# QUARTERLY ECONOMIC MONITOR

Eurobank Cyprus Research
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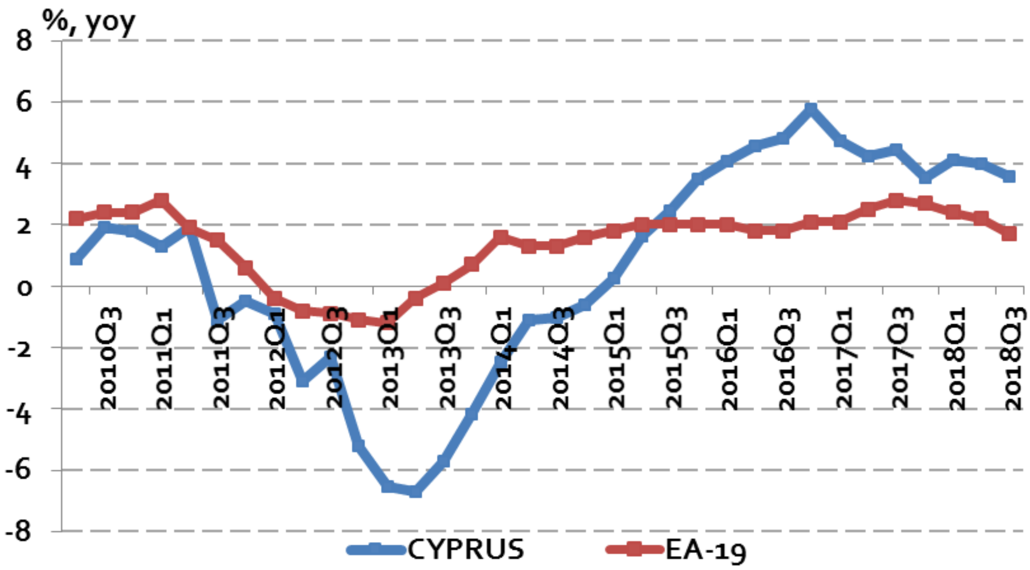
# 1. Latest Economic Developments & Outlook ahead

## 1.1 The latest GDP growth estimate for Q3-2018 – an inch higher compared to the flash CYSTAT estimate- suggests the economic cycle peak is most probably behind us

The second and latest estimate of CYSTAT on the seasonally adjusted Q3-2018 GDP-reading, revised the flash estimate of 0.7% QoQ/3.6% YoY by an inch higher to 0.8% QoQ/3.7% YoY, bringing the year to September performance at 3.9% YoY. This strong reading compares to 0.8% QoQ/4.0% YoY in Q2-2018, 1.1% QoQ/4.1% YoY in Q1-2018 vs. 1.0% QoQ/3.5% YoY in Q4-2017, up from 1.1% QoQ/4.4% YoY in Q3-2017.

Real GDP growth marked the fifteen consecutive positive reading on a both quarterly and annual basis after a previous three-year recession. The GDP growth rate of Q3-2018 is among the highest in EA-19 and EU-28, both on a quarterly and an annual basis (Figure2 & 3) and, for a fourteen consecutive quarter in a row, above that of EA-19 (Figure 1). This output performance is still among the highest during the post-Lehman period, surpassing analysts' expectations and international organizations' full year initial or revised forecasts. It signals the economy has embarked on a faster growth path than previously envisaged. The Cypriot economy is likely to outperform the initial conservative official forecasts.

**Figure 1: GDP growth (YoY) in Cyprus above that in EA19 since Q3-2015**



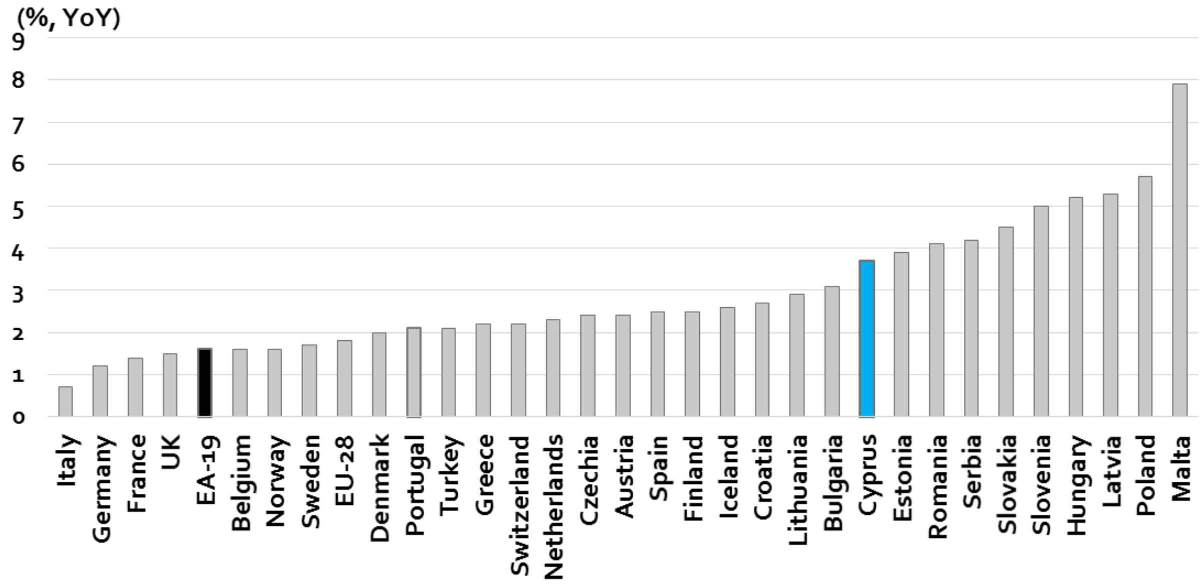

*Source: Eurostat, CYSTAT, Eurobank Research*

Finally, CYSTAT also announced[1] the revision of the national accounts data for 2016-2017. CYSTAT presented the finalized data of the national accounts for 2016 and revised upward

[1]http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/E99702C8D4AB3B9CC225830100351BD0?OpenDocument&sub=1&sel=1&e=&print

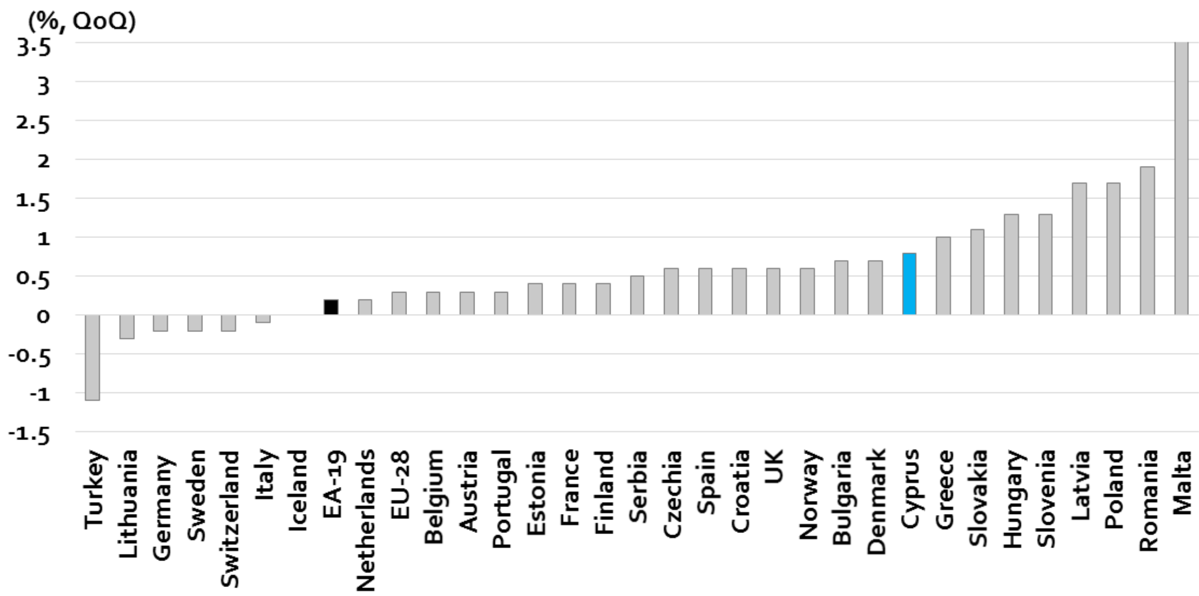
the national accounts of 2017 in both nominal and real terms. The revision showed that the economy rebounded even faster in 2016 than previously thought: the Statistical Service revised the real GDP growth rate of FY2016 to 4.7% from 3.4% in the second estimate and only 3% initially announced. Moreover, the real GDP growth rate of 2017 was revised to 4.2% from 3.7%. As a result, the level of GDP in 2017 in constant prices already stood 0.3% above that in 2008 and 3.6% above that of 2012. Therefore, the level of GDP in 2018 is expected to be above the level of 2008 under any conservative assumption of real GDP growth scenario.

**Figure 2: Third Quarter GDP growth (YoY) in Cyprus among the highest in EA19 & EU28**




*Source: Eurostat, CYSTAT, Eurobank Research*

**Figure 3: Third Quarter GDP growth (QoQ) in Cyprus above EA19 & EU28**




*Source: Eurostat, CYSTAT, Eurobank Research*

### 1.2 The IMF concluded the Article IV consultation with Cyprus stressing the need of further reducing NPEs in the context of amended legislative frameworks and highlighting the downside risks for the medium-term outlook

The statement of the Executive Board[2] on the occasion of the conclusion of the Article IV consultation with Cyprus confirmed the preliminary findings of the IMF mission in early October and elaborated further on the macro-outlook of 2018-2019. According to the consultation, the near-term outlook for the economy is favorable, with GDP growth expected to remain at around 4.2% in 2018–19, supported by the services sector and largely foreign-financed investments. However, over the medium term, economic growth is projected to slow to its long-run potential rate of around 2.5%, as the transitory effects of the investment boom gradually dissipate. Sustaining this medium-term growth will require progress in structural reforms crucial for lowering systemic financial risks and catalyzing productivity enhancing investments.

The IMF also welcomed the recent reforms undertaken to address key vulnerabilities in the banking sector, including the resolution of Cyprus Co-operative Bank (CCB), a large systemic state-owned bank. However, the IMF called for steadfast implementation of the amended legislative framework on foreclosure, insolvency, sale of loans and securitization, supplemented by a strengthening of the court system and removal of uncertainties related to title deeds. In addition, it also stressed the need to enhance the governance and supervisory framework for the recently-established asset management company. Finally, the IMF recommended that in order to limit moral hazard, the proposed "ESTIA" scheme, which is aimed at encouraging distressed borrowers to begin servicing their loans, be better targeted and based on appropriate assessment of borrowers' capacity to repay.

The latest IMF flagship publication in October upgraded its forecasts to reflect the ones prescribed earlier in the second post-program staff monitoring report of June[3] (Table 1). In terms of the macro-outlook of 2018-2019, the WEO now sees GDP growth inching up to 4% in 2018 and 4.2% in 2019. The average inflation projection in 2018 was raised to 0.8% in an illustration of upside price pressures throughout the year so far, up from 0.2% in the June monitoring report, while it is further seen at 1% in 2019. Unemployment is seen to decline from a projected 9.5% in 2018 down to 8% in 2019. The current account is seen as widening from 3.1% of GDP in 2018 to 5.2% in 2019.

The above optimistic growth forecasts of the IMF mission represented a newer assessment as they were not present in the IMF's earlier flagship publication, namely the April World Economic Outlook (WEO). In the earlier April 2018 WEO, the full year 2018 GDP growth was projected lower, at 3.6%, yet up from 2.6% in the October 2017 WEO and 2.3% in the April 2017 WEO. In that same April WEO, the GDP growth forecast of 2019 was even more conservative at 3.0%, contrasting sharply with the June Board forecast of 4.2%. In the same WEO publication, unemployment is forecasted to further decline from a projected 10.0% in

[2] https://www.imf.org/en/News/Articles/2018/11/30/pr18448-cyprus-imf-executive-board-concludes-2018-article-iv-consultation
[3] https://www.imf.org/~/media/Files/Publications/CR/2018/cr18153.ashx

2018 to 9.1% in 2019. The average inflation is expected to remain subdued at 0.4% in 2018, down from 0.7% in 2017, and climb to 1.6% in 2019.

