would limit the impact on the NPL portfolios that are up for sale. Indeed, investors' appetite did appear to be strong, and as reported by the banks and the authorities, the discussions for these sales were proceeding as expected. Nonetheless, there were some market participants who expressed concerns that these amendments introduced legal uncertainties on the foreclosure process, and that if it comes into effect, they would potentially increase the time needed to resolve these loans as reducing the recoverability and ultimately affecting the bidding price.

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

To avoid such an impact, the Central Bank of Cyprus (CBC) has been in consultation in trying to develop an alternative mechanism to address the consumer protection concerns that have been raised by the parliamentarians. The aim is to replace these legislative amendments with this mechanism while preserving the foreclosure framework, as was amended in 2018.

Finally, there was a question of why the take-up rate on the Estia scheme has been quite low. The Estia application process is still ongoing, and staff are exploring the possible reasons for the low take-up rates. One of the reasons cited was the lengthy process that is needed to prepare for the application documents. For example, banks mentioned about the delays in getting land registry documents. An alternative explanation that was also given is that there are many borrowers who are strategic defaulters, and they would not be eligible for the scheme or that the enforcement of the foreclosure framework remains weak and does not provide sufficient incentive for borrowers to come forward.

To summarize, the authorities are making progress with the comprehensive multipronged strategy to facilitate the NPL reduction, but clearly there are implementation challenges.

The staff representative from the Strategy, Policy, and Review Department (Ms. Gonzalez) made the following statement:

We would like to notify the Board that the authorities made a request for a modification under the transparency policy in paragraph 17 of the staff report with regard to the Estia scheme, and we are still discussing a possible solution on this matter.

Ms. Andreicut made the following statement:

We did not issue a gray as we largely share staff views. We welcome the sustained growth and the good progress made in tackling financial crisis legacy risks. We support staff’s call for building on recent gains by advancing reforms to secure macroeconomic stability and strengthening the economy’s growth potential. We particularly welcome staff’s emphasis on strengthening bank profitability and capitalization. In this context, we found the selected issues paper on digitalization in the banking sector interesting. It was useful to see the cross-country comparison linking digitalization to higher profitability and operational capacity. We also welcome the discussion on determinants of bank digitalization and policy implications.

Considering the case of Cyprus, what do staff see as the key impediments to further digitalization? The paper notes that the authorities have developed a regulatory framework for the application of fintech and that several domestic banks have been cooperating with tech companies. Taking this into account, does the bottleneck lie with human capital? What can Cyprus learn from other countries whose banks are more digitally advanced?

Mr. Di Tata made the following statement:

Cyprus' performance in recent years has been characterized by robust growth rates, declining unemployment, low inflation, improved competitiveness, and satisfactory fiscal indicators, which have allowed the country to reduce risk premia and regain investment grade status. As the country has been able to access market financing at low grades, the authorities have indicated their intention to reimburse outstanding Fund credit.

Notwithstanding the commendable progress that has been made since the financial crisis, economic vulnerabilities persist. Economic growth is gradually decelerating. The public debt, although on a downward path, is still high at close to 100 percent of GDP, and nonperforming loans have declined significantly but remain elevated compared to euro area averages.

The medium- to long-term growth potential is hindered by weak productivity growth. Moreover, considering domestic and external factors, we concur with staff that risks to the outlook are predominantly tilted to the downside. Against this backdrop, we welcome the focus of the consultation on reforms to secure financial stability and raise potential growth by enhancing efficiency and productivity.

Regarding the financial sector, ongoing efforts to strengthen bank profitability and capitalization should continue, including by diversifying sources of income, rationalizing operational costs, and digitalization. Nonperforming loan (NPL) resolution and sustainable workout space and a well-functioning resolution framework remain crucial for financial stability. In this regard, we welcome the 2018 legislative changes and strengthening Cyprus' foreclosure insolvency and sales of loan laws. We also support Mr. Doornbosch's point on state subsidy schemes.

Efforts should also continue to improve oversight for credit-acquiring companies and finalize the governance and operational structure of the state-owned Cyprus Asset Management Company (CAMC).

We agree with staff on the need to follow up real estate developments and take macroprudential measures tailored to the market segment if warranted. At the same time, we welcome the authorities’ commitment to further strengthen anti-money laundering compliance, which remains a key priority. The fiscal performance remains strong. The general government primary surplus is projected at around 5 percent of GDP on average over the medium term, which should keep Cyprus’ public debt on a rapid downward trajectory. The effort is ambitious and requires a strict adherence to spending discipline. As Ms. Pollard and Mr. Grohovsky, we believe that some increase in priority spending is warranted if growth were to slow significantly.

