Funding Economic Development and the Role of National Development Banks

The Case of Cyprus

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Key Points

- Prior to its privatisation in 2008, the Cyprus Development Bank played an important role in the economic development of Cyprus, intermediating international finance from multilateral development banks.
- This function was subsequently undertaken by commercial banks, which are currently limited by balance-sheet fatigue, however, and lack necessary elements for successfully executing this role.
- Our analysis shows a current void of institutional capacity in funding growth-bearing projects.
- Proceeding in a normative way, we recommend reinstalling a development finance agency that will tackle the issues by swapping equity for debt relief.

Introduction

Cyprus has suffered two economic devastations in the past 50 years: notably, the period after the Turkish invasion of the island in 1974, and the current period following the 2013 bail-in. It is worth comparing these two periods, thereby examining the role of the Cyprus Development Bank (CDB), the country's national development bank (NDB), in the period after the Turkish invasion and its absence in the period since the bail-in, given its privatisation and change to a commercial bank in 2008.

The invasion's aftermath was far more catastrophic than the impact of the bail-in. Following the invasion, more than one-third of the population was forcefully ousted and had to be accommodated and re-employed in what remained of the country, which was relatively underdeveloped compared to the captured and occupied part. Concomitantly, as an oil-dependent country, Cyprus had to face rising oil prices following the 1970s crisis, along with the necessity for adapting its manufactured goods to European Community standards, in preparation for proceeding to an EU Association Agreement (EIB, 1971: 143). Yet an 'economic miracle' was performed. What were the key factors that contributed to rebuilding an economy that was in every respect shattered?

It is not our purpose to account for all the factors that played such a role. We will, however, highlight some differences exhibited in the 2013 crisis and why we think the latter proved to be harder to overcome. Foremost, in 1974, although the loss of assets on the balance sheets of economic actors was massive, private debt remained low. Any debts that were related to the occupied areas were suspended, and those losing a substantial part of their assets in these areas had a smaller, but nevertheless clean balance sheet to start from in recovery. The financial situation of economic actors was satisfactory, but the country needed sufficient funding sources, most importantly, to be directed towards viable projects. This is where the CDB was in the position to play a vital role. With the World Bank (WB) starting to support the CDB in 1972, other multilateral development banks (MDBs) such as the European Investment Bank (EIB), the Council of Europe Development Bank (CEB) and bilateral development banks (BDBs), namely the Kreditanstalt für Wiederaufbau and the UK Export Credit, were keen to follow with funds and technical assistance (TA), on condition that the CDB investment proposals would be bankable.

The Cypriot 'government, with the objective of making CDB the major instrument of development assistance to industry and tourism, restructured and refinanced CDB in 1976 with WB assistance' (WB, 1984: 1). This was necessary as the CDB had lost more than half of its assets in the occupied part of the island but 'retained the liabilities related to borrowings incurred to finance the projects' (WB, 1984: 4). The 'CDB became essentially a quasi-government institution, but its operational independence has been safeguarded' (WB, 1984: 4). In 1991, the CDB ceased to be 100% government-owned when the EIB acquired 5.5% of its share capital, increasing the stake to 12% in 1996. Most importantly, however, MDBs have been the CDB's primary funding sources. This allowed the CDB to concentrate 'exclusively at medium and long-term, but [it had] to borrow all its resources' (WB, 1979b: 8). MDBs, as back-to-back financiers, have supported the CDB in its centre-stage role of reactivating the economy within the framework of three successive Cypriot emergency action plans after the 1974 catastrophe. They had initially replenished the CDB's exhausted foreign currency resources and, after its restructuring in 1976, they supplied it with credit lines for both debt and equity in new viable investments, mainly export-oriented manufacturing and tourism. Additionally, MDB support further reinforced the CDB's know-how (WB, 1979b; WB, 1984; and interview material). Consequently, MDB endorsement prompted commercial banks to crowd into major CDB projects. For all the CDB's performance, MDBs were disagreed about its role, with some preferring its involvement in key infrastructure projects (interview material), while others aligned with the government's focus on the private sector to constrain public spending (WB, 1976b: iii). Recognising the CDB's contribution to stimulating 'dynamic and responsible entrepreneurship' (WB, 1976b: iii), satisfied by its financial performance and using the recommendations of the 'report on industrial opportunities survey mounted under [United Nations Industrial Development Organization] auspices' (WB, 1976b: 12), the MDBs pushed the government to rehabilitate the CDB (WB, 1976b: 8), so that it could continue acting as a catalyst for investment and economic growth.

By contrast, the 2013 crisis came while Cyprus was claiming a role as an international financial centre, which resulted in unproductive loans being dumped on the local economy, mainly stemming from the great influx of foreign funds deposited in Cyprus banks. This was the key difference between the situation after the devastation of 1974 and the predicament the country found itself in after 2012. In 2013, private debt was at a world-record high, weighing most heavily on Cypriot economic entities because deposits were mostly pledged to foreign creditors. In 2020 in Cyprus, private debt remains extremely high, and it is still hard for a large number of economic actors to make ends meet, let alone service their existing loans. The only realistically possible objective for banks, therefore, is to maximise their returns by using the only recourse available, capturing any collateral and guarantees of existing non-performing loans (NPLs). One might ask why this is the only remaining purpose for banks. A bank cannot grant sufficient new productive loans with adequate repayment capability in a faltering economy without enough creditworthy entities and lacking domestic demand to bring in new viable investments. In 2013, as in 1974, the world was in a recession. However, unlike the previous crisis, in 2013 Cyprus did not have an NDB because the CDB was now in private ownership.