**Table 1: IMF World Economic Outlook Forecasts for Cyprus**

| IMF WEO | 2018 | | 2019 | |
|---|---|---|---|---|
| | Apr 2018 WEO Forecast | Oct 2018 WEO Forecast | Apr 2018 WEO Forecast | Oct 2018 WEO Forecast |
| **GDP growth** (%, YoY) | 3.6 | 4.0 | 3.0 | 4.2 |
| **Consumer Prices** (%, average) | 0.4 | 0.2 | 1.6 | 1.0 |
| **Unemployment** (% of Labour Force) | 10.0 | 9.5 | 9.1 | 8.0 |
| **Current Account Deficit** (% of GDP) | -4.1 | -3.1 | -4.6 | -5.2 |

*Source: IMF World Economic Outlook April 2018 & June 2018*

### 1.3 In its Autumn 2018 forecast, the EU Commission upgraded its growth forecasts for Cyprus in 2018-2019, while stressing that risks to the outlook have widened because of the state support to the financial sector

The EU Commission upgraded the GDP growth forecasts for the Cypriot economy in its Autumn-forecasts published last October. The EU Commission now sees Cyprus expanding at 3.8% in 2018 up from 3.6% in the Spring-forecasts, up from 3.2% in the Winter-forecasts, and up from only 2.9% in the previous Autumn-forecasts. GDP growth is now forecasted to decelerate to 3.3% in 2019 vs. 2.7-2.8% in the Autumn-Winter forecasts. The growth momentum is expected to remain strong, fueled by buoyant foreign-funded investments and solid private consumption, the latter driven by the boost in confidence and disposable incomes following the decline in unemployment.

Yet, the EU Commission underlined that the fiscal risks to the outlook have widened because of the state support to the financial sector. The state support measures have shifted public debt upwards and are likely to have deficit increasing effects. Robust economic growth is expected to support sustained budget surpluses (2.8% in 2018, 3% in 2019 and 2.9% in 2020) and a decline in public debt from 2019 onwards (98.4% in 2019 and further to 91.0% in 2020 down from 105.0% in 2018). Tourism, a key driving force behind the acceleration in services exports in the past years, is expected to soften. Tourism is confronted with increasing competition from the re-opening of neighbor markets, where safety concerns are abating, and the lower purchasing power of some tourists (predominantly British and Russian) as a result of their currency depreciations.

**Table 2: EU Commission Forecasts for Cyprus**

| IMF WEO | 2018 | | 2019 | |
|---|---|---|---|---|
| | Spring Forecast | Autumn Forecast | Spring Forecast | Autumn Forecast |
| **GDP growth** (%, YoY) | 3.6 | 3.9 | 3.3 | 3.5 |
| **Consumer Prices** (%, average) | 0.7 | 1.3 | 1.2 | 1.4 |
| **Unemployment** (% of Labour Force) | 9.0 | 8.2 | 7.1 | 6.3 |
| **Current Account Deficit** (% of GDP) | -9.0 | -9.3 | -9.7 | -9.5 |

*Source: EU Commission forecasts, Autumn 2017-Winter 2018-Spring 2018*

### 1.4 Investments had the strongest positive contribution in third quarter's GDP growth, while final consumption dynamics remain strong

From a demand point of view, final consumption dynamics were strong for yet another quarter. The final consumption rebound continued into Q3-2018, making a +3.1ppts contribution to GDP growth. Final consumption expanded by 0.6% QoQ/3.7% YoY in Q3-2018 compared to 1.7% QoQ /+4.9% YoY in Q2-2018, up from +0.2% QoQ/+3.8% YoY in Q1-2018, and up from 1.3% QoQ/+3.4% YoY in Q4-2017 compared to +1.6% QoQ/+4.4% YoY in Q3-2017. The consumption rally is underpinned by a number of factors, which all boil down to the rise of disposable incomes and the propensity to consume, namely: The sustained sentiment improvement mirroring the earlier lasting progress within the programme, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from the fiscal relaxation after the graduation from the programme and the acceleration of public consumption in Q3-2018.

As far as the other growth components, there are two points to make. First, investments' volatile performance continued in this quarter too. Investment spending in Q3-2018, at constant prices, was significantly higher on an annual basis compared to Q3-2017 (+31.5% YoY), thereby having a significant positive contribution to GDP growth which reached +5.6 ppts. Looking deeper into the component statistics of investments, we conclude that this extraordinary outcome was driven by inventories building and investments in transportation equipment, the latter most probably due to purchases of ships. The amount of the aforementioned category was higher on an annual basis in constant prices in Q3-2018 (€109.0mn up from a negative value of €27.3mn in Q3-2017). The performance of the two other key categories which refer to construction- both residential (+13.7% YoY) and other buildings (+25.8% YoY)-was also very supportive to investments.

Second, the positive investments' performance was more than offset by the net exports' negative contribution, a trend we witnessed again in Q1-2018. The contribution of net exports amounted to -5.0ppts. In Q2-2018 we actually witnessed a combined effect from both exports contracting by -5.4% QoQ/-5.0% YoY, and imports remaining contained at -2.6% QoQ/+2.8% YoY. The slowdown in export activity reflects a sizeable quarterly decrease in the exports of goods' volume (-24.3% QoQ/-22.5% YoY). On top, exports of services failed to impress (-0.2% QoQ/-0.2% YoY) driven by lower activity in the sectors of gaming and financial services as a result of regulatory changes while the tourist season had already kicked in.

On the supply side, GDP dynamics were shaped by the steady performance of key sectoral pillars of the economy. Output in the combined sectors of "wholesale and retail trade, transport, accommodation and food service activities," expanded by +0.6% QoQ/+4.1% YoY in Q3-2018, +0.5% QoQ/+4.9% YoY in Q2-2018, compared to 1.6% QoQ/+6.9% YoY in Q1-2018, and up from 1.4% QoQ/+6.3% YoY in Q4-2017 compared to +1.4% QoQ /+7.3% YoY in Q3-2017. The performance of these national accounts items reflects largely the robust private consumption dynamics and is being reinforced by the performance of the flourishing tourism industry, primarily in the summer months.

Manufacturing slowed to +0.5% QoQ/+3.5% YoY in Q3-2018 down from +1.1% QoQ/+5.3% YoY in Q2-2018, down from +0.7% QoQ/+6.4%YoY in Q1-2018 vs. +1.2% QoQ/+8.2% YoY in Q4-2017 compared to +2.2% QoQ/+9.3% YoY in Q3-2017.

In contrast, professional services edged up to +1.3% QoQ/+6.4% YoY in Q3-2018 compared to +1.4% QoQ/+6.8% YoY in Q2-2018 compared to +2.0% QoQ/+6.4% YoY in Q1-2018 vs. +1.5% QoQ/+4.8% YoY in Q4-2017 up from +1.7% QoQ/+4.3% YoY in Q3-2017.

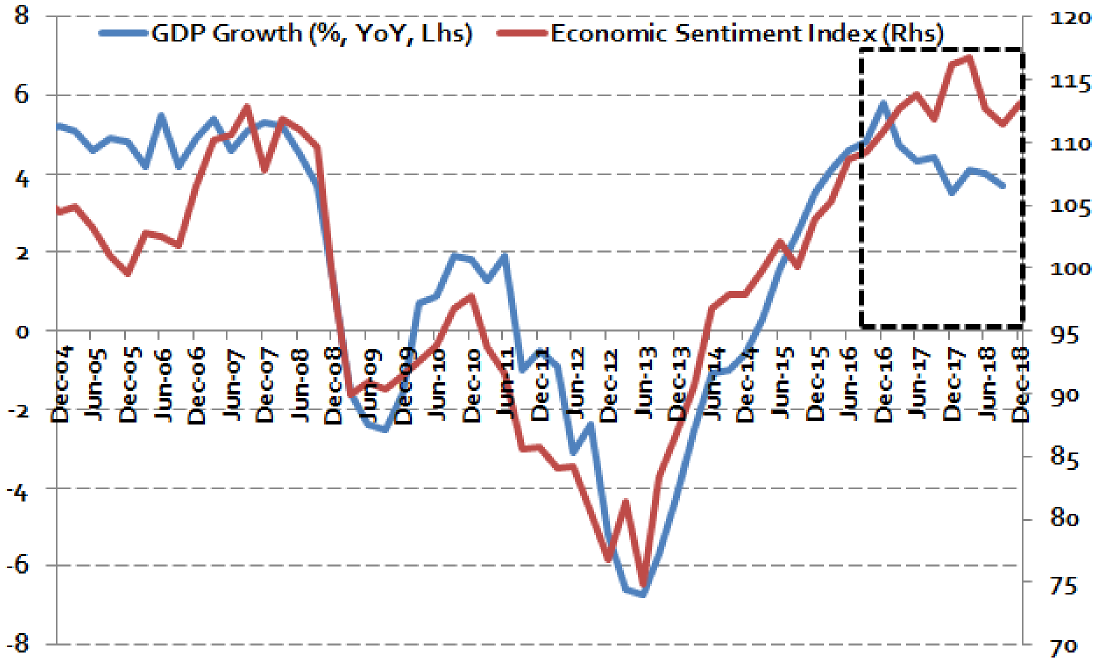
Furthermore, construction accelerated its dynamic double-digit expansion even at a lower rate, expanding by +7.2% QoQ/+22.8% YoY in Q3-2018, +3.8% QoQ/+18.2% YoY in Q2-2018 vs. +5.0% QoQ/+21.8% YoY in Q1-2018 compared to +5.0% QoQ/+21.1% YoY in Q4-2017 down from +3.2% QoQ/+24.6% YoY in Q3-2017.

Financial Services continue to be the exception to the upward momentum: They remained a drag on economic recovery, recording negative growth on annual basis for an eighth quarter in a row. Financial services have been in negative territory since Q3-2016. Nevertheless, the pace of contraction has slowed down in the last quarters. Financial services contracted by -0.6% QoQ/-3.0% YoY in Q2-2018, -0.7% QoQ/-2.1% YoY in Q2-2018, -1.1% QoQ/-2.3% YoY in Q1-2018 compared to -0.7% QoQ/-4.3% YoY in Q4-2017, down in absolute terms from 0.2% QoQ/-2.7% YoY in Q3-2017. The negative contribution to GDP growth by the financial sector reflects largely the bank restructuring activities (debt to asset swaps), write-offs and the ongoing deleveraging.

### 1.5 Real economy indicators performed relatively well in Q4-2018, yet visible signs appear that the peak of the economic cycle is behind us

Economic sentiment and economic growth are highly correlated. The slump in sentiment usually raises a red flag on growth, yet it may not always be so. For example, the earlier sentiment slump in May-June of this year – an event likely related to the negative news surrounding the resolution of Cyprus Cooperative Bank (CCB), had no meaningful impact on GDP in Q2 or the short-term prospects of economic activity. Subsequently, the ESI index rebound in the following months - despite rising global uncertainties and trade disputes - point to sentiment normalization. We will be looking for further evidence in the next few months on whether the sentiment rebound will be sustained or the last two readings have only been a temporary spike. High frequency and leading indicators were performing relatively well in Q4-2018, yet signs that that we may have seen the peak of the economic cycle are slowly creeping up.

**Figure 4: Economic Sentiment & Economic Growth in Cyprus**




*Source: Eurostat, CYSTAT, Eurobank Research*

More specifically:

- **Sentiment:** The ESI Index remained relatively unchanged in October-November fluctuating around the levels recorded in May. In more detail, ESI inched down by 0.2 points to 113.0 in November from 113.2 in October, compared to 115.0 in September, retrenching back to comparable levels recorded in May.