We encourage the authorities to contain fiscal risks from the National Health System (NHS) and strengthen the governance of state-owned enterprises. Raising Cyprus’ medium-term growth potential requires structural reforms to enhance productivity and improve public sector governance and efficiency. We take positive note of the authorities’ intention to implement policies aimed at addressing low labor productivity, promoting entrepreneurship, improving business interconnectedness, and enhancing access to finance, and welcome their plans to move ahead with local governance and judiciary reform. It would also be important to expedite the approval of legislation to strengthen the governance and autonomy of the Central Bank of Cyprus.

With these comments, we wish the authorities every success in their future endeavors. Thank you.

Mr. Moreno made the following statement:

As a general review, we share your message at the beginning, Chair, on the importance of commending the authorities for their efforts to achieve a remarkable fiscal adjustment and improving the asset quality of banks and NPL reduction during the robust positive cycle. We think it is important that authorities keep this path as a solid growth is likely to continue, and significant imbalances and legacies from the crisis remain, including high levels of private, public, and external debt and the still considerable stock of NPLs.

We share the staff’s overall assessment on the need to boost growth potential, secure financial stability, and to improve the efficiency of public spending and public services. We will have some specific comments about policies.

On fiscal policy, the authorities have sustained large primary surpluses since 2016. The projected budgetary surpluses would support the continued decline in the public debt-to-GDP ratio. The main concerns here are inefficient public spending and contingent liabilities, which create downside risks to the budget. Expenditure growth should be firmly controlled in order to maintain the current path of public debt, especially as the high level of debt levels in Cyprus make the country vulnerable to financial markets and growth shocks. There is also scope to address features of the tax system that may facilitate aggressive tax planning by multinationals, including by means of outbound payment.

On the financial sector the reduction of NPLs continues to be the central challenge. We welcome recent progress in reducing them, and they remain well provisioned, but the stock of NPLs remains very large and is the second highest in the euro area. The staff has been reassuring this morning on the measures undertaken by the authorities. We think this is a key priority for the authorities. I would like more comments on this because you were mentioning that there was this proposal by the central bank in relationship to the foreclosure procedure. How is that going politically? This is certainly a key priority for the authorities.

On the financial sector, it is also key that authorities effectively tackle AML/CFT risks, which also remains a priority. Finally, on the structural policies, the challenge here is to renew the reform drive and to boost the growth potential and to ensure better resilience and inclusiveness.

We will highlight a number of reforms; first, the need to strengthen public sector governance and effectiveness, including through an improved monitoring of the governance of state-owned enterprises (SOEs) and local government.

Second, improving the effectiveness of public employment services and reinforcing the support of the young population, including delivering on the reform of the education and the training system, to reduce the skill mismatches and improve inclusiveness and child education and care.

Third, focus on the investment-related policy on digital skills, research and innovation, and sustainable transport, and energy efficiency and renewable energy. And, finally, stepping up the efforts to improve the efficiency of the judicial system, which is also key in terms of the foreclosure system, including revising civil procedures, increasing the specialization of courts, and accelerating anti-corruption reforms.

Finally, on the debate between SPR and the authorities, we wish that you come to an outcome, and we particularly look to SPR in this case. On this we share Mr. Doornbosch's remarks. With these remarks, we wish the authorities success in their policy endeavors. Thank you.

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

Thank you, Mr. Moreno. I do not think that there is a debate between SPR and Mr. Doornbosch, but just try to clarify what is the fact, but I am sure they will find a solution.

Ms. Levonian made the following statement:

We welcome the economic recovery in Cyprus post the financial crisis and particularly the decreasing levels of unemployment. We urge the authorities to address the levels of youth unemployment, which remain elevated. The bill establishing the Court of Appeals is a positive development, as it should lead to a swifter process in adjudicating commercial claims, and we encourage the authorities to expedite the legislative process in this regard. We note that access to finance is perceived as the most problematic factor for doing business in Cyprus, and we were wondering if staff could comment on the initiatives, if any, taken by authorities in order to ease this constraint.

Finally, on the transparency policy, this chair has repeatedly raised concerns with the transparency policy and asked for its review. We hope that this issue raised by Mr. Doornbosch is adequately addressed to the satisfaction of both the authorities and the Fund. Thank you.

Ms. Pollard made the following statement:

I just want to make one point, and it is on this issue of Estia and the NPLs more broadly and maybe two points within that. Let me begin on the transparency policy issue. This chair has always strongly supported transparency and the need to be transparent and also the need for the Fund to speak with candor with the authorities, but I think the request that Mr. Doornbosch made preserves the information without being too explicit, and so I think it seems to fit a happy medium here. I think it is very important for the Board to have this information. I don't see that deleting one phrase is going to create huge problems with transparency, and so I do hope that a solution can be reached that will allow the authorities to publish the report.

A broader question on this issue of NPLs, and it is interesting that a couple weeks ago we discussed Greece, which is the country in the euro area that has the highest outstanding level of NPLs. These are obviously not the last housing crises that we are going to see that are going to spill over to housing, and so I think it would be interesting to look at best practices and what other countries have done to be able to resolve this and to reduce the longstanding NPLs. I think that would be helpful for the membership overall.