The importance of NDBs as institutional capacity and potent industrial policy instruments for economic resilience and development has been sufficiently stressed by MDBs (Diamond and Gulhati, 1973; WB, 1976a)[1] and academic scholars (Botta et al., 2018; CGD, 2016; Griffith-Jones, 2016; Humphrey, 2015; Mertens and Thiemann, 2017; Mohieldin et al., 2018; Naqvi et al., 2018; Rubio, 2018; Stiglitz, 2019; Xu et al., 2019). The recent global crisis thus triggered a resurgence of NDBs and led several countries, developed as well as developing and among them Portugal, Malta, Romania and Greece (Rubio, 2018), to create them anew, regardless of whether they had ever had an NDB or had one and privatised it (Naqvi et al., 2018). As a result, in the EU currently only Cyprus is without such an institution, and the issue has not been addressed.

While building on existing secondary sources regarding cooperation between MDBs and NDBs, the developmental role of the banking sector and the economic history of the two major contemporary crises in Cyprus, the present study predominantly relies on primary sources. These include macroeconomic statistics; data on MDBs' operations in Cyprus; and seven semi-structured interviews with key officials of MDBs, the CDB, the Cyprus

[1] From an apologist in the 1990s, the WB became a disparager of NDBs, but reverted after the outbreak of the world economic crisis in 2008.

Ministry of Finance (CMF) and a member of the Cypriot Parliament, carried out in May 2019. Unfortunately, statistical data could not be obtained from Cypriot sources because the CDB has been privatised, and the Central Bank of Cyprus refused information on grounds of confidentiality.

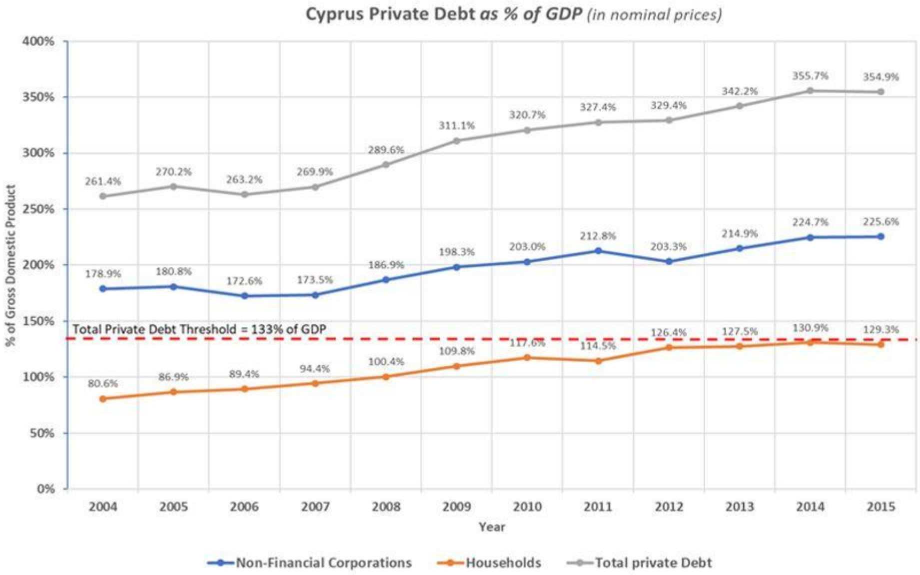
The case of Cyprus is revealing because there are two crises to study within 50 years: one with an NDB in place and the other without one. We proceed with a twofold contribution. Through a historical investigation, we demonstrate the correlation between the existence of an NDB and economic recovery in Cyprus, and a current lack of institutional capacity for supporting industrial policy by funding projects and offering related advisory services. We posit that an NDB could address the current market failure in viable investment financing and, in a normative way, we recommend the establishment of an NDB or development finance agency (DFA), also proposing an appropriate model.

This article is organised as follows. The next section presents the role of private debt in the current economic context in Cyprus. This is followed by a demonstration of the need for an NDB/DFA to spearhead economic recovery, and a subsequent proposal of a model for such an institution. The conclusion summarises the main findings.

Private Debt Holding the Economy to Ransom

Cyprus's total private debt in 2013 was at a world-record high of about 350% of gross domestic product (GDP) (Figure 1). Moreover, while loans weighed almost entirely on Cypriot economic actors (Savvides, 2016), deposits were largely owed to foreigners.

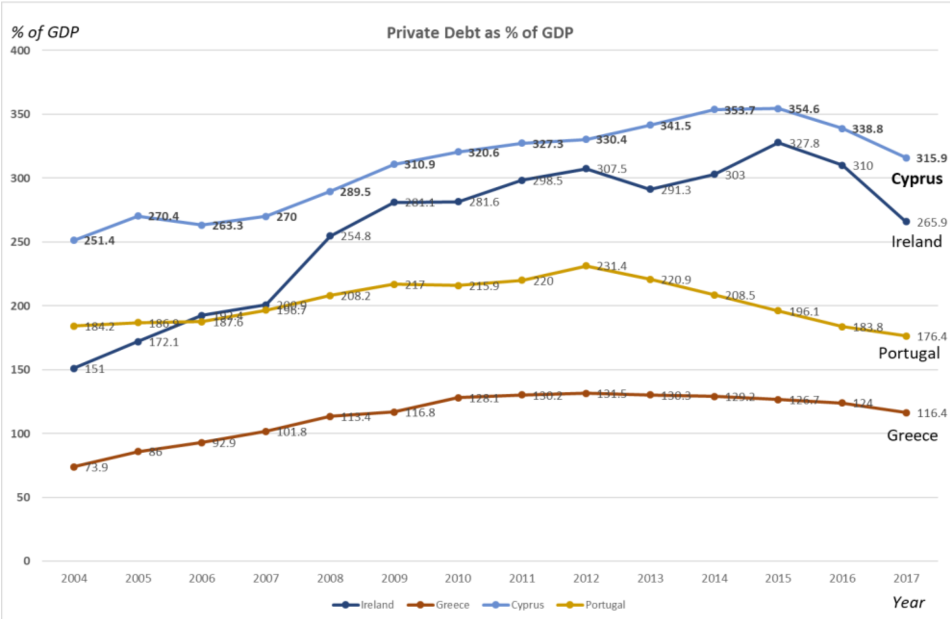
Figure 1: Private debt—percentage of GDP, 2004–2015