- **Retail Trade:** Retail sales on a calendar and not seasonally adjusted basis, except for motor vehicles and motorcycles, expanded in volume terms by 3.8% YoY in Q3 down from 5.3% YoY in Q2 and 9.5% YoY in Q1, bringing the year performance to September at +6.2% YoY. Similarly, retail sales in value terms expanded by 5.9% YoY in Q3 compared to 5.4% YoY in Q2 and 6.4% YoY in Q1, bringing the year performance to June at +5.9% YoY.

- **Credit-card transactions**: The value of credit-card transactions expanded by 33.3% YoY by Cypriots and 18.3% YoY by foreigners in 10M2018 (JCC Payments Ltd).

- **Tourism:** The positive momentum in the tourism industry continued in 10M-2018. Tourist arrivals increased by +7.8% YoY in 10M-2018. Similarly, tourism revenues expanded by +2.3% YoY in 9M-2018.

- **Industrial sector**: After expanding by 1.6%QoQ/6.7%YoY in Q4-2017, industrial production on a calendar - not seasonally adjusted- terms, slowed down to 0.1% QoQ/3.4% YoY in Q1-2018, rebounded to 3.2% QoQ/+8.8% YoY in Q2-2018, but slipped again to -1.4% QoQ/+3.2% YoY in Q3-2018. Industrial confidence was equally very volatile. After rebounding strongly in September and October back to the levels seen in February, equal to the highest pre-crisis level of June2018, industrial confidence slumped again in November repeating the pattern of Q1.

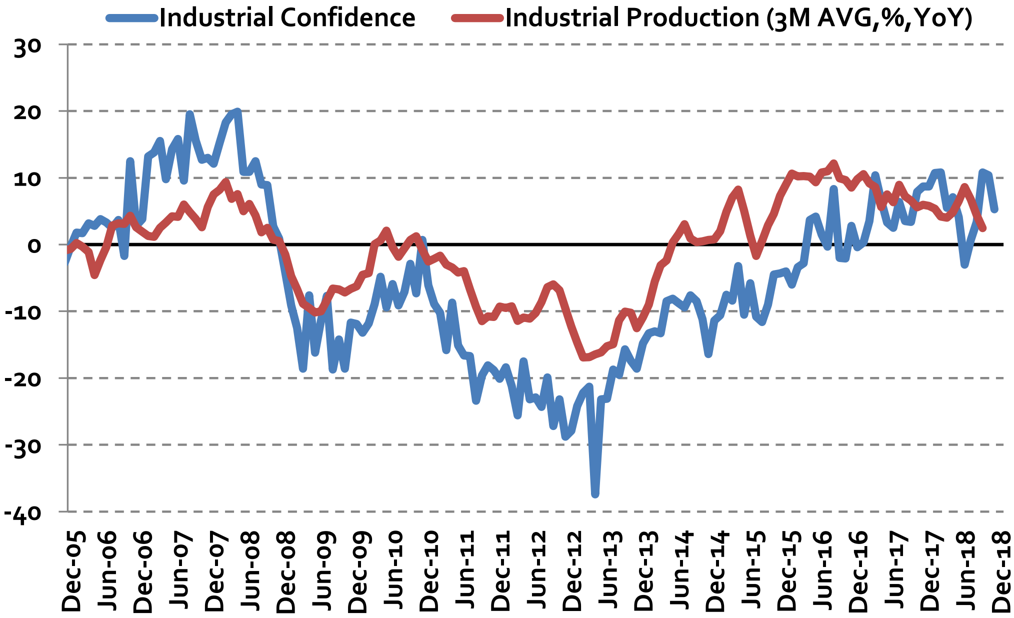
- **Labor market**: Having reached multi month lows and fully converged to EA-19 levels in Q2 and Q3, unemployment edged up in the first month of Q4. The unemployment rate in seasonally adjusted terms edged up to 8.5% in October up from 8.4% in September and 8.2% in August, down from 10.4% in October 2017 and from its peak of 16.7% in October 2013.

- **Deposits:** Depositors' sentiment stabilized further in the months of September and October. The annual rate of expansion remained unchanged at 3.8% YoY in the months of September and October.

- **Property-market**:
  - **Construction:** The latest building permits release predisposes for a continuation in the construction output rebound. According to CYSTAT, the total value of building permits issued in the first nine months of the year increased by **45.8% YoY**, while the total area of building permits rose by **32.2% YoY**. During the period January – September 2018, 4,702 building permits were issued, up from 4,281 in the corresponding period of the previous year.
  - **Real estate transactions & prices:** The number of real-estate market sale contracts has risen by 21.4% YoY in 11M-2018 (from 7,197 to 8,442: Department of Lands and Surveys). Property prices were on an increasing path in Q2-2018. The Residential Property Price Index (RPPI) expanded by +1.7% YoY in Q2-2018 compared to +1.8% YoY in Q1-2018, recording the sixth consecutive annual increase on a monthly basis for the first time since 2008 (Central Bank of Cyprus). The House Price Index (HPI), another metric calculated and published by CYSTAT, is in positive territory since Q4-2016. The HPI expanded on an annual basis by +0.6% QoQ/+1.2% YoY in Q2-2018 down from -1.8% QoQ/+3.7% YoY in Q1-2018 compared to +2.7% QoQ/+2.4% YoY in

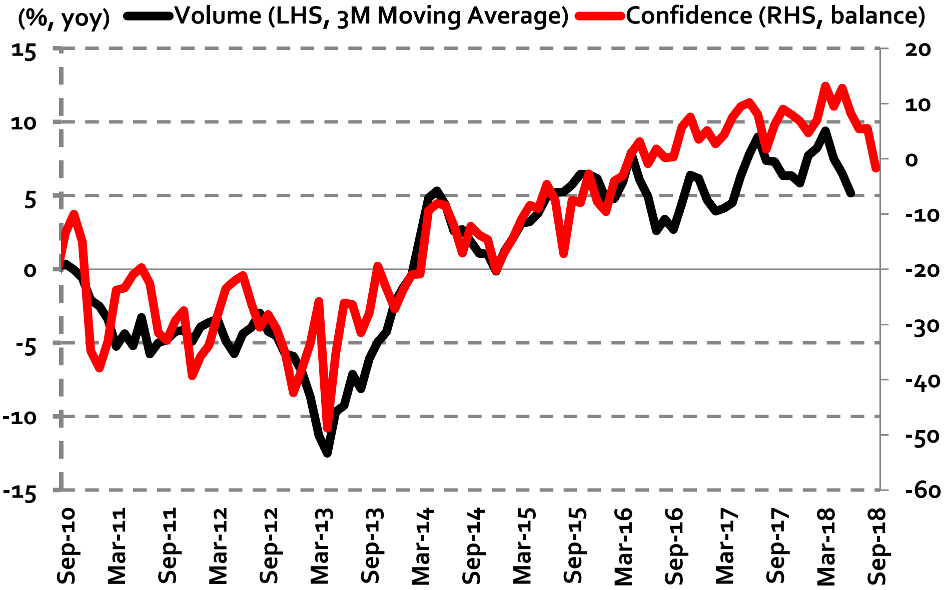
Q4-2017 vs. +3.1% QoQ/+3.6% YoY in Q2-2017. The Cypriot reading-although lagging behind that of EA-19 (+4.3% YoY) in this quarter- still bodes well with the ongoing rebound in the property market.

**Figure 5a: Industrial Production & Confidence in Cyprus**




*Source: Eurostat, CYSTAT, Eurobank Research*

**Figure 5b: Retail Trade & Confidence in Cyprus**




*Source: Eurostat, CYSTAT, Eurobank Research*

## 2. Fiscal policy: Budget over-performance gives rise to spending pressures

In 2018 the budget execution has surpassed the most optimistic expectations for yet another year. According to the latest data, the general government recorded a surplus of 4.1% of GDP (up from 2.5% in 10M-2017) and a primary surplus of 5.9% of GDP (up from 4.0% in 10M-2017) in the first ten months of the year. According to the draft budget plan (DBP) of 2019,[4] the general government surplus is expected to reach 2.9% of GDP in FY2018 – the highest since 2008 the year Cyprus entered Euroarea-up from 1.8% in FY2017. The primary surplus is expected to end at 5.4% in FY2018, up from 4.3% in FY2017. The aforementioned performance is even more impressive despite the lower Central Bank dividend by about 0.2 ppts of GDP relative to last year, and despite the gradual withdrawal as of July 1, 2018 of the public sector's wage cuts and their estimated fiscal impact of about 0.1 ppt.

On the other hand, it is important to note that the aforementioned metrics don't account for the public support measures in the sale and orderly winding down of Cyprus Co-operative Bank (CCB). The state intervention in the banking system occurred at the expense of temporarily reversing the downward trend in public debt dynamics. The one-off banking system state injection pushed the projected public debt to GDP ratio temporarily up to 104% of GDP in 2018 from 97.5% in 2017. This increase is not expected to reverse the overall downward trajectory of debt-to-GDP, provided fiscal policy remains prudent and nominal GDP growth remains robust. The public debt-to-GDP ratio is expected to decline to 97% in 2019 and further to 91% in 2020 and to 85% in 2021.

For year 2019 the EU Commission has already approved the DBP plan as being in line with the provisions of the Stability and Growth Pact (EU Commission opinion on DBP).[5] The budget of 2019 targets a general government primary surplus of 5.6% and headline surplus of 3.1% of GDP. Total revenue is expected to expand by 3.9% YoY. This growth is lower than the projected nominal rate of GDP growth hence revenues are expected to decline as a percentage of GDP to 39.4% from a projected 39.7% in 2018. The revenue growth is driven mainly by the continued cyclical improvement of the economy plus the already legislated tax increases on labor (legislated rises in social security contributions and the introduction of compulsory health insurance contributions), which are estimated to increase revenues by 0.4% of GDP. Despite the envisaged labor tax increases, the EU Commission claims labor tax revenue in Cyprus is still expected to remain below the corresponding EU-28 average.

In 2019 total expenditures are forecasted to increase by 3.3% YoY - below the revenues rate of increase and the rate of nominal GDP increase. Hence as a percentage of GDP, expenditures are expected to decline to 36.3% from a projected 36.9% in 2018. The gradual withdrawal of public sector's wage cuts and the introduction of the ESTIA subsidy plan are the main discretionary initiatives introduced in the budget of 2019. The first one was legislated in June 2018 and is estimated to cost about 0.2% of GDP on an annual basis in 2019-2023. The second is estimated to cost around 0.1% of GDP on an annual basis in 2019.

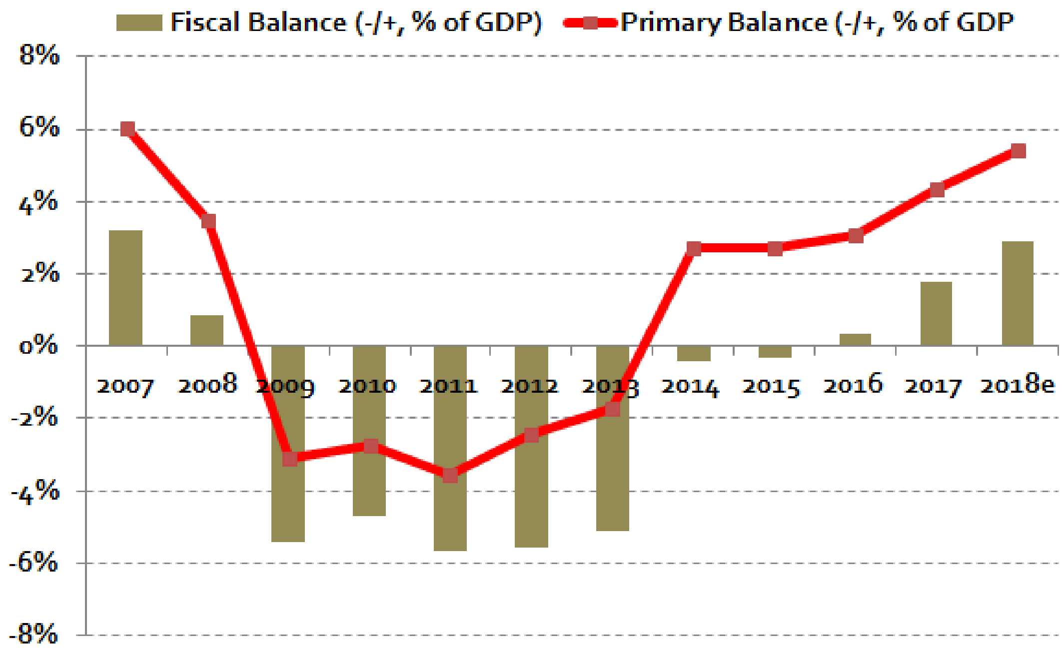
[4] http://mof.gov.cy/assets/modules/wnp/articles/201810/438/docs/draft_budgetary_plan_2019.pdf
[5] https://ec.europa.eu/info/sites/info/files/economy-finance/c-2018-8012-cy_en_.pdf

However, according to news media reports, the fiscal over-performance and the need to achieve political consensus on the implemented fiscal policies has given rise to spending pressures.