Mr. Inderbinen made the following statement:

It is welcome the confirmation you gave on the early repayment of the IMF outstanding credit, not only for debt management purposes of the authorities, but also to respect the revolving character of the Fund's resources.

In the gray we put out, we welcome the robust growth. We also commended the authorities for the prudent fiscal stance and encouraged strict spending discipline going forward. To that effect, we also encouraged or underlined the importance of fiscal structural reforms to underpin the strong fiscal stance going forward.

We had one question on the opportunity of conducting a fiscal transparency evaluation, and from the answer that staff helpfully provided, we understand that this has not yet been discussed with the authorities. And you also state in the written response the areas that the authorities are currently focusing on in strengthening public financial management (PFM), which seems fair. I was just wondering whether you might wish to elaborate a little bit on the values you might see that the authorities could take from undertaking such an evaluation going forward to underpin these efforts further.

Second, on the financial sector, like others, we underline the importance of ensuring continued work out of the impaired loans that still remain in the system, even if they are not in the financial system any longer. Thank you to staff for elaborating this morning on the possible contingency measures in place if the legislation would come to pass. It is currently under review by the Supreme Court. I was wondering if you could elaborate a little more on the mechanism you mentioned in your opening statement that would ensure this. I am not quite sure that I caught everything that you said on that.

On Estia, we stress close monitoring of the program and the importance to strengthen eligibility criteria going forward to limit moral hazard risks, in particular of the strategic default, the issue raised by Mr. Merk and Mr. Palei and Mr. Tolstikov in their grays.

And on the issue in paragraph 17, similar to Ms. Pollard, we support the principle of transparency and also the application of the transparency policy of the Fund. Looking at the sentence, it would seem like a typical sentence that is intended well and where the substance is completely correct but might generate some unintended consequences in the authorities' ambitions and policy steps going forward, so I do hope a timely resolution can be found on the deletion of the sentence in question. I would have thought this typically would be one of the issues that we should take up when reviewing the transparency policy next. It is not a statement of a fundamental assessment of the economic policies of the authorities that is in question, but it is more a sentence that seems to have got in the way of domestic deliberations. It would be valuable to have these examples in mind when we next review the transparency policy going forward.

We had a last point on the importance to strengthen governance going forward and the structural reforms there and in particular also the authorities' strategy to fight corruption, but we would stress that continued efforts are needed to strengthen the AML/CFT framework going forward, and we look forward to seeing the results of the upcoming mutual assessment in that regard.

Mr. Alkhareif made the following statement:

We would like to take this opportunity to commend the Cyprus authorities for the growth momentum and their efforts to address the legacies of financial crisis. Maintaining fiscal discipline would help in mitigating debt sustainability risks. Here we agree with staff that improving spending efficiency and having enough spending for structural reforms that enhance sustainable growth and inclusive growth would be a step in the right direction.

On financial sector, I echo the point raised by Mr. Moreno on the need to strengthen the AML/CFT framework. It is also important to continue the reforms to repair the banking system balance sheets to help address the legacy challenges. Mr. Inderbinen raised a good question about traction from Fund's TA, and I note the Legal Department TA to enhance the effectiveness of the NPL resolution framework. We take positive note of staff's answer that this has been broadly supportive of the authorities' reforms, and we are encouraged that the staff have close cooperation with the authorities on these issues.

On structural reforms, we are encouraged by the authorities' efforts to proceed with the reforms, including priority areas to address low labor productivity. I agree with Ms. Levonian on the need to enhance prospects of jobs to youth employment andimproving access to finance will also help in this area. We welcome the authorities' strategy to improve investment in ICT, infrastructure, STEM training, and research and development innovation.

On technology, we welcome the authorities' efforts to enhance digital strategy in the public sector with the focus also to improve digital transformation both in the public and private sector, as highlighted in Box No. 1.

If I may have one question on Figure 2 on page 25, I notice that the unit labor cost (ULC) has dropped significantly since 2012 and has remained low and would appreciate staff elaborations on the reasons behind the significant decline in labor cost.

Finally, I support the point raised by Ms. Levonian and Ms. Pollard on the need to rethink about the transparency policy going forward.

Ms. Endlich made the following statement:

We agree with Mr. Moreno and Mr. Doornbosch's remarks and would like to highlight the following points for further consideration. We fully agree with staff that Cyprus' adjustment, bolstered by significant reforms in recent years, has been remarkable. However, the reform momentum has slowed recently and needs to be reinvigorated as considerable vulnerabilities remain. Political pressure to revoke key reform measures needs to be countered, as it could weigh on future growth performance. Tackling financial sector vulnerabilities by further reducing nonperforming loans and addressing the low structural profitability of the banking sector is of high importance for financial stability and further growth. Escalating trade tensions or the continuing possibility of a no-deal Brexit could impact Cyprus' highly competitive service sector.