Source: http://ec.europa.eu/eurostat/web/macroeconomic-imbalances-procedure/private-sector-debt-consolidated.

Despite an attempt at window-dressing through legislative facilitation provided to banks to sell off their loans, so that the country could pretend that private debt has been reduced, the actual total private debt remains as high as ever. Private debt rose from 330% of GDP in 2012 to about 354% in 2015, falling only marginally to 316% in 2017 (Figure 2). It has remained significantly higher than in all major EU countries except Luxembourg, where the local economy is not affected because the risk is not internalised, as private debt is mostly both owed to and owned by companies outside the country.

Figure 2: Total private debt—percentage of GDP, 2004–2017—select EU countries

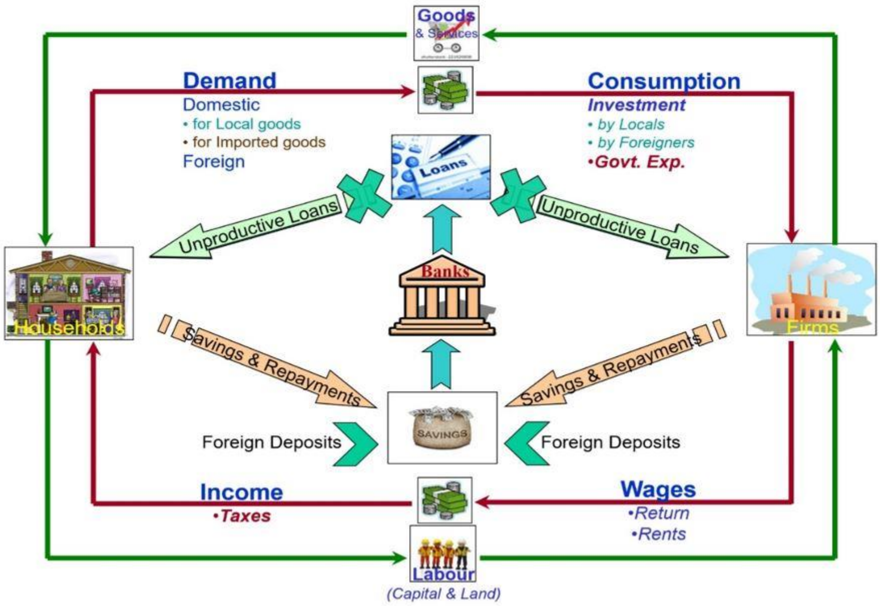


Source: http://ec.europa.eu/eurostat/web/macroeconomic-imbalances-procedure/private-sector-debt-consolidated.

In excessive private debt conditions (Figure 3), as currently in Cyprus, only a few potential borrowers remain creditworthy for new loans. Moreover, because a large part of income needs to be channelled towards loan repayments,[2] domestic demand suffers and this, in turn, makes investment opportunities scarce. In such situations, the banks are unable to channel new viable loans productively, back into the economy using the savings collected from repayments. The recourse route is therefore the only option available to banks, though it transfers wealth from the people to the banks. This further weakens the balance sheet position of economic agents and makes them even less creditworthy and less capable of receiving new funding.

[2] Cypriot economic agents have dissaved to support their consumption (Manison and Savvides, 2017). Paradoxically, this has kept the economy from falling into a recession, which Koo (2015) argues will eventually happen when loan repayments are resumed.

Figure 3: Economic and financial flows



Source: Savvides, S. (2019).

Inevitably, these circumstances have engendered a recession (Koo, 2015) and secular stagnation (Hansen, 1939; Summers, 2014), either from the demand side (Dutt and Ros, 2007) or the supply side (Gordon, 2015). These conditions are further aggravated by the evident divergence between core and periphery in the eurozone, attributed partly to the quantitative easing (QE) policy of the European Central Bank (ECB) since January 2015. Aimed at stabilising the eurozone financial markets and credit systems, the policy has resulted in a limited injection of fresh resources to peripheral economies for purchasing domestic assets or providing domestic loans, since a significant part of the QE back-tripped and 'inflated' core economies (Botta et al., 2018: 20), sidelining the tools for smoothing the economic cycle.