Fiscal pressures are evident in a fiscal package of €100mn of additional discretionary spending, currently debated between the ruling party DHSY and DHKO, the third largest party in the parliament. The fiscal package contains measures targeting vulnerable groups such as low income pensioners (an additional €50 per month for each pensioner, resulting in €23mn spending increase), an "ESTIA 2" subsidy scheme for eligible borrowers who service their debts (€30mn spending increase) and the reduction of the fuels consumption tax (€45mn loss in revenue). The fuels consumption tax has been chosen to replace the planned taxation reform of defense withholding tax on interest. The defense withholding tax on interest rate was originally planned to be reduced from 30% to 17% as of 1st January 2019 and was estimated to have a fiscal cost of approximately €45mn.

Overall, current fiscal policy continues the earlier credible fiscal path. In 2019 the government would broadly be running a balanced budget for a sixth consecutive year in a row. Figure 6 shows Cyprus performed an impressive fiscal adjustment in 2013-2014, which outperformed initial targets. A general government primary surplus of 2.7% of GDP was already achieved in 2014, two years ahead of schedule vs. a primary deficit of -1.7% in 2013, -2.4% in 2012 and -3.5% in 2011. Accordingly, the general government deficit[6] declined from -5.1% of GDP in 2013) to only -0.4% of GDP in 2014 (and -0.3% of GDP in 2015) and switched to a surplus of 0.3% of GDP in 2016 and 1.8% of GDP in 2017.

**Figure 6: The fiscal surplus is expected to reach at the highest level since 2008**




*Source: CYSTAT, Eurobank Research*

[6] The fiscal metrics don't account for the capital injection in the Co-operatives which amounted €1.5bn in 2014 and €175mn in 2015.

# 3. Recent domestic banking sector developments

## 3.1 The stock of NPEs decreased by only €15mn in August on top of €24mn in July, with the ratio standing at 40.4% - but with the CCB carve-out not reflected in the official data yet

According to data released by the Central Bank of Cyprus, the stock of non-performing exposures (NPEs) decreased by only €15mn in August on top of €24mn in July, compared to a large drop of €3.3bn in June. Over the longer period from December 2014 to July 2018 the stock of NPEs is down by 39.3%

At the same time deleveraging of the banking sector continues. Total loan exposures (performing plus non-performing) decreased by €107mn from €41,155mn in July 2018 to €41,048 in August, which is a slightly larger drop than the decrease in their non-performing component alone. The ratio of NPEs (non-performing to total exposures) remained flat on a monthly basis at 40.4% in August 2018. Yet the ratio is much lower than the 43.7% in December 2017, 47.2% in December 2016, 45.8% in December 2015 and 47.8% in December 2014.

Recall that according to the EBA conservative definition, a restructured NPE is still classified as an NPE for a probation period of at least 12 months, even if it is properly serviced without incurring new arrears. As a result, a large fraction of the restructured loans are still classified as NPEs (€6.4bn out of €9.2bn in August 2018). Overall, the carving out of the Cyprus Co-operative Bank (CCB) NPEs from the banking system is yet to be reflected in the official data. The resolution of CCB was a game changer in the battle to address the thorny issue of NPEs. The sizeable amount of removed NPEs from the banking sector (approximately €6bn) will allow for an important -but one-off- decline in the NPEs ratio further down to 30%. Please also note that the aforementioned official Central Bank statistics for the NPEs as of June have already mirrored the Bank of Cyprus (BOCY) securitization transaction with Apollo (€2.8bn)-to be approved by SSM by late 2018 or early 2019.

NPEs remain the elephant in the room, an issue we have consistently highlighted in all our previous reports. As of June 2018, the ratio in Cyprus is the second highest in the Euro Area behind Greece. Moreover, the stock of NPEs appears bigger when measured relative to the size of the economy. As of June 2018, the NPEs as a percentage of projected 2018 GDP stood at 82.3% - below the 100% threshold - compared to 105.1% in December 2017- down from 128.8% in December 2016, compared to 150.3% in December 2015 and 155.4% in December 2014.

Following the carving-out of NPEs from the banking sector, the new country challenge is how to handle them at the level of the established management company. Smooth handling necessitates the implementation of a transparent, professional, efficient and publicly accountable governance framework. The success of this management company is crucial not only for the recoverability of the NPEs – that would minimize the cost to the taxpayer – but also because failure to deliver could induce moral hazard in the rest of the system.

## 3.2 Further progress in the issue of NPEs relies on the newly adopted insolvency and foreclosures frameworks and the implementation of the ESTIA scheme

Further progress on the NPEs issue hinges upon two more game-changing factors: 1) the implementation of the reformed insolvency and foreclosures frameworks, and 2) the government-subsidized ESTIA plan. Regarding the first item, the adoption of the new insolvency and foreclosures laws by the parliament without any amendments has created optimism that the new framework will empower banks to pursue strategic defaulters more efficiently than previously. Regarding the second item, the government has drafted and made public the so-called ESTIA plan,[7] a subsidy scheme introduced to help vulnerable groups of distressed borrowers.[8]

The ESTIA scheme incentivizes both creditors (the banks) and debtors (borrowers) to come into an agreement on restructuring the non-performing mortgage loans for primary residence. The lender is required to offer a restructuring of the loan to eligible borrowers. The bank undertakes the responsibility to restructure the mortgage loan and forgive the loss coming from the difference between the market price and the book value of the collateral. Then, eligible borrowers – households and micro companies would receive a government subsidy equal to one third of their monthly installment, provided that their restructured mortgage loans are secured against their primary residence and they resume servicing the other two thirds of their monthly payment. If the borrower stops servicing its loan, it is foreseen that the bank initiates the foreclosure of the property.

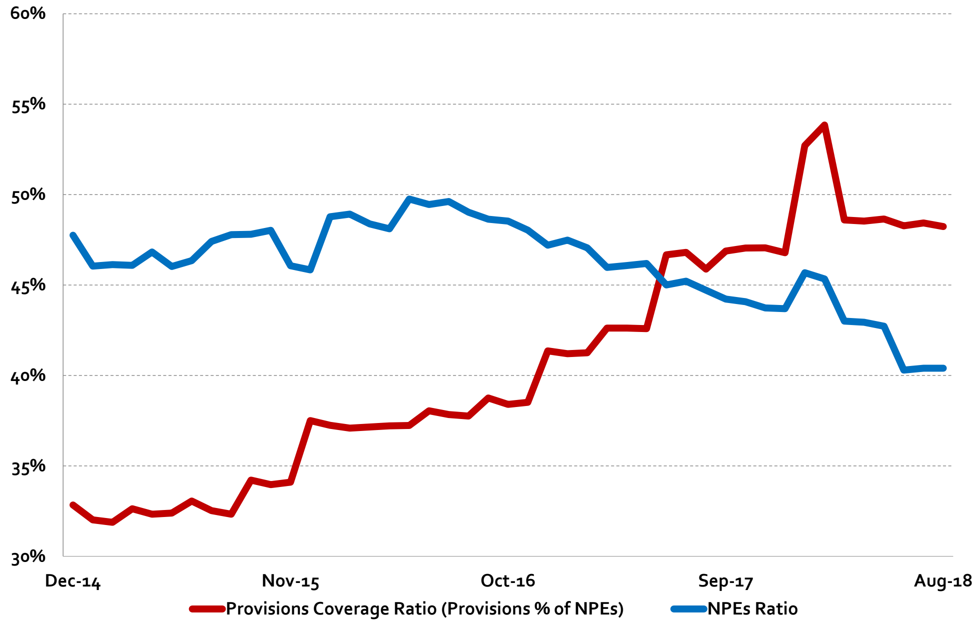
Earlier, on December 3rd, the European Commission approved the "ESTIA" plan,[9] concluding that the scheme is well-targeted, is limited in time and scope and would not create undue distortions to competition, the latter required by the EU state aid rules. The scheme, which has an annual budget of around €33mn, sets strict eligibility criteria in terms of the value of the primary residence (a maximum value of €350,000) and income of the borrower to ensure it is targeted at those in need. The revised version of the scheme ties eligible borrowers' income upon their marital status and the number of their family members. As a result, the scheme foresees a ceiling of €20,000 for singles, €35,000 for a married couple, €45,000 for a married couple with one sibling, €50,000 for a married couple with two siblings, €55,000 for a married couple with three siblings and €60,000 for a married couple with four children or more. More importantly, the net other assets of the eligible borrowers cannot exceed 80% of the market value of the primary residency (instead of 120% in the previous version of ESTIA) or the absolute amount of €250,000.

Despite the Commission approval, the announced criteria of eligibility for ESTIA have been heavily criticized publicly as overly generous and inducing moral hazard. According to news media, at the time of the writing, the endorsement of the scheme has been subject to a

[7] http://mof.gov.cy/assets/modules/wnp/articles/201807/427/docs/estia_021118_en.pdf
[8] http://mof.gov.cy/assets/modules/wnp/articles/201807/427/docs/estia_scheme_31_10_2018_final.pdf
[9] http://europa.eu/rapid/press-release_MEX-18-6649_en.htm

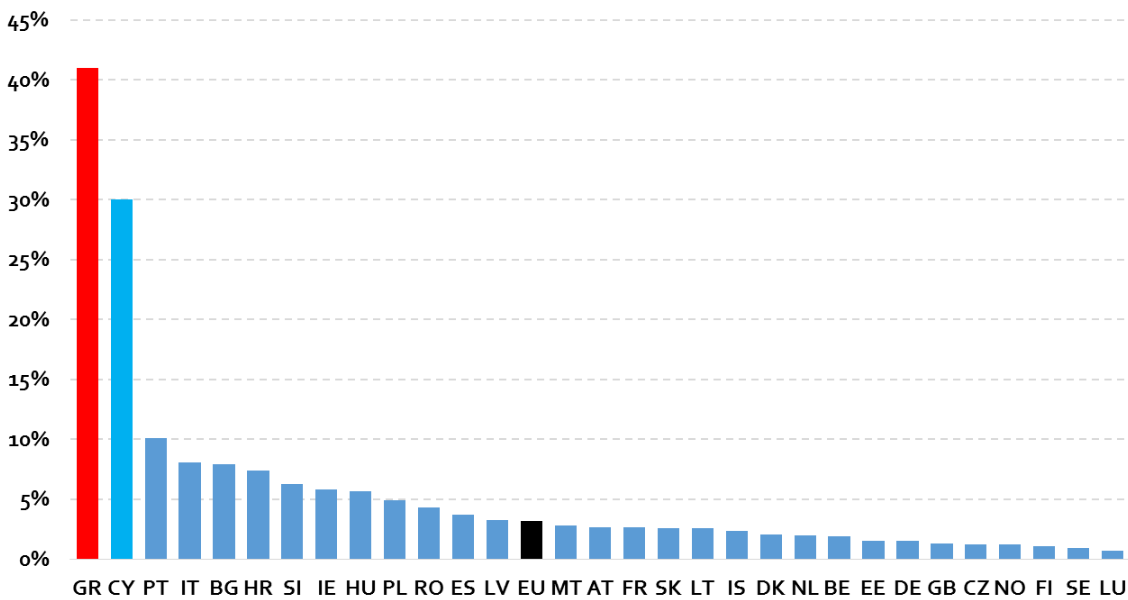
heated debate among political parties, which may ultimately result in a delay of its implementation given that the ruling party (DHSY) doesn't hold parliamentary majority.