As a follow-up to staff's answers on the diversification of banks' revenue sources and the rationalizing of operational costs, could staff elaborate on the political resistance which banks face with respect to increasing fee-based income? Moreover, enhancing operational efficiency by reducing the number of employees has so far focused on voluntary retirement schemes to employees. How effective are these schemes, and are banks considering also nonvoluntary layoff of staff in order to increase operational efficiency?

We furthermore appreciate the increasing supervisory efforts to mitigate AML/CFT risks. In this context, we look forward to the upcoming MONEYVAL AML/CFT assessment, which should shed further light on how effective Cyprus' AML/CFT regime has become.

Mr. Merk made the following statement:

We have issued a gray, and we associated ourselves and do that again with Mr. Moreno's statement, so here I would like just to add my support to Mr. Doornbosch's request to delete the reference to possible schemes beyond the Estia burden-sharing scheme.

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

One of the questions was on the challenges to digitalization. As we have highlighted in the report, when we had the discussion with the Chief Scientist in Cyprus, one of the main issues that were raised was the lack of the human capital. Even though it is very skilled, the focus on STEM has not been sufficient. The other issue is that, as we have noted also in the public sphere, the investments in innovation and the creating of a digital infrastructure has been more limited, so the lack of overall digital infrastructure has also been a key constraint. The authorities are very much focused now on implementing a new digital strategy, they have just actually presented a legislation to Parliament for establishing a new Deputy Ministry for Digital Strategy and they have appointed a chief scientist as well. This is a key priority for the government.

On the issue of the mechanism, the key concern was that the code of conduct that was being implemented that is under the purview of the central bank was not being effective, which resulted in these amendments that gave more power to the financial ombudsman. Our view is that the overall compliance of the code of conduct should stay within the remit of the central bank in its capacity as a supervisor, so the central bank has been working on trying to see if a mechanism can address some of these concerns. We have not seen the details of the mechanism. Our understanding is they have been in consultation with the ECB, and something could be proposed by the end of the year, in which case if there is a political agreement on this, this could replace the legislative amendments.

On the issue of the access to finance, as we explained in our technical responses, one of the issues is that the interest rates remain very high. It has been declining, but relative to euro area, it is still quite high, which reflects the fact that the NPLs also remain very high. Other than the banking sector, the lack of access to alternative financing, equity financing, or any venture capital financing is a key constraint in Cyprus. And given the small size of the economy, this remains a key challenge. The authorities have undertaken some measures, including trying to establish an equity fund. The Cyprus Securities and Exchange Commission (CySEC) is involved in developing some regulatory measures here to facilitate capital raising for small and medium-size enterprises (SMEs). There is a credit guarantee scheme also with the support of Cyprus Investment Program (CIP) that has been implemented.

On the issue of fiscal transparency, this has not been something we have discussed with the authorities. The priority has been on implementing the PFM reforms. We note there are resource constraints. There is merit in approaching this, and we are happy to follow up with the authorities, but we need to be mindful of the resource constraints in undertaking these measures.

The question of the ULC in the selected issues papers, there is a chart that shows the breakdown of the components. The big drop actually comes from the decline in wages during the crisis andthis partly reflects the public sector wage cuts; but during the crisis, the private sector also took a big hit.

On the banking side, there has been a consolidation going on. Banks have been relying on the voluntary redundancy schemes. It is true that non-voluntary layoffs have been more difficult, and banks have raised the concerns about difficulties with the collective agreements in going that route, and this is a key challenge that the banking sector faces.

The staff representative from the Strategy, Policy, and Review Department (Ms. Gonzalez), in response to questions and comments from Executive Directors, made the following statement:

Just to react to some of the calls for a review on the transparency policy, as has been mentioned before, there is a review scheduled after the Comprehensive Surveillance Review (CSR) takes place, so these legitimate concerns will be included then. In the meantime, we are bound by the current policy. We are trying to accommodate and be as constructive as we can with the current concern, and we know that we will be able to find a solution that hopefully is acceptable to the authorities but also consistent with the current policies.

Mr. Doornbosch made the following concluding statement:

Thank you, Chair, and let me on behalf of the Cypriot authorities thank Ms. Tuladhar and the entire team, five great women and one equally great man, for their constructive engagement with the Cypriot authorities back in September.

Since the crisis, the authorities have been focused on crisis management in Cyprus, and rightly so. Cyprus' real effective exchange rate and the public debt and the private debt all needed to come down. The authorities with the support of the IMF and the EU institutions were successful in doing so. Cyprus' cost competitiveness increased sharply. Public debt reduction is on a solid downward path, and NPL levels decrease year after year with two major NPL sales expected, which should reduce the NPL level to total loans to 15 percent. Now that the implementation of public and private debt reduction is firmly on track, we can look further, and we can take a closer look at the structural challenges to the Cypriot economy; and in that light, the authorities very much appreciated staff's selected issues paper on the expert competitiveness and digitization in the banking sector. We would invite staff to further bolster this advice going forward.