The requirement to finance economically viable investments and the need for an NDB to spearhead economic recovery is vital in situations of excessive private debt. Sustained development results only from the productive use of economic resources to create real wealth. When conditions are conducive to productive investments, prudent funding facilitates the course of economic development. These conditions, however, do not currently exist in Cyprus. Soaring debt and the increasingly wasteful use of financial resources contributed to the culmination of the 2013 financial crisis, the aftermath of which left the economy with a huge pile of unproductive loans and economic agents with broken balance sheets. Many economic studies have shown that the fast growth of private debt eventually leads to a marked slowdown in economic growth, as diminishing returns set in from the use of abundant finance (Hudson, 2012; Mian and Sufi, 2014; Vague, 2014b). Most notably, Koo (2015) coined the term 'balance-sheet recession' to describe the recession that inevitably follows from ignoring the problem of excessive private debt, which weakens the two requirements essential for an economy to grow and develop on a sustainable basis—first, clean balance sheets among economic agents; and second, manageable private debt and the ability to repay this—as it depletes equity and makes economic agents not creditworthy. In turn, insufficient aggregate net income results in feeble domestic demand and scarcity of viable investments. This sets the economy on a downward spiral that, as Koo argues, results in a long and possibly deep balance-sheet recession like the one experienced in Japan in recent decades. This, in turn, has been attributed to one of the factors leading to secular stagnation, as economies are unable to operate below full capacity owing to structural weaknesses, triggering deficiencies in aggregate demand (Summers, 2014). To improve the resilience of the financial system and the amplitudes of the financial cycle, the ECB, among other central banks, has been concentrating on the first, while neglecting the second (Thiemann, 2018). Consequently, calls for increased institutional capacity have become increasingly vocal, and especially for curbing 'the diverging dynamics between the core and the periphery of the Eurozone' (Botta et al., 2018: 23). The importance of industrial policy foreseeing an increased role both for MDBs (Botta et al., 2018; CGD, 2016; Humphrey, 2015; Mohieldin et al., 2018) and NDBs (Humphrey, 2015; Manison and Savvides, 2017; Morozkina, 2015; Rubio, 2018) has been stressed anew. This was the approach followed worldwide in the first decades of international development after 1948. In this direction, the WB pioneered partnerships with NDBs, starting with the Development Bank of Ethiopia in 1950 (WB, 1976a), establishing a path-dependency approach subsequently followed by all MDBs, leading them to channel their funding to small- and medium-sized enterprises (SMEs) through NDBs (CEB, 2017; Gordon, 1983; Lewenhak, 1982; Unwin, 1999; WB, 1976a). Intermediated finance through NDBs developed rapidly with the WB, from 6 partner NDBs in 1960 to 68 within 15 years while, volume-wise, this activity represented 20–30% of MDBs' annual lending (WB, 1976a), having been successfully applied during the first Cyprus crisis through the CDB (CEB, 2017; CMF, 2019; WB, 1984; and interview material).

There are two contradictory schools of thought regarding how to deal with a failed economy in extreme conditions of private (and public) debt. The predominant one, the neoclassical view, ignores private debt and argues that, through a process of 'creative destruction', new investment will take place, and the bad will be replaced by the good. In other words, the market will work things out so long as there is no outside interference (Schumpeter, 1942). The other school, initiated by Minsky, argues that private debt cannot disappear, certainly not without huge negative economic consequences (Minsky, 1992). Cypriot policymakers endorsing the first approach, however, have embarked on a policy of saving the banks in the belief that this will bring recovery. However, this is, at best, a myopic attempt to deal with the real problem, which is the gargantuan private and mostly unproductive debt suffocating the economic agents. In situations of widespread and overwhelming private debt, as currently exists in Cyprus, there is not much of the real economy left unaffected. In the absence of viable lending, banks have no purpose other than seeking to recover pledged assets and collateral from the indebted economic actors. Cypriot banks have, therefore, transformed themselves from providers of finance to insolvency practitioners and asset management companies. Further to the need for increased aggregate demand, there are also reasons for overhauling institutional arrangements and appropriate industrial policy in order to restart the economy through viable investments. Beyond financing, NDBs have the objective of identifying and designing such projects (Manison and Savvides, 2017). Thus, economic development both depends on and contributes to the growth and diversification of the financial sector. 'The rate and character of development, meanwhile, are influenced by the priorities and efficiency of the sector's institutions and instruments' (Gordon 1983: 5). It is thus imperative to have in place a mechanism through which refinance assets and released resources can be channelled into new viable projects.

Having replaced informal moneylenders since the nineteenth century, commercial banks aim at assembling savings and providing funding, mainly in the form of loans for high-yield activities. Because banks traditionally focus on short-term lending (WB, 1983; Morozkina, 2015), 'term lending runs counter to their institutional habits, attitudes, criteria, and procedures' (Gordon, 1983: 5). In Cyprus, the banks are not able to trigger recovery by themselves because:

1) They do not have adequate project finance tools and expertise.
2) They cannot act as investment/development banks because they cannot simultaneously be a lender and a shareholder.
3) Banks are individually unable to disentangle the complex funding web of existing businesses (most of which are financed by more than one bank, with all holding different collateral and undertakings on the same assets). In such situations, it is almost impossible for a new financing structure proposed by one bank to gain the consent of another.
4) Even if it was possible for a bank to convert part of its loans into equity funds (and assuming other banks would consent), the bank would be in a conflict of interest deadlock by acting in parallel as both lender and shareholder.
5) A worse impact of the uncontrolled and wasteful credit expansion is that the equity capital-base of economic entities has been almost totally depleted. The bank's recourse—collecting on its collateral and guarantees—is argued to be a cure for the country's economic woes. But as often remarked (Savvides, 2014, 2015, 2016), this will lead to a huge loss of value and a need for further recapitalisation because it

> does nothing to tackle the root cause of the problem, which is the restructuring needed to fund new, viable investments.