**Figure 7a: Banking Sector Provisions Coverage & NPE ratio**




*Source: Central Bank of Cyprus, Eurobank Research*

**Figure 7b: NPEs (%of total exposures) as of Q2-2018**




*Source: European Banking Authority, Eurobank Research*

## 4. Sovereign ratings & bond markets update:

### 4.1 DBRS became the third rating agency after S&P and Fitch to award Cyprus investment grade status in the post-MoU era.

On November 23th, **DBRS** became the third rating agency to upgrade the long-term sovereign rating of Cyprus to investment grade status in the post-Lehman era. More specifically, DBRS upgraded the long-term sovereign rating by two notches from **BB low** to **BBB low** with a stable outlook (they call it "trend"). The upgrade decision was driven by the material reduction of NPEs, which reflects the stepped up efforts of both the government and banks to reduce NPEs. According to DBRS, the liquidation of the Co-operative Bank and the sales of NPEs are expected to halve the stock of NPEs in the banking system by the end of the year. Moreover, the rating upgrade is also driven by the solid performance of the Cypriot economy. Cyprus is on track to expand by 4% YoY in FY2018, one of the strongest in the Euro-area. According to the DBRS, risks to the ratings are broadly balanced. The ratings could come under upward pressure from sustained healthy economic growth and sound fiscal position as well as progress in reducing private sector debt and banking system NPEs. On the other hand, the ratings could come under negative pressure in a period of significantly weak growth combined with large fiscal imbalances or materialization of large contingent liabilities.

Earlier, on May 25th, DBRS had upgraded the long-term sovereign rating of Cyprus by one notch from BB (Low) to BB with a positive outlook (they call it "trend"). The rating agency had cited the decline in the banking system NPLs and the better-than expected fiscal performance. The stock of corporate NPLs declined by 36% in the Apr2015-Dec2017 period and the stock of household NPLs declined by 16% in the Feb2015-Dec2017 period, bringing the NPLs ratio of the banking system down to 42.5% of total loans in December 2017, compared to the 49.0% peak in May 2016.

Despite their decline, the agency had cited the NPLs as the main risk to financial stability and a major rating challenge for Cyprus. DBRS currently forecasts real GDP growth to remain robust in the coming years and average 4.0% in 2018-19, driven by important investment projects, exports, and consumption. DBRS states that so far growth has been broad-based with tourism, shipping, professional services, manufacturing, and construction all making a contribution. Meanwhile, fiscal performance is expected to remain positive so that the government budget will maintain a healthy surplus above 1.5% of GDP over the next four years, supported by strong revenues and contained expenditure.

Overall, all major rating agencies (FITCH, DBRS, Moody's and now S&P) upgraded their long-term sovereign rating of Cyprus in 2018, awarding at least one notch in their respective rankings. Recall that on September 14, 2018, **S&P** was the first rating agency to **upgrade** the long-term sovereign rating of Cyprus in the post-Lehman era by one notch from BB+ **to BBB- with a stable outlook**. Then on October 19th, **Fitch** became the second rating agency to **upgrade** the long-term sovereign rating of Cyprus in the post-Lehman era by one notch from

BB+ **to BBB- with a stable outlook**. Earlier, on July 27, **Moody's** had **upgraded** the long-term sovereign rating of Cyprus by one notch from Ba3 **to Ba2 with a stable outlook**.

Following the last round of assessments, there still remains a **slight divergence** of views between the rating agencies on the sovereign rating of Cyprus (Table 3). Moody's is the only agency among the four major ones which classifies Cyprus two notches below investment grade status. Cyprus regained its investment grade status by three rating agencies 2.5 years after its exit from the economic adjustment program in late March 2016.

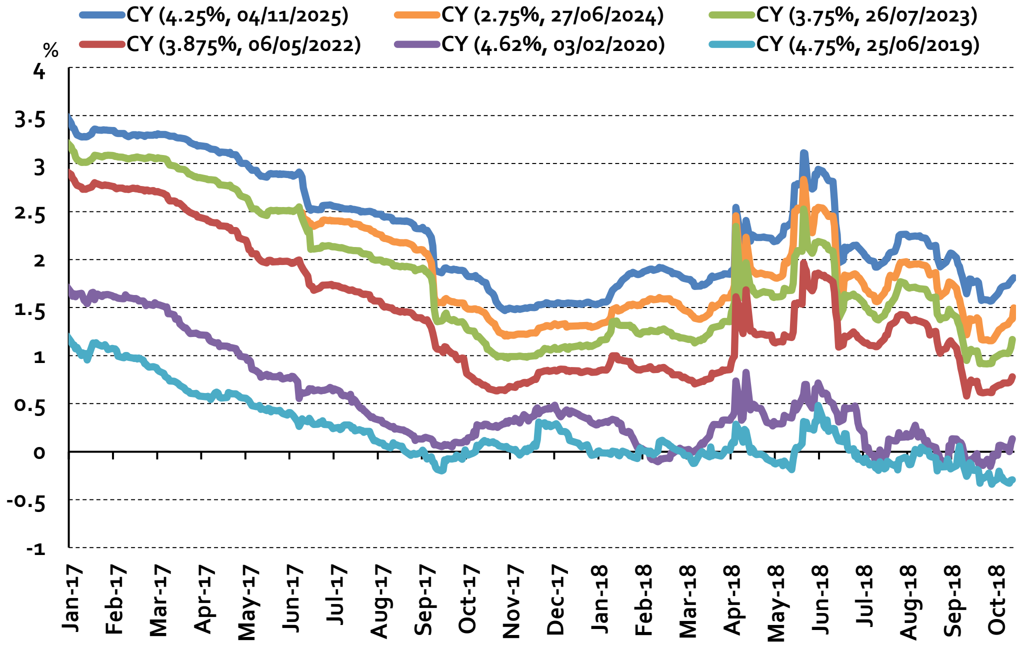
### 4.2 Cypriot government bonds monitor

Until mid-September, the lack of investment grade status prevented Cyprus from qualifying to join ECB's Quantitative Easing (QE) program. Earlier, when Cyprus was still in a Program, an ECB waiver allowed participation in QE. Following the upgrade, the ECB announced that the Cypriot bonds became eligible and that it has started buying Cypriot bonds within the framework of the Quantitative Easing program. The press release added that "*the Eurosystem's pace of purchase in Cypriot government bonds will take the specific market liquidity situation of the Cypriot government bond market into account in calibrating a gradual and measured increase in Eurosystem holdings towards Cyprus's share in the ECB capital key*".

The Quantitative Easing Program is about to end at the end of this month, in December, for all of the Euro Area. Yet in the future the ECB would be able to keep appropriate amounts of Cypriot and other Euro Area bonds it originally bought by refreshing its buying at the maturity of those bonds.

Despite not participating in ECB's QE, the medium-term Cypriot bond yields were on a declining trend since March 2016, which was interrupted for six months by market fears for the CCB resolution. Yet upon the parliamentary approval of the state guarantees for the asset protection scheme attached to the CCB assets acquired by of Hellenic Bank and the revamping of the foreclosure and repossession frameworks in early to mid-July, government yields declined sharply (Figures 8a-8b).

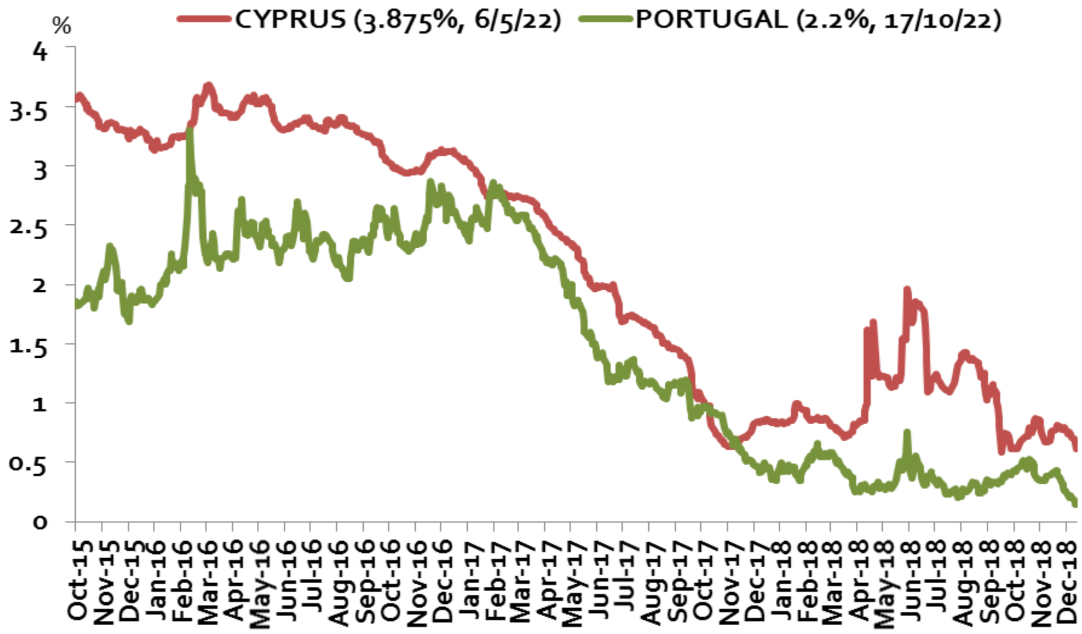
**Figure 8a: Annualized Yields to Maturity of outstanding Cypriot Government Bonds**




*Source: Bloomberg, Eurobank Research*

*Note: The maturity of each bond declines as we move from left to right on the diagram. The first observation is on December 15, 2016 and the last observation is on July 19, 2018. On that date, the longest 04/11/2025 bond had a maturity of 7 & 1/4 years. At the other end, the shortest 25/06/2019 bond had a maturity of 11 months.*

**Figure 8b: Annualized Yields to Maturity of Government Bonds maturing in 2022: Cyprus vs. Portugal**




*Source: Bloomberg, Eurobank Research*

*Note: The Cypriot bond matures in May 2022 and the Portuguese about six months later, in October 2022.*

**Table 3**

**Foreign Currency Long Term Sovereign Ratings of Cyprus**

| Moody's | S&P | Fitch | DBRS | Rating Description |
|---|---|---|---|---|
| Aaa | AAA | AAA | AAA | Prime |
| Aa1 | AA+ | AA+ | AA High | High Grade |
| Aa2 | AA | AA | AA | |
| Aa3 | AA- | AA- | AA Low | |
| A1 | A+ | A+ | A High | Upper Medium Grade |
| A2 | A | A | A | |
| A3 | A- | A- | A Low | |
| Baa1 | BBB+ | BBB+ | BBB High | Lower Medium Grade |
| Baa2 | BBB | BBB | BBB | |
| Baa3 | BBB- | BBB- | BBB Low | |
| Ba1 | BB+ | BB+ | BB High | Non-Investment Grade |
| Ba2 | BB | BB | BB | |
| Ba3 | BB- | BB- | BB Low | |
| B1 | B+ | B+ | B High | |
| B2 | B | B | B | |
| B3 | B- | B- | B Low | |
| Caa1 | CCC+ | CCC+ | CCC High | |
| Caa2 | CCC | CCC | CCC | |
| Caa3 | CCC- | CCC- | CCC Low | |
| Ca | CC | CC | CC High | |
| | | | CC | |
| | | | CC Low | |
| | C | C | C High | |
| | | | C | |
| | | | C Low | |
| C | SD | DDD | D | Default |
| C | D | DD | | |
| C | D | D | | |

*Source: Rating Agencies*
*(Upgrade within the last review is marked with green color. Affirmation is marked with grey color)*