Crisis management might be difficult, but bringing deep structural reforms to a good end might be even more difficult. Cyprus is engaged in the structural reforms on several fronts. To name a few, the wide-ranging reforms in the justice system, the rollout of the national health service, and an overhaul of local governments. Some of these reforms go smoothly. Others take more time than expected. It is the nature of politics that well-thought policy advice from the Fund can help build traction for these difficult structural reforms. I have also listened carefully to those Directors that encourage the Cypriot authorities to continue working on AML/CFT legislation and would like to confirm that the authorities have continued efforts on that part. For example, they are working on clarifying the definition of shell companies.

The Cypriot authorities have always greatly appreciated their interaction with the Fund. Something in this relationship will change—as the mission chief mentioned—as the authorities have announced that they will reimburse their 570 million SDRs of outstanding IMF credit. While doing so, they have also indicated that they want to keep up the enhanced policy dialogue with the Fund. This for me shows that after six years of intense engagement with the Fund since the 2013 approval of the SBA program, the authorities continue to see the Fund as a trusted advisor who adds value in preparing policy.

Finally, I want to thank all Directors for their comments. I would like to thank Directors for their support on the sensitivity of mentioning the complementary schemes. The comments by Directors confirm the authorities in holding up on their efforts on expenditure restraints and the NPL reduction while at the same time opening new avenues for structural reforms. I will relay these greatly appreciated comments to the Cypriot authorities.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong economic recovery and declining unemployment rate, and commended the authorities for the good progress in addressing banking sector vulnerabilities and improving macroeconomic fundamentals. Directors pointed out that productivity growth has been weak, reflecting institutional bottlenecks and the slow pace of technology adoption, and that private sector indebtedness remains high amid ongoing challenges in debt workouts. Looking ahead, given the significant downside risks, Directors encouraged further steadfast efforts to address crisis legacies by continuing to reduce debt vulnerabilities, improve public spending efficiency, and raise economic growth potential and inclusiveness.

Directors emphasized the importance of steady NPL resolution and sustainable debt workouts. They highlighted the need for ensuring a well-functioning NPL resolution toolkit, including through implementation of a credible foreclosure framework, along with complementary reforms in the judiciary. Directors also stressed the need to continue strengthening the supervisory and regulatory framework of credit acquiring companies and to finalize the governance structure of state-owned Cyprus Asset Management Company. They underlined the importance of minimizing moral hazard risks inherent in the state-subsidy scheme for primary homeowners (Estia).

Directors saw a need for broader efforts to further strengthen banks' balance sheets and profitability. They advised that banks should continue to maintain adequate provisions and capital buffers. Directors agreed that to ease pressures on profitability, policies should encourage lower cost-to-income ratios through diversifying income sources, rationalizing operations, and implementing digitization solutions. Directors noted that macro-financial risks from the property market appear limited now but warrant close monitoring.

Directors welcomed Cyprus's strong fiscal performance, and stressed the need to continue to reduce debt sustainability risks and to enhance the efficiency of expenditures. Directors considered that expenditure growth, particularly that of the wage bill, should be contained to keep debt firmly on a downward path and to prevent crowding out of productive spending. They agreed that there is scope to improve the efficiency of education spending and increase investment in technological innovation and human capital buildup to reduce skills mismatches and achieve more inclusive growth, particularly among the youth. Managing incentives and costs of services as well as ensuring the competitiveness of the public health sector is key to control fiscal risks from the recently implemented National Health System.

Directors emphasized that structural reforms are key to raise medium-term growth potential. Given low labor productivity growth and challenges to investment and economic efficiency, they called for policies to support greater market diversification, competition, and technology adoption. Directors welcomed the authorities’ strategy to improve STEM training and research and development innovation and to ease access to finance, as well as their national digital strategy. They recommended continued efforts to improve the efficiency of the judiciary and strengthen public sector governance. Directors agreed that mitigating existing inherent AML/CFT risks remains a critical priority.

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

APPROVAL: May 21, 2020

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 and risks

1. Considering that the UK is one of the top destinations of Cyprus' financial service export, could staff shed light on how the Brexit would impact the financial service export to UK, and whether some UK based financial service firms would relocate to Cyprus?

- While Cyprus' financial service exports to UK have declined sharply since 2014, UK remains one of the most important financial services markets of Cyprus, constituting around 5 percent of total financial service exports of Cyprus in 2018 (based on the bilateral trade in services data from ITC, UNCTAD, WTO, and Eurostat). On the one hand, Brexit is expected to further reduce existing financial service exports to the UK. On the other side, Brexit could bring opportunities to Cyprus financial service exports as some UK-based financial service firms might relocate or shift their business to Cyprus over time since Cyprus is a regional financial center. Net impact is ambiguous, particularly in the short-run, and to the extent that financial service exporters also include SPEs.