The inability of commercial banks to promote development has been the main reason for establishing NDBs across the world since the Second World War. NDBs were created to spearhead growth by diversifying the financial sectors, and 'by being a laboratory, an example, and a source of initiative' (Gordon, 1983: 7). Through 'long-term credit to targeted industries considered vital for growth, but which the private sector was too risk averse to finance' (Naqvi et al., 2018: 3), 'in marked contrast to the short-term perspective that dominates in private financial markets, development banks can help design, fund, and coordinate expertise in specific areas of investment' (Stiglitz, 2019: 61). Additionally, the intermediation of NDBs with MDBs, on one hand, and with commercial banks, on the other, leverages their impact through high multiplier effects (Griffith-Jones, 2016). This constitutes the most important reason for an NDB to lead the way for new, viable investments in Cyprus, aiming not at 'curing' existing loans but rather creating new business structures. Furthermore, an NDB can handle many of the bigger loans, which, as noted, are entangled in a complex web of loans, collateral and other securities (fixed/floating charges and personal guarantees) lodged with many banks independently. There is thus a need to have a reliable mechanism that can ensure viability (adequate return and acceptable risk profile) in order to enable new equity to start flowing from potential investors. In lending, NDBs have traditionally assumed the double role of financial institution and development agent (Diamond and Gulhati, 1973: 18). Their intermediation of international finance takes the form of credit lines received from MDBs, which they channel to smaller-scale undertakings according to pre-agreed eligibility conditions. As the intermediated funding is injected into the real economy at longer-term maturities, and in some cases with tax exemptions, there are clear benefits for the final beneficiaries, including occasionally lower interest rates. The NDB's role was, however, swept away, and a lot of them have been abolished or sold as a result of the neoliberal euphoria wave of the late 1990s, despite having never been an 'étatist' policy instrument (Diamond and Gulhati, 1973). Many of them have been privately owned, or some or all of their shareholders have been private (WB, 1976a). At the national level, NDBs have been promoting national macroeconomic and development goals, while at the international level, their intermediation of MDB funding has assured their alignment with global development objectives, key areas and practices, which NDBs in turn diffused through their domestic business communities, often in the form of TA. Their due diligence scrutiny, not only of financial merits but also of technical, environmental and economic viability (Diamond and Gulhati, 1973), in path-dependency on MDBs assured that projects they financed would generally have positive economic and social impact, with an average economic rate of return up to 23% (WB, 1976a). Furthermore, NDBs have often passed on their expertise to domestic actors in the form of proactive advising or 'leading by example', as part of a two-way process of mutual influence. Additionally, NDBs often contributed to the development of domestic capital markets by broadening and diversifying their sources of funds, escaping their original dependency on official resources, representing a median of some 80% of their funds (Diamond and Gulhati, 1973: 11).

In Cyprus, the activity and role of the CDB for economic recovery after the Turkish invasion in 1974 was decisive up to its privatisation in 2008 (CEB, 2017; Kavvadia, 2011; Unwin, 1999; WB, 1984; and interview material). The WB was the first MDB to start operations in Cyprus in 1963, and it ceased as Cyprus climbed the development ladder, with its last loan approved in 1991. In its 30 years of operations, the WB provided 30 loans in Cyprus totalling US$418.80 million. Of these, US$14 million (3% of the total), were to the private sector, using the CDB as its sole intermediation partner for three loans, starting in 1972. With an average multiplier effect of 6%, the WB viewed its impact through the CDB as very satisfactory. Solely through the WB's last credit line to the CDB of US$5 million, signed in 1979, 77 SMEs have been financed, creating and/or securing 850 jobs (WB, 1983). The WB ceased its cooperation with the CDB in 1983 when the latter indicated that 'further loans for its normal operations [were] not essential' (WB, 1983: 12). Cyprus became a CEB member in 1963, but the bank began its loan operations in the country after the Turkish invasion, with the exception of a very small loan of €1 million (current equivalent) for reconstructing two villages after a natural disaster in 1969. Between starting its regular activity in Cyprus in 1976, and up to the CDB's privatisation in 2008, the CEB loaned a total of €2 billion in Cyprus (current equivalent), of which €417 million (21%) was to the private sector, exclusively through the CDB. As of May 2019, the CEB had loaned a total of €2.4 billion in Cyprus, which remains one of its ten largest borrowers (CMF, 2019). No loan has been provided, however, for the private sector, and no intermediation with another banking institution has been set in place, since the CDB's privatisation. The CEB was the largest source of multilateral funding for Cyprus until 2001, when it was passed by the EIB, which stepped up its activity before and during the country's accession to the EU (CMF, 2019).

The EIB started its operations in Cyprus while the WB was phasing out. From its start in 1981 and up to the privatisation of the CDB in 2008, the EIB loaned a total equivalent to €1.7 billion in Cyprus,[3] mainly after the country's pre-accession period. Of this amount, €127 million was through five credit lines from the EIB's own resources directly to the CDB, while a further line of €4 million of risk-capital budgetary resources was shared between the CDB and two other financial institutions, the Popular Investment and the Cyprus Investment and Securities Corporation (CISCO). The EIB's activity through the CDB, prior to its privatisation, 'supported some 150 SMEs and secured some 1,200 jobs in the private sector' (interview material). Recognizing the CDB's role in private sector development in Cyprus, and therefore wishing to strengthen its capital structure, the EIB became its minority shareholder with €3 million from risk-capital budgetary resources on behalf of the EU—initially the equivalent of €1 million, 5.5%, in 1991 and increased to the equivalent of €2 million, 12%, after the CDB ceased to be 100% government-owned in 1996. It was then reduced to 6.13% in 2001, after Piraeus Bank became the CDB's strategic investor through a capital increase, which also limited the government's share to 45%. The latter change allowed Piraeus Bank to control 37.8% and the CDB staff 1% of CDB