## 5. Interpreting the latest Cypriot Economic News (October-December 2018)

**High-frequency indicators behaved relatively well in Q4 despite rising world environment uncertainties**

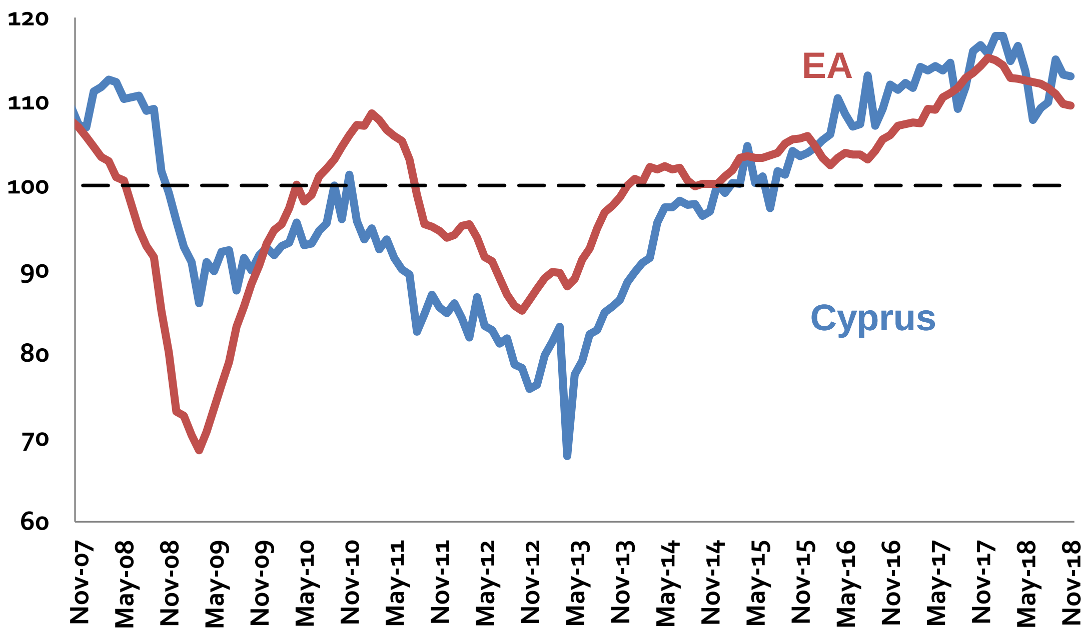
**Economic Sentiment Index (ESI Index)**

**Confidence remained almost flat in November, fluctuating in the last two months around the levels recorded in May**

The ESI Index remained almost flat in November on top of a small decline recorded in October. In more detail, ESI inched down by 0.2 points to 113.0 in November, compared to 113.2 in October and 115.0 in September. However, the ESI Index still fluctuates close to comparable levels recorded in last May. The picture was mixed among different sectors. The more pronounced improvement in expectations came from the services and retail trade components, which expanded by 9.4 and by 2.7 points respectively. In contrast, industry and construction were among those components which registered the biggest declines on a monthly basis, by 5.1 & 5.6 points respectively. Consumer sentiment showed a small –not enough to change the current dynamics-deterioration by 1.3 points.

Having slumped in Q2, the ESI index resumed its rising trend in Q3 despite rising world environment uncertainties. The ESI index had reached a new pre-Lehman Brothers period peak in January-February 2018 at 117.8 (the previous pre-Lehman period peak stood at 117.3, which was recorded in August 2007). The ESI Index decline in Q2 was not reflected in the concurrent GDP growth reading. In our previous report, we had expressed our reservations in interpreting the ESI reading decline as a leading indicator of a more pronounced slowdown for the short-term economic activity prospects given that in August2017 we had witnessed a decline of similar size. Summing up, the ESI Index stands above its long-term average. The improvement recorded in the past five years – a total of 45.9 points since the crisis period in April 2013 - is still the highest among all countries in EU-28 over the same sample period. Sentiment improvement has been one of the key drivers of the consumption rebound, which feeds into output growth.

**Figure 9: Index of Economic Sentiment**

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*Source: Eurostat, Eurobank Research*

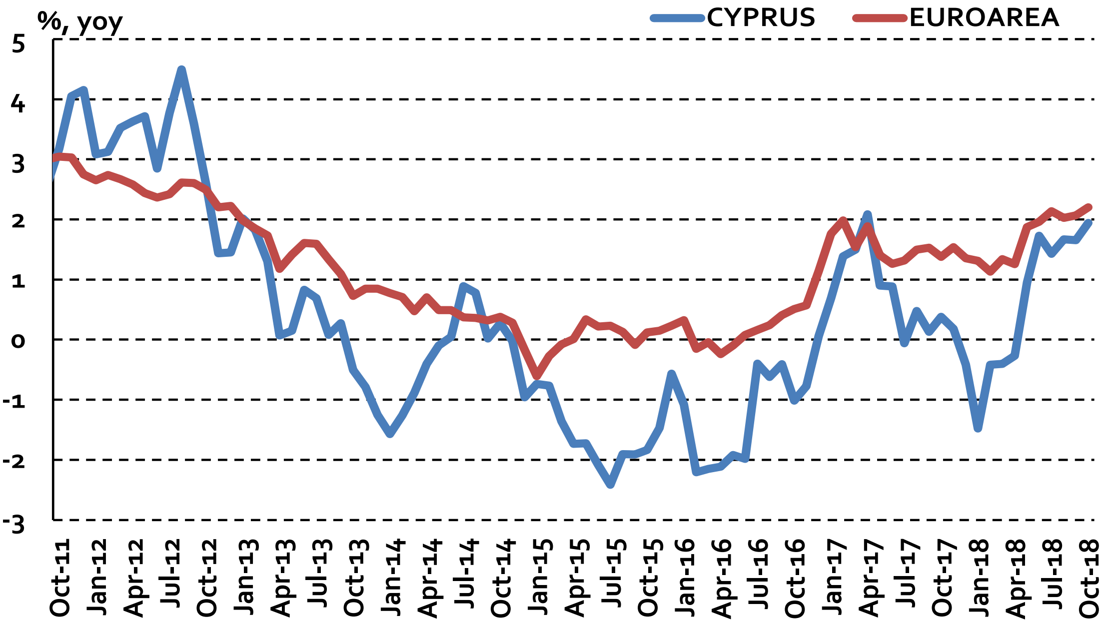
## Consumer prices (HICP)
### Inflation accelerated further in Q4-2018 on higher energy and food prices

Having re-entered in positive territory in May 2018, consumer prices measured by HICP climbed further in October2018. Having jumped to a multi month high at +1.0% MoM/+2.1% YoY in April 2017, compared to only +0.3% MoM/+0.1% YoY in December 2016, HICP dived again in negative territory in late 2017-early 2018. After a five month disinflation break between December 2017 and April 2018, HICP started climbing again. More specifically, HICP came at -0.3% MoM/+1.9% YoY in October up from -0.8% MoM/+1.7% YoY in September unchanged vs. +1.2% MoM/+1.7% YoY in August 2018, up from -0.2% MoM/+1.4% YoY in July 2018, compared to +1.0% MoM/+1.7% YoY in June 2018, +1.4% MoM/+1.0% YoY in May 2018 and +1.1% MoM/-0.3% YoY in April 2018.

One of the biggest increases on an annual basis was observed in the categories of "Utilities" (+0.2% MoM/+12.9% YoY in October compared to +3.2% MoM/+12.2% YoY in September up from +1.2% MoM/+7.1% YoY in August). The rise is driven by the spike in world energy prices in that period while the rise in "utilities" reflects also the subsequent increase in the local electricity tariffs by the state-owned energy company mirroring the spike in world energy prices. "Food & Non-alcoholic Beverages" stands out because it was the category with the third highest annual increase (-0.8% MoM/+3.3% YoY in October vs. -0.1% MoM/+3.9% YoY in September vs. +2.1% MoM/+3.8% YoY in August).

As of October, the rise of energy prices and prices of services accounted for 1.4ppts and 0.2ppts of HICP inflation respectively, the volatile food (fruit and vegetables) another 0.5ppts while non-energy industrial goods subtracted -0.3 ppts from the headline respectively. Having emerged out of a four year deflation, the average annual HICP climbed to 0.7% YoY in 2017 up from -1.2% YoY in the 2016, -1.5% YoY in 2015 and -0.3% YoY in 2014. However, it temporarily declined again to -0.8% YoY in Q1-2018 only to rebound to 0.8% YoY in Q2-2018 and further double to 1.6% YoY in Q3).

**Figure 10: HICP in Cyprus vs. EA-19**




*Source: Eurostat, Eurobank Research*

## Deposits & Loans

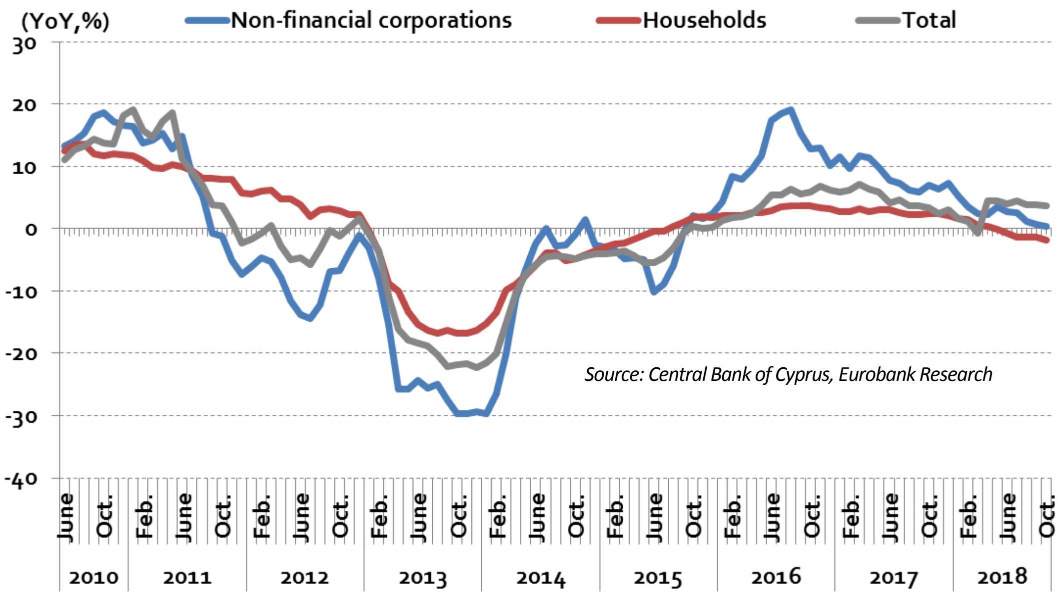
**Banking system deposits rebound in October, offsetting previous month's decline. Deleveraging accelerated in October driven entirely by the segment of financial intermediaries**

The Central Bank of Cyprus published on November 28th the Monetary and Financial Statistics (MFS) of October.[10] From a flow point of view, total deposits recorded a net increase of €299.7mn in October on top of a net decrease of €230.4mn in September against a net decrease of 176.3mn in August on top of a substantial net increase of 796.4mn in July and a net substantial decrease of €745.2mn in June, up from a substantial net increase €201.2mn in May and €2,386.4mn in April. The substantial increase of April can be attributed to the deposit placed by the Cypriot government to CCB equal to €2.5bn.

The annual rate of expansion in deposits - which has been in positive territory since October2015 with the exception of only one month in March2018 -stood at 3.8% YoY in October remaining unchanged compared to September and August vs. 4.5% YoY in July 3.1% YoY in Dec2017, compared to 6.2% YoY in Dec2016 and only 0.2% YoY in Dec2015. Total deposits reached €47.8bn in October up from €47.4bn in September against €51.1bn in August marginally up from €50.9bn in July compared to €50.2bn in June vs. €50.9bn in May, €50.5bn in April, compared to €49.0bn in December 2016 and €45.97bn in December 2015.[11]

Total loans in October exhibited a net decrease of €976.5mn on top of a net decrease of €5.2mn in September, a net decrease of €187.2mn in August, and a net decrease of €74.7mn in July compared to a net increase of €305.2mn in June. The annual growth rate of contraction came at -2.8% YoY in October, up from -0.6% YoY in September, -0.8% YoY in August, -0.6% YoY in July vs -1.1% YoY in June, compared to -1.7% YoY in December 2017 and -10.7% YoY in December 2016. A substantial part of these repayments concern previous transfers of loans from non-resident MFIs and are not related to the domestic economic activity. The outstanding amount of loans reached €39.9bn in October up from €39.6bn in September, €45.9bn in August compared to €46.2bn in July down from €46.7bn in June vs. €51.4bn in December 2017 and €55.3bn in December 2016.