2. Given domestic demand's strong contribution to growth, could staff clarify the impact of low inflation rate on both medium-term growth and fiscal consolation objectives?

- While too low inflation could in general intensify the adverse effect of debt overhang on growth, such effect depends on other factors. In Cyprus, strong investment growth is financed primarily by foreign financing, including intercompany loans. Furthermore, the decline in nominal interest rates could mitigate the effect of low inflation on investments. Nevertheless, given limited monetary space to lower nominal interest rates further, growth could be lower in the event of an adverse shock.

- The impact on fiscal consolidation also depends on factors other than inflation. As discussed in the Staff Report, Cyprus's large fiscal primary balance is underpinned by strong spending discipline and Cyprus's long-term borrowing cost remains at record low levels. Debt sustainability analysis indicates that the large primary balance and real GDP growth, rather than real interest rate, are two primary factors contributing to the durable decline in public debt.

Fiscal

3. Given the benefits of further strengthening PFM, has staff discussed the possibility of conducting a Fiscal Transparency Evaluation?

- Staff has not discussed conducting a Fiscal Transparency Evaluation for Cyprus. Currently, the priority is on implementing the medium-term PFM Reform Strategy that was created in the context of the EFF-supported program. The authorities' efforts are continuing in this area. Accordingly, a short-term expert visited Nicosia recently to assist the authorities implement a performance-based budget.

4. Additionally, could staff comment on the potential fiscal impact from an unfavorable ruling by the Supreme Court on the wage bill, as well as the prospects for the constitutional amendment mentioned on page 15?

- On March 29, the Administrative Court ruled against the government in relation to public sector wage cuts which were introduced in 2011/2012. According the authorities, the unfavorable ruling by the Supreme Court would frontload the reversal of the wage cuts that already is implemented and would imply an additional net payment of €844 million over the period 2019–22 (€264 million in 2019, €234 million in 2020, €194 million in 2021, and €154 million in 2022). However, the authorities assured the mission that there is a political agreement in place to enact a constitutional amendment to nullify the adverse fiscal impact in the event of an unfavorable ruling in the appeal, given the damage to the fiscal position and market perception such a ruling would entail.

5. Could staff comment on the status of the launch of the NHS initially planned for June 2019 and whether this has led to a temporary increase in the fiscal outlay so far?

- The first phase of the NHS, which brings outpatient and pharmacy services under the national insurance system funded by social contributions, was launched in June 2019, as planned. The second phase of the NHS, which will bring inpatient services under the system, will be launched in June 2020.

- By design, the launch of the NHS increases the fiscal outlay on social transfers, as many healthcare providers who were not associated with the state healthcare sector are brought under the national insurance which is part of the general government. This additional fiscal outlay is matched by additional social contributions.

- However, the launch of the NHS has led to a temporary increase in the fiscal surplus in 2019. This increase stems from the fact that social contributions have been collected since March 2019 while the NHS service begun only in June 2019. The difference in the timing has generated an estimated 0.5 percent of GDP surplus this year. The saving is temporary because it stemmed from the difference in the timing of the start of revenue collection and fiscal outlay. Roughly the same size of a temporary fiscal deficit is projected to arise in 2020 when the second phase of the NHS is implemented, while the system is expected to balance every year thereafter.

Financial sector

6. Given the concentration of NPLs in the two largest banks, what are in staff's view the incentives to develop an NPL market?

- One of the main strategies for banks to reduce NPLs is to offload NPLs through sales to third-party foreign investors, similar to the recent sale of Helix I portfolio by the Bank of Cyprus. Investor appetite appears to be strong as indicated by the non-binding bids received by banks. This may reflect the ample liquidity conditions as well as prospects for underlying value recovery. The authorities have also enacted a series of laws including the sale of loans law which facilitates access to data for a proper assessment and the securitization law. Nonetheless challenges remain given the small size of the portfolio and uncertainties in the foreclosure framework, as outlined in Annex VI.

7. Could staff provide more details on the composition of the collaterals and their recoverability?

- Information on system-wide composition of collaterals is unavailable. Based on the financial statements of two largest banks, 70-80 percent of NPLs are backed by collaterals. These collaterals include residential property, commercial property, hotels and hotel apartments, plots, farmland and other land. NPLs backed by primary residence would be potentially be eligible for Estia scheme. For NPLs backed by other types of collaterals, anecdotal evidence and reports from banks and credit acquiring companies suggest reasonable recoverability of these collaterals, though time taken to recover the value of these collaterals vary by the types of these collaterals.

8. We would be interested to learn whether the scheme (Estia) is still expected to have a fiscal cost of around 4 percent of GDP?