[3] Financing was under four financial protocols attached to the EEC–Cyprus Cooperation Agreement, defining the amount of EU funds to be made available. The amount available through the EIB consisted of EIB loans (€142 million) and risk-capital budgetary resources (€17 million) managed by the EIB under EU mandate. The financial protocols also foresaw grant aid through the European Commission. Additionally, Cyprus benefited from €37 million of EIB loans under the Horizontal Facility of the EU's Redirected Mediterranean Policy (1992–1996). From 1998 up to the country's accession to the EU in 2004, EIB financing was provided under the pre-accession facility.

shares, while the CDB's remit was extended to full-fledged banking operations, enabling the bank's entrance to the stock exchange. The latter signalled the government's preference for increased private investor participation in the CDB (interview material), which led to its full privatisation in 2008, after 'concerns on its relevance' (interview material) resulting from an 'over-ambitious project pipeline, including satellite investments' (interview material) and reports of irregularities in 2005 (Stockwatch, 2005). Beyond its role in multilateral financing intermediation, the CDB actively promoted the restructuring of the private sector through:

1) Crowding-in and coordinating commercial bank and other financing for projects appraised as economically viable.
2) Strengthening the higher added-value and export-oriented output in manufacturing and services, along with tourism, through a contribution averaging 10% of the gross fixed capital formation (WB, 1983).
3) Advising private investors (Savvides, 1994) and the government, contributing to state-of-the-art due-diligence practices, innovative financial products (WB, 1983; and interview material) and policy issues including the telecommunications sector and a national health scheme (CDB, 2019) along with managerial and IT issues through its subsidiary Novasys Information Services Ltd, established in 1990 (CDB, 2019).
4) Contributing to the feasibility study for the creation of a stock exchange in Cyprus (interview material), especially as the EIB had 'considered issuing an EIB euro-bond in Cyprus pounds' in 1998 (Unwin, 1999).[4]
5) Breaking-through operations in environmental awareness and environmental impact assessment studies through its subsidiary Enalion Environmental Management Centre Ltd (Georghiou et al., 1998) and international cooperations under the Mediterranean Environmental Technical Assistance Programme (interview material).

[4] CDB could have issued bonds in a more developed domestic capital-market or the euromarket area after Cyprus joined the EU and the eurozone in 2004, but its privatization in 2008 halted such plans.

6) Cooperating with international and European organizations and networks, such as the United Nations Development Program, for strengthening the competitiveness of Cypriot industry, the International Investment Partners Scheme through its EC Centre created in 1992 to provide advice regarding European funding opportunities for the domestic private sector (CDB, 2019).
7) Externalising its know-how and experience through international cooperations, such as with the Palestinian Authority for the establishment of an NDB in Gaza/the West Bank, which did not materialise (interview material), and the establishment of the Investment Bank of Kuban (IBK) headquartered in Krasnodar, Russia, in 1999, which was also the first cooperation of the CDB with the European Bank for Reconstruction and Development (EBRD),[5] the latter holding 25% of IBK's share-capital, with CDB the remaining 75% (CDB, 2019).

In the wake of the 2013 crisis in Cyprus, commercial banks took over the role of intermediating MDB funding, mainly from the EIB and the EBRD. The latter strengthened the capital structure of some commercial banks by taking up minority stakes, but not in the CDB (in its private bank status). The EIB has injected funding into 9 banks for 450 projects totalling €853 million (65% of the aggregate EIB lending in Cyprus) over the period 2013–19 (EIB, 2019a).[6] Despite this important private sector support through commercial banks, the EIB admits that investment barriers are 'preventing small businesses from reaching their full potential and identifying and tackling specific investment barriers that are crucial to unlock economic growth and job creation' (EIB, 2018).[7] Although Cyprus scored well among

[5] Cyprus is a founding member of the EBRD, which started operations in Cyprus for the period 2014–2020, lending €220 million in the private sector, in areas such as commerce, infrastructure, transport and renewable energy sources up to mid-2017 (CMF, 2019).
[6] As of 26 June 2019 the EIB partner banks were Alpha Bank Cyprus Ltd, Astrobank Ltd, Bank of Cyprus, Cyprus Development Bank, Eurobank Cyprus Ltd, Hellenic Bank Public Company Ltd, Cyprus, National Bank of Greece (Cyprus) Ltd, RCB Bank Ltd and Société Générale Bank–Cyprus (https://www.eib.org/intermediarieslist/search/result?country=CY).
[7] Barriers to investment of tangible and intangible capital (EIB, 2017: 44).