**Figure 11: Annual growth of deposits**




[10] https://www.centralbank.cy/images/media/xls/MFS_August2018eng.xls

[11] The Central Bank is using ECB methodology to calculate the annual growth with a special formula taking into account the monthly transactions

## Residential Property Price Index (RPPI)-Q2-2018

**The RPPI Index recorded in Q2-2018 the sixth increase on an annual basis**

The Central Bank of Cyprus published in mid-October the residential property price index (RPPI) for Q2-2018. On a quarterly basis, the RPPI increased by +0.3% QoQ, recording the eighth consecutive quarterly rise since 2009, compared to +0.6% QoQ in Q1-2018, +0.4% QoQ in Q4-2017, +0.4% QoQ in Q3-2017, +0.5% QoQ in Q2-2017. The quarterly rise reflects the combined effect of an increase in both flat apartments and house prices by +0.7% QoQ and +0.2% QoQ respectively.  On an annual basis, the RPPI Index expanded by +1.7% YoY in Q2-2018 compared to +1.8% YoY in Q1-2018, recording the sixth consecutive monthly increase for the first time since 2008 (Figure 12B). This was up from +1.5% YoY in Q4-2017, +1.4% YoY in Q3-2017, +1.1% YoY in Q2-2017 up from +0.2% YoY in Q1-2017, -0.9% YoY in Q4-2016 compared to -1.3% YoY in Q3-2016, -1.7% YoY in Q2-2016, and smaller in absolute terms than -1.6% YoY in Q1-2016, -1.8% YoY in Q4-2015 and -3.7% YoY in Q3-2015.

Overall, the RPPI trajectory in the past quarters, in combination with other high frequency data from the construction industry hint towards further recovery of the real estate sector. Having expanded with double digits throughout 2017, construction output still increased by 13.1% YoY in Q2-2018 vs. 19.4% YoY in Q1-2018, notwithstanding the outstanding performance in Q2-2017 (+34.4% YoY) that had a negative base effects impact on the second quarter's reading.

**Figure 12a: RPPI Index (2010Q1=100)**

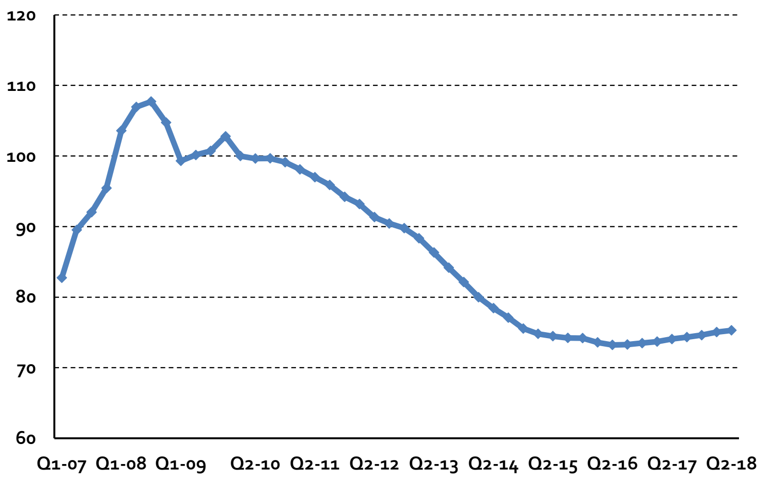
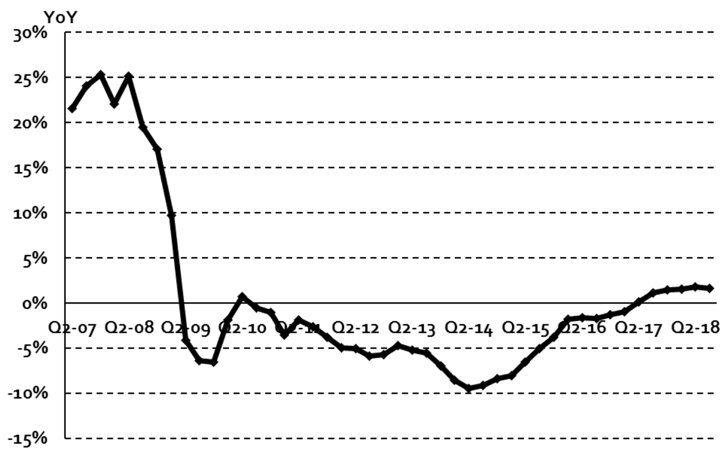



**Figure 12b: RPPI Index (%, YoY)**



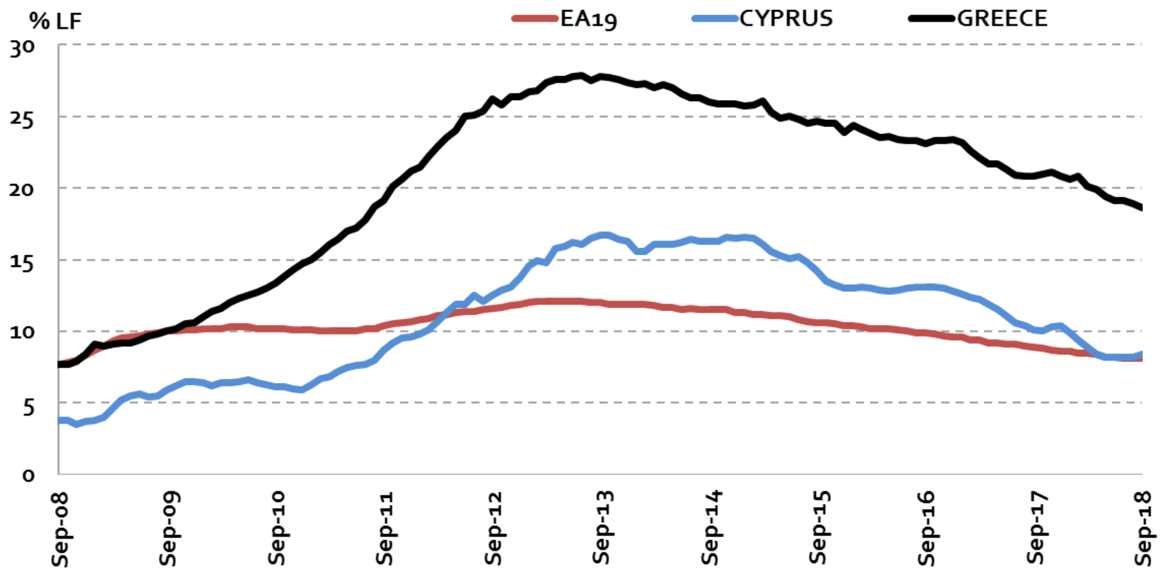

*Source: Central Bank of Cyprus, Eurobank Research*

## Unemployment

**Unemployment reaches new multi-month lows in Q3-2018, dropping below the EA19 average for the first time since 2012**

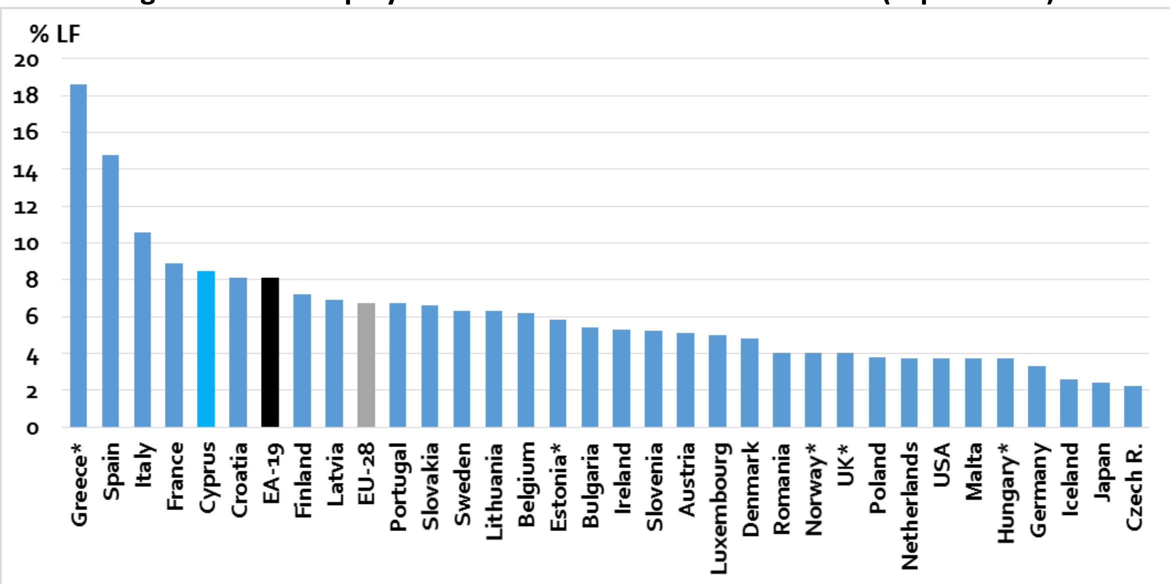
According to the latest Labor Force Survey (LFS), unemployment on a seasonally adjusted basis declined further to 7.5% in August-reaching a new multi-month low- down from 7.6% in July, 7.9% in June 10.4% in December 2017, 12.8% in December 2016, 13.1% in October 2016, and 16.7% at its peak in October 2013. Overall, Cyprus recorded the highest unemployment decline (by 2.9 ppts) in EU-28 in the first eight months of 2018, so that unemployment has now declined very close to that of Euro Area (See Figure 13). Despite the improving trend, unemployment in Cyprus is still the seventh largest (behind Greece, Spain, Italy, France Croatia and Finland) in EU-28. Youth unemployment is a source of concern and requires more attention.

**Figure 13a: Unemployment rate**




*Source: Eurostat, Eurobank Research*

**Figure 13b: Unemployment rate across EU-28 October-2018 (September*)**



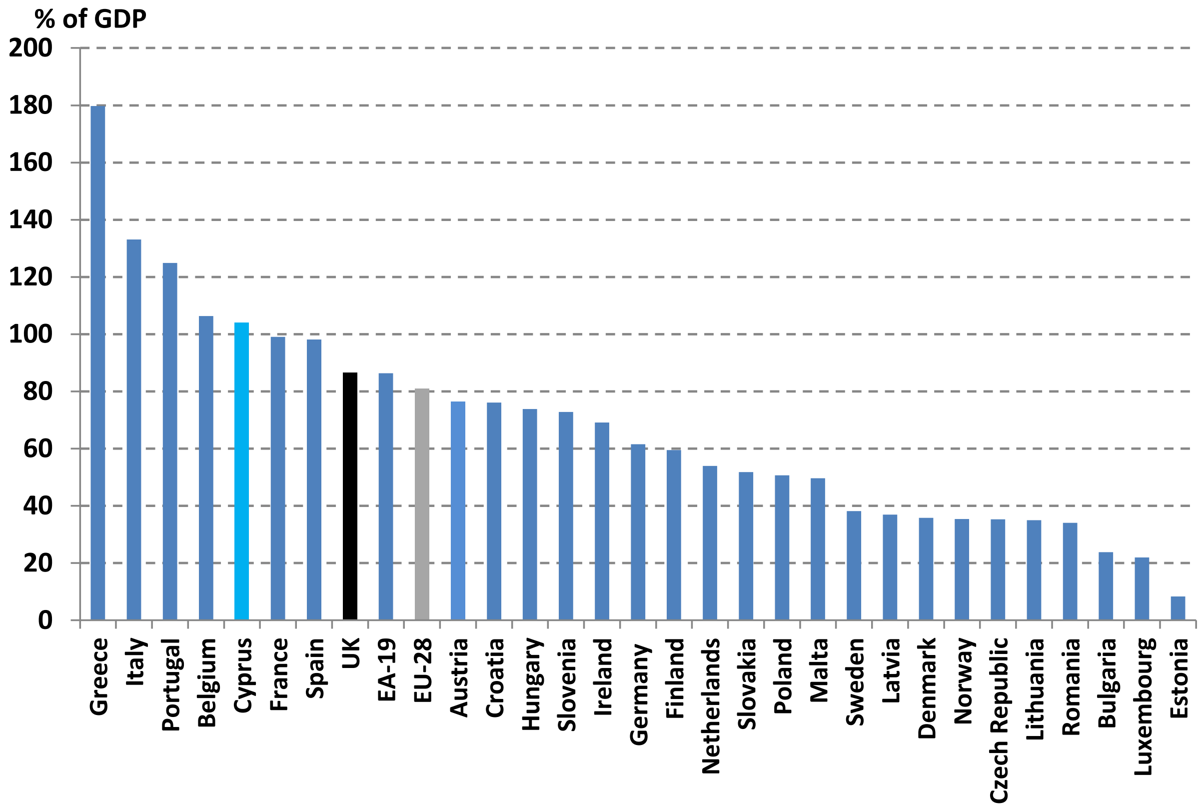
**Q2-2018 General Government Deficit and Public Debt (ESA2010 terms)**