- The estimated impact of 4 percent of GDP is the maximum amount based on an assumption that all Estia-eligible borrowers apply and are approved for the scheme. The fiscal cost will likely be lower than this estimate to the extent that the take-up rate is lower.

9. Staff comment on the prospects of finalizing the governance and operational structure of the Cyprus Asset Management Company to speed up debt workouts, would be welcome.

- According to KEDIPES's plans presented during the mission, several actions on this front are scheduled for 2019Q4-2020Q2. It includes finalizing the governance structure (2019Q4); setting up CEO process and control functions (2019Q4); and setting up and implementing the new organization structure (2020Q2). The appointment of an advisor is expected to facilitate these processes.

10. Also, can staff comment on the effectiveness of the 2018 TA by LEG on the legal framework for NPL resolution?

- The 2018 amendments to the foreclosure and insolvency legislation and the sales of loans law, which were underpinned by the 2018 LEG TA, all aimed to enhance the toolkit to address NPLs on a durable basis. The strengthening of the foreclosure framework in July 2018 has led to increased foreclosure initiations, sales of properties and greater willingness of borrowers to engage in NPL restructuring generally. Importantly, the effective implementation of these amendments needs to be supported by structural reforms, particularly of the court system and processes for the issuance and transfer of title deeds. Recent amendments to the foreclosure rules (currently under review by the Supreme court and not yet effective) have created legal uncertainty regarding the foreclosure framework as amended in 2018. Staff are closely monitoring the developments in this regard and stand ready to assist the authorities as needed.

11. Access to financing due to high borrowing costs has been cited as the single most problematic factor for doing business (Paragraph 27). This is somewhat puzzling in a context where interest rates on new loans have been lowered, liquidity is excessive (Paragraph 15) and slow credit growth arises primarily from weak demand for loans (while recognizing that deleveraging by banks may be constraining their lending operations). Staff's comments are welcome.

- Though interest rates in Cyprus have been declining, they remain high relative to the euro area economies (see text chart for Paragraph 7), reflecting the still high level of NPLs and risk averseness of banks. Financing difficulties also refer more broadly to limited use of alternative financing sources such as equity and venture capital financing. Rapid investment-led GDP growth in the past years was mostly financed via FDI, intra-company loans or retained earnings. Weak demand for loans reportedly also reflects lack of good-quality projects with sufficiently high returns. This has contributed to sluggish credit growth and excessive liquidity in the banking system.

12. Noting that non-resident banking services are declining and domestic competitive pressures are rising, is there scope for domestic mergers of Cyprus' smaller banks?

- On aggregate, the banking system in Cyprus has relatively low operational efficiency compared with euro area average, marked by its large number of branches and employees. The banks are in the process of consolidating their branch network and rationalizing their workforce. Some consolidation of smaller banks is underway such as the acquisition of the USB Bank by Astrobank earlier this year.

13. Credit pickup has stayed weak. Is it the reflection of a fall in banking assets with transfer of two large NPL portfolios to credit acquiring companies, or there are some other specific reasons? Staff may like to comment.

- The transfers of NPL portfolios to credit acquiring companies have reduced the stock of bank credit, but these transfers are not counted as part of the credit flows used to calculate credit growth— a methodology followed by the European Central Bank. Growth of net credit transactions, defined as pure new loans and interest accrued minus repayments, remained weak. The growth of pure new credit to domestic residents, though positive, has been decelerating for the most part of the year.

14. Aside from digitalization, could staff elaborate more on how banks in Cyprus could diversify their revenue sources and rationalize operational costs?

- To diversify revenue sources, banks are exploring opportunities for international lending through syndicated loans and domestic lending in sectors with high-growth potential such as the sectors of energy, shipping and education. Given that Cypriot banks rely mainly on interest income, banks could potentially increase fee-based income, although this has met some political resistance recently.
- To rationalize costs, Cypriot banks should enhance their operational efficiency, which are low compared with their euro area peers, as reflected in the large number of branches and employees. While ensuring the quality and adequacy of services, banks could reduce the number of branches and employees. Banks are in the process of consolidating branches and offering voluntary retirement schemes to employees. Some banks have announced negative deposit rates on large institutional customers.

15. Could staff comment on measures that are being considered by the authorities to use of technologies to improve banks' efficiency?

- CBC has transposed the EU Directives based on the category of the activities. For instance, CBC has transposed the EU Directive on payment services in the internal market, and the provision of electronic money services in Cyprus is regulated by the provisions of the Electronic Money Laws of 2012 and 2018 which were transposed into national legisations. Cyprus has also adopted the strategies of the European Commission in the area of network and information security. Banks' digitalization activities are subject to EBA's guidelines on outsourcing arrangements, where outsourcing risk management includes risks assessment landscape; due diligence for the selected service providers; assessment of contract provisions and considerations; continuous oversight and monitoring of service providers. The authorities' regulatory agenda for technology in banks is generally guided by that of EBA, ECB and EC.