EU countries in investment increases in 2017,[8] the EIB highlighted the main barrier to investment, apart from high energy costs (which is self-evident for an island country completely dependent on oil imports and not connected to e.g. gas pipelines), as being investment uncertainty (EIB, 2017: 44; EIB, 2018), where Cyprus comes in second place in the EU, after Greece and Slovakia. Investment uncertainty, apart from the macroeconomic concerns, includes elements 'regarding the future path of demand, technology, and output and input market conditions' (EIB, 2017: 325). Uncertainty about input markets also includes the uncertain access to finance, given that 'credit-constrained firms are substantially more likely to cite uncertainty as impeding their investment activity' (EIB, 2017: 325). The EIB also counts access to finance as one of the distinct categories of impediments to investment. Under this category, Cyprus is third among EU countries, after Greece and Malta (EIB, 2017: 44), although the EIB does not mention this as crucial for Cyprus. Disregarding the conceptual pitfall of the unclearly delimited categorisation—difficulties in access to finance are encompassed in two categories of the EIB investment survey—one can surely draw the conclusion that, apart from other elements of uncertainty, access to finance is the main impediment to investment in Cyprus, despite the EIB's strong support of the banking sector. This is not surprising, as commercial banks are limited, as mentioned, by balance-sheet fatigue. Moreover, they cannot play the curative policy role desired by the EIB—improving credit allocation based on the fundamentals of return on investment—while promoting structural reform policies to reduce the cost of labour and reallocate capital. In other words, they cannot act in 'a system of pro-cyclical fundraising and counter-cyclical investment spending' (EIB, 2017: 325). Commercial banks lack the main prerequisite for assuming this decisive mission: it is not their primary objective, which, on the contrary, is profit-making, as with all private undertakings.

This is why NDBs have been playing an increasingly important role in setting up and implementing EU financial instruments (FIs) and budgetary guarantees, which 'have witnessed a marked expansion in the last two multi-

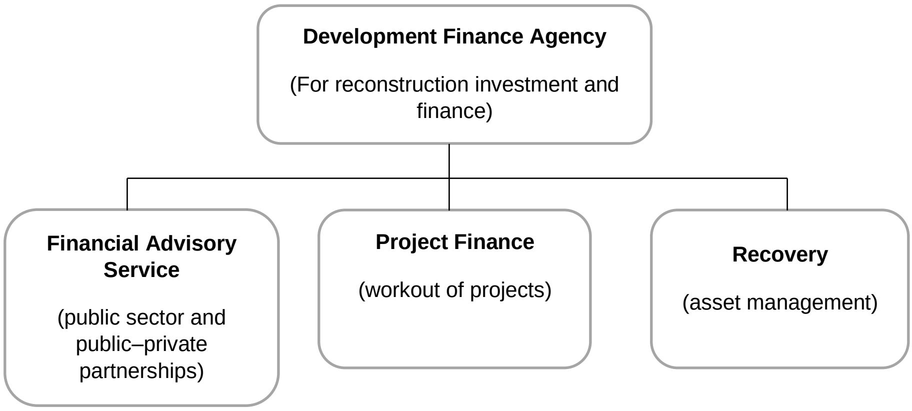
[8] In absolute terms, the largest increases were in Malta, the Netherlands, Cyprus, Denmark and Sweden, where investment in residential property increased by more than 20% in 2017 (EIB, 2017: 18).

annual financial frameworks (MFFs) and … are called to play an even more significant role in the forthcoming MFF' (Rubio, 2018: 5). NDBs have proved to be effective, not only in supplying credit but also in correcting market failures, such as information asymmetries among borrowers,[9] which particularly impede long-term funding. NDBs, representing one-third of the European Fund for Strategic Investments under the Investment Plan for Europe, known as the Juncker Plan promoting recovery from the global economic crisis, are considered key strategic partners in its implementation (Stiglitz, 2019). Additionally, under the forthcoming MFF, NDBs will be entrusted with the implementation of FIs, along with the EIB, which will no longer be the exclusive managing authority,[10] for the first time since its establishment. Cyprus currently has no institution to intermediate this 'sources absorption dance'. Our analysis of the current macroeconomic and institutional context shows a void of institutional capacity to evaluate and facilitate the funding of viable projects and to intermediate international financing from the EU and MDBs while also offering valuable advice to state decision-makers on major development projects. It is, of course, entirely up to the Cypriot authorities to seek the appropriate policy instruments for facilitating private investment conducive to growth. However, based on the renaissance of NDBs across Europe and the world (Rubio, 2018; Stiglitz, 2019; Xu et al., 2019), we make a normative proposal for creating a special-purpose financing and advisory institution in Cyprus, such as an NDB/DFA, possibly with the support and/or involvement of MDBs and BDBs. As with the CDB in the past, such an institution would be able to coordinate, support and refinance the restructuring of distressed businesses into new viable projects by swapping equity for debt relief, as well as catalysing investments conducive to growth through its intermediation of international MDBs and EU FI funding. Additionally, owing to its positioning and clout, such a new institution, like peer institutions (Xu et al., 2019), could also offer crucial advisory services to investors, while also acting as an asset management

[9] 'The inability of a borrower to get access to funds at any interest rate, even though similarly situated borrowers do get credit' (Stiglitz, 2019: 61).
[10] NDBs can be entrusted with European structural investment FIs if they fulfil the criteria 'to be considered an "in-house entity" according to Article 12 of the EU Public Procurement Directive' (Rubio 2018: 6).

company, and it could deal effectively with bank assets in need of a smooth recovery.

Figure 4: Proposed NDB/DFA

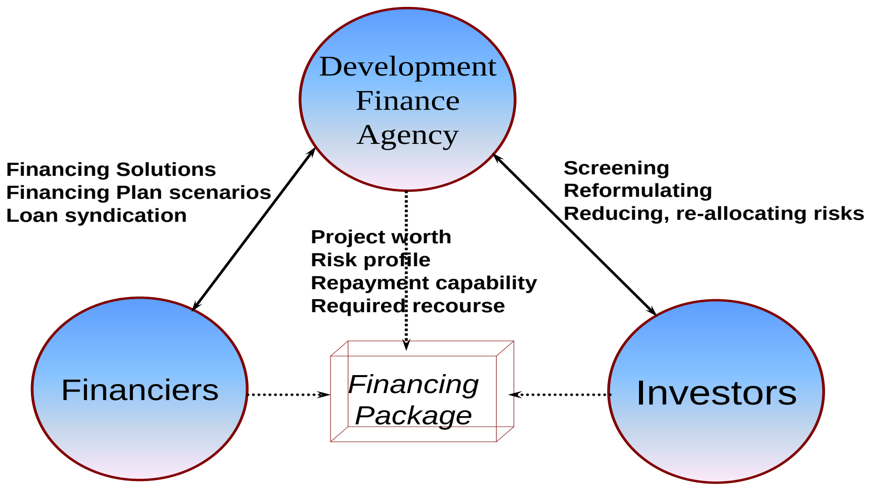


Source: Savvides, 2016: 51–9.