16. Could staff also elaborate on the current regulatory landscape for fintech in Cyprus?

- EU-wide fintech regulations and guidelines are applied in Cyprus, which is technology neutral and depends on the activities carried out by the fintech business concerned. The regulatory authority for the authorization, operation and supervision of payment institutions, is the Central Bank of Cyprus (CBC). The financial regulator is the Cyprus Securities and Exchange Commission (CySec), which is responsible for the supervision of the Cyprus Stock Exchange; licensed investment services companies, collective investment funds, fund management companies, including fintech companies. CySec has been actively establishing dialogue with businesses providing emerging financial technologies to determine and accelerate their business models. For example, Cysec is currently in the process of developing regulations on crowdfunding for startups to avoid potential risks. The cyber security regulation is already in place. In addition, Cyprus aims to be among the first country to regulate aspects of Distributed Ledge Technology (DLT). In this regard, the bill to establish a Deputy Ministry of Innovation and Digital Policy, which will act as the coordinating body and oversee the digital transformation in different sectors in the country, has been presented to Parliament.

17. Could staff elaborate on the role of Fintech to increase financial service digitalization?

- Banks are currently using fintech to enhance financial service delivery. Currently, the digitalization strategies of the two biggest banks focus on three pillars: 1) client-facing enhancement; 2) improvement in the internal process procedures; 3) providing tools to improve staff performance. Some examples include the enhancement of mobile banking applications, outsourcing of certain functions including data and email management, and replacement of payment system and card management. While competition from fintech companies for Cypriot banks has been mostly absent, as domestic fintech companies largely provide non-bank financial services and are not direct competitors with banks. Nevertheless, financial services provided by global fintech firms, such as Revolut, are on the rise.

18. We would appreciate staff's comments whether stricter CIP controls could dampen house price increases in specific segments.

- The luxury segment of the real estate market and the construction sector have picked up rapidly, supported by strong CIP-related demand by nonresidents for luxury properties in some coastal areas. In the past, staff has called for decoupling eligibility requirements of the CIP scheme from real estate to avoid excessive concentration of economic activity in this sector, over-supply of luxury properties and the risk of a future sharp price correction. To address concerns recently raised by the EC, the authorities have put a cap on the number of citizenships granted under the scheme, raised the threshold for real estate investment and established a Registry of Service Providers for the CIP scheme. While it is premature to see their effect, the stricter CIP controls appear to be limiting the number of applications which could cool the demand for luxury properties and weigh on prices over time.

Structural issues

19. Finally, did staff carry out any analysis on the issue of climate change?

- Staff did not analyze climate change-related issues in this Article IV consultation. Given limited resources, the focus of this consultation was centered around broader banking sector challenges and Cyprus's sluggish productivity growth and medium-term growth potential. Cyprus's climate-related policies is guided by the EU policy framework, an area of increasing focus reflecting the "green mandate of the new Commission and the new EU Parliament. Staff plan to look at climate-change related issues in the 2020 Article IV consultation, building on Fund's cross-country works that are underway.

20. The figure in paragraph 28 of the report lists corruption as one of the problematic factors for doing business. Could staff comment on the authorities' efforts to address this?

- Cyprus has recognized the threats associated with corruption and has established a number of measures to address this. A National Strategy against Corruption was approved by Cyprus' Council of Ministers in June 2017 with the objective to demonstrate the country's commitment to fight corruption, to identify high risk areas and to increase full transparency. A national AML/CFT Strategy endorsed by Cyprus' Council of Ministers in March 2019 added a double pronged approach by using AML/CFT measures which included action points to monitor the implementation of anti-corruption measures. Further, Cyprus' Police has developed a strategy for the years 2019 to 2021 which contains among others a pillar aimed at fighting corruption.

An internal affairs service has been established within the Police inter alia to investigate corruption cases within the Police. Conviction cases show that Cyprus has effectively tackled corruption in some cases by offering immunity to bribe-giving construction companies to turn evidence against bribe-receiving public officials.

21. We would be interested in staff providing more details on the actions planned to enhance the country's connectivity that would translate into greater geographical diversification.

- Efforts are already underway to improve external connectivity, given Cyprus's low air and maritime connectivity, and relatively weak digital connectivity. The measures aim to enhance Cyprus' position as a regional business hub. In the area of digital technologies, this includes the formulation of a Digital Strategy. In maritime transportation, these efforts include major investments in infrastructure and the deregulation and privatization of sea ports. In air transportation, an open skies policy has been adopted, and the airport operator Hermes Airports offers incentives for airlines developing their business in Cyprus; and the deputy ministry of tourism are reaching out to transportation service providers to start common travel package to utilize tourists who travel to neighboring countries.