Consequently, the main systemic banks would concentrate on their healthy portfolio, while being ready to participate in project financings put together in cooperation with the NDB/DFA. Preferably, these new special-purpose vehicle companies (SPVs) should be financed by a conversion of existing loans to equity and a syndicated agreement with the loan providers, based on their economic viability and repayment capability. With that as the key criterion, the Cypriot authorities could seek to provide the support necessary to enable and accelerate this process, leading to economic development.

An NDB/DFA can also serve as a solid and independent advisor to the government on public–private partnerships, following the example of NDBs in countries such as Ireland and the Netherlands, whose models we find quite appropriate for Cyprus. It is a coincidence that the Irish model has already been recommended to Cypriot authorities, by the WB back in 1987, as 'the most desirable option (for institutional support to industrial development)' (WB, 1987: 30). Such professional institutions drive the financing of viable projects because they also i) have equity and quasi-equity instruments in place to support the need to replenish the depleted equity capital base of viable businesses; ii) can offer experts in project finance solutions; MDBs and BDBs may provide TA so as to get the new bank up to speed quickly; iii) assist commercial banks and their existing customers to reach amicable agreements, including the selling of unproductive assets and the taking of equity to reduce debt and enable their restructuring into viable projects; iv) ensure that projects to be financed are viable and have sustainable repayment capability; v) work out solutions for existing loans by either converting them to equity or repaying them through asset selling, or even partially writing off for the purpose of arranging appropriate refinancing packages; and vi) enable the participating banks to have a share of the up-side while they focus on their healthy loan portfolio and without disturbing their normal bank operations. In Cyprus, the NDB/DFA would serve the current need for investment support. It is expected to cooperate with existing banks and investors (Figure 5), seeking to apply project-finance types of solution by formulating new viable business plans utilising the current resources and assets of existing debt-laden companies. Successful and sustainable restructurings can only come about on the basis of new SPVs that are well capitalised and have a manageable debt. The current attempts to restructure the existing loans within the shell of the existing companies' balance sheets is, in most cases, doomed to fail. Their excessive and wasteful take-up of debt during the 'happy years' hinders their viability and repayment capability, even for new, bankable projects.

Figure 5: NDB/DFA: catalyst for financing viable projects



Source: Savvides, 2016.

Credit-constrained firms would consequently be enabled to return to efficiency and have their loan obligations reduced to non-threatening levels. If debt reduction is applied in a structured manner, competitive yet highly indebted companies could return to manageable funding structures, often through a new SPV. To facilitate the restructuring, participating commercial banks could conditionally write off a pre-agreed portion of the existing loan-balance in order to facilitate restructuring, and the NDB/DFA could match this through a quasi-equity instrument. In this way, competitive enterprises taking part in such a programme would be able to replenish their equity. Reformulated projects should be packaged as new corporate entities or SPVs and funded through both new equity and equity converted from old loans, and/or through new, long-term loans. In this way, the NDB/DFA should be in a position to manage the need for foreign or local direct investment in newly defined investment projects. Additionally, the proposed solution would reduce red tape, as investors would have a one-stop shop for acquiring distressed assets and/or participating in new ventures in the newly restructured projects. In this manner, the catalytic role and the intermediation of the NDB/DFA for international funding from MDBs/RDBs would once more prove itself decisive for the reconstruction of the Cypriot economy.

Conclusions

In the aftermath of the 2013 bail-in, the Cypriot economy needs a complete restart from a clean slate. After the Turkish invasion of the island in 1974, the devastation was far greater; but other than country risk, an investor had no structural risks such as those of the currently over-indebted economy. The CDB played an important role by intermediating international finance from MDBs, developing and passing on know-how and state-of-the-art capacity for catalysing private sector development. The CDB has been crowding-in the commercial banks and guiding funds towards economically viable projects, while demonstrating marked activism in building capacity, through advisory services.

Since the CDB's privatisation in 2008, the developmental role has been entrusted mainly to the commercial banks, which are limited not only by their scope but also by balance-sheet fatigue resulting from the excessive levels of private debt. The unprecedented and overwhelmingly high levels of private debt, the huge value of NPLs and scant and weakening local demand are currently stifling the recovery of the Cyprus economy. Although the political and economic actors do not acknowledge the urgency of the situation, a 'courageous' policy intervention is needed to avoid exacerbating the balance-sheet recession and the impediments to productive investment in Cyprus, as the options and tools available for a swift recovery from such dire straits through conventional methods are severely limited and most likely insufficient.

In an era of an NDB renaissance, called to play a centre-stage role in economic development within an international cooperative network of MDBs/NDBs, Cyprus is currently the only EU country without an NDB, risking a hampered uptake of potential future EU FIs. In the current international and national context, we suggest the re-establishment of an NDB/DFA and propose a model that allows equity to be swapped for debt relief, while engaging commercial banks and intermediating MDB international finance.

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