**Cyprus temporarily deteriorates in the public indebtness ratio in Eurostat rankings as a result of the liquidity injection in the banking sector**

On October 23rd, Eurostat announced the provisional data for the fiscal deficit and public debt in the second quarter of 2018.[12] In ESA2010 terms, Cyprus recorded a €18.7mn general government deficit in Q2-2018 which is equivalent of -0.4% of the GDP in the same quarter compared to a 297.3mn general government surplus in Q1-2018 which is approximately 7.1% of the GDP in the same quarter, switching from an earlier deficit of €87.0mn or -1.7% of the GDP in the same quarter in Q4-2017, compared to a balanced position in EU-28 and a Euro Area surplus of 0.4% in the same period.

As a result, the general government debt as percentage of GDP climbed to 104.0% or €20.9bn in Q2-2018 up from 93.4% of GDP or €18.5bn in Q1-2018, compared to 96.1% of GDP or €18.8bn in Q4-2017, down from 101.3% or €19.5bn in Q3-2017, compared to 104.4% or €19.8bn in Q2-2017. Cyprus' ranking among EU-28 members deteriorated: As of Q2-2018, the Cypriot government debt as a percentage of GDP was the fifth highest, behind that of Greece (179.7%), Italy (133.1%), Portugal (124.9%), and Belgium (106.3%). The public debt of Cyprus is primarily in the form of loans (58.7% of total) and debt securities (44.7% of total).

**Figure 14: General Government Debt across EU-28 members in Q2-2018**




*Source: Eurostat, Eurobank Research*

[12] https://ec.europa.eu/eurostat/documents/2995521/9332918/2-23102018-AP-EN.pdf/62d87091-1ff0-41f6-9f26-afffb1a307b6

## January-October 2018 Budget execution

### The budget was in surplus in the first ten months of 2018

The budget was in surplus during the first ten months of 2018. The budget was in surplus during the first ten months of 2018. The consolidated government surplus increased to €852.8mn in 10M-2018, up from €495.4mn in 10M-2017. As a percentage of GDP, the consolidated government surplus came at +4.1% in 10M-2018, compared to +2.5% of GDP in 10M-2017.

The primary surplus stood at +5.9% of GDP in 10M-2018 compared to +4.0% of GDP during the same period a year ago. Total revenues improved by +8.5% YoY, driven by double digit growth in VAT revenues collection (+16.4% YoY) and social security contributions (+9.2% YoY). The only item which registered a decrease was property taxes (-32.3% YoY). On the other hand, total expenditure remained relatively contained, expanding by +2.8% YoY driven by higher spending on public wages (+3.0% YoY), social benefits (+2.9% YoY) and current transfers (+4.1% YoY). On the other hand, spending items such as interest payments (-15.7% YoY) and capital expenditure (-2.9% YoY) decreased.

**Table 4: General Government Budget Execution**

| General Government Adjusted Budget Balance on cash basis (January-October 2018) | | |
|---|---|---|
| in % GDP | January-October 2017 | January-October 2018 |
| I. Government Budget and SSF | | |
| Total Revenue | **29.0%** | **29.4%** |
| Current revenue | 28.7% | 29.0% |
| Direct Taxes | 8.3% | 8.3% |
| Indirect Taxes | 12.0% | 12.6% |
| of which, VAT | 7.4% | 8.2% |
| Social security contributions | 4.7% | 5.0% |
| Non-tax revenue | 3.5% | 3.0% |
| Capital Revenue | 0.0% | 0.0% |
| Grants | 0.3% | 0.4% |
| Total Expenditure | **26.6%** | **25.8%** |
| Current expenditure | 25.7% | 25.0% |
| Wages and Salaries | 6.9% | 6.8% |
| Goods and services | 1.7% | 1.3% |
| Subsidies | 0.3% | 0.2% |
| Social Security payments | 6.2% | 5.0% |
| Pensions | 2.3% | 1.8% |
| Social Pensions | 0.3% | 0.2% |
| Current transfers | 5.8% | 4.5% |
| Non-allocated | 0.1% | 0.1% |
| Interest payments | 2.2% | 1.8% |
| Capital expenditure | 0.8% | 0.8% |
| Balance (I) | **2.4%** | **3.6%** |
| II. Other General Government Bodies | | |
| including | | |
| Local Authorities | 0.0% | 0.1% |
| Semi-public Entities | 0.0% | 0.1% |
| Other Entities | 0.0% | 0.1% |
| Balance (II) | 0.1% | 0.3% |
| III. ESA 2010 adjustments | | |
| Balance (III) | 0.0% | 0.0% |
| III. General Government Balance | | |
| Budget Balance (I+II+III) | **2.5%** | **4.1%** |
| Primary Balance (excl. interest) | **4.5%** | **5.9%** |
| Cyprus GDP (Mrd EURO-CYP) | 19,816.0 | 20,800.0 |

*Source: Ministry of Finance, Eurobank Research*

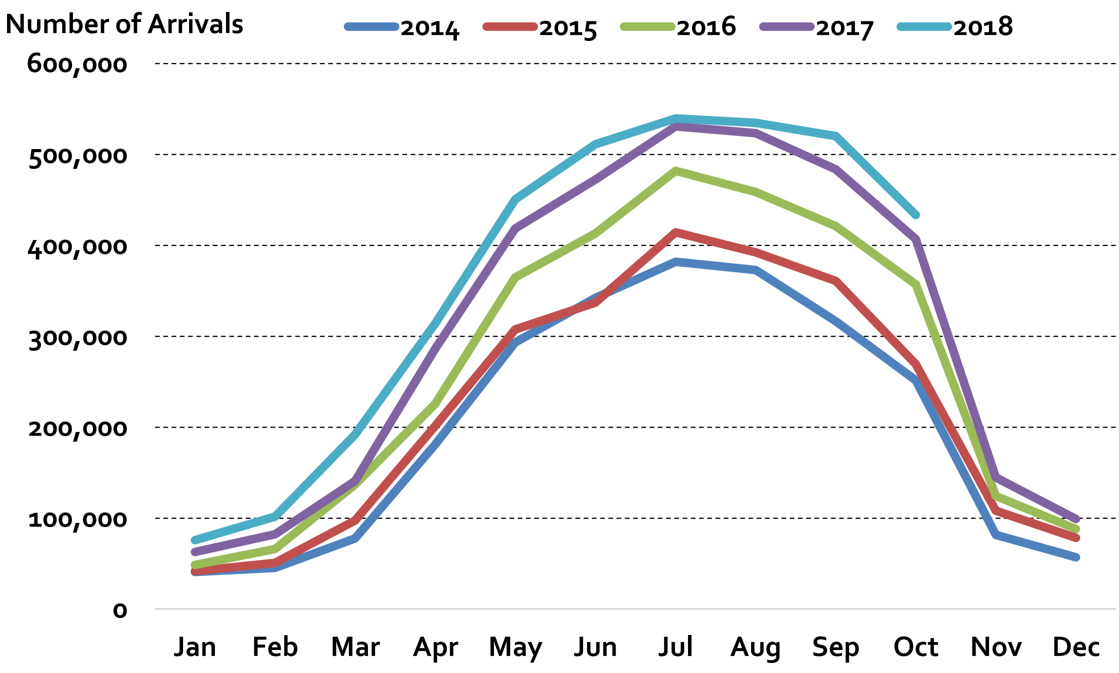
## Tourism arrivals (January-October2018) & revenues (January-September2018)

### Poised for another year of records in tourism arrivals

The positive momentum in the tourism sector continued into 10M-2018. Tourist arrivals expanded by 6.6% YoY in the month of October 2018 to 433.6 thousand, up from 406.8 thousand in same month a year earlier (October 2017). The month of October was the fortieth consecutive month with a positive rate of increase on an annual basis. This sets a new record as it was the highest volume of tourist arrivals ever recorded in Cyprus during October. Overall, the number of tourist arrivals increased by 7.8% YoY in 10M-2018 (3,673,677 vs. 3,408,473 in the same period last year). Tourist arrivals from Eastern Europe countries such as Poland (+56.0% YoY) and Ukraine (+47.9 YoY) and Nordic countries such as Finland (+25.2% YoY) and Sweden (+12.3% YoY) recorded a hefty increase. Tourist arrivals from some traditional markets such as Germany (-1.8% YoY), Greece (+9.0% YoY), Israel (-11.4% YoY), and UK (+6.1% YoY) had a mediocre performance in 10M-2018. In addition, tourist arrivals from niche markets such as Russia (-4.9% YoY) were weak while tourist arrivals from Switzerland, a new niche tourist market for Cyprus has been growing fast in 2018 (+29.2% YoY).

Accordingly, tourism revenues also expanded by +2.3% YoY in January-September 2018 to €2,268.5mn, up from €2,216.7mn compared to the same month last year. However, the corresponding statistics for expenditure per person are on a declining trend. The expenditure per person for January – September 2018 reached €700,21 compared to €738,49 in the corresponding period of the previous year, recording a decrease of 5.2%. In fact, the expenditure per person/per day for the period of January – September 2018 compared to the period of January – September 2017 also recorded a decrease of 3.2% (from €77,74 to €75,29). Overall, the tourism industry is poised for another year of records in 2018 contributing to the GDP growth rebound of the Cypriot economy.

**Figure 15: Tourism Arrivals**




*Source: CYSTAT, Eurobank Research*

# Eurobank Cyprus Research

| Economic Indicators | Description | Source | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **National Accounts** | | | | | | | | | | | | | | | | |
| Population | Number | Eurostat | 722,893 | 733,067 | 744,013 | 757,916 | 776,333 | 796,930 | 819,140 | 839,751 | 862,011 | 865,878 | 858,000 | 847,008 | 848,319 | 854,802 |
| GDP (%YoY) | Constant Prices | Eurostat | 4.6 | 3.7 | 4.5 | 4.8 | 3.9 | -1.8 | 1.3 | 0.3 | -3.1 | -5.9 | -1.4 | 2.0 | 3.4 | 3.9 |
| Households and NPISHs Final Consumption Expenditure (YoY%) | Constant Prices | Eurostat | 7.2 | 3.5 | 4.4 | 10.2 | 7.9 | -6.4 | 3.3 | -0.7 | -1.3 | -5.9 | 0.7 | 2.6 | 3.3 | 4.2 |
| General Government Final Consumption Expenditure (YoY%) | Constant Prices | Eurostat | 1.2 | 2.8 | 7.0 | 3.3 | 5.7 | 6.4 | 1.2 | 2.1 | -1.8 | -8.1 | -7.2 | -2.8 | -0.4 | 2.7 |
| Gross Fixed Capital Formation (YoY%) | Constant Prices | Eurostat | 4.7 | 6.9 | 21.0 | 7.8 | 8.8 | -13.6 | -2.6 | -12.1 | -20.5 | -12.9 | -17.5 | 13.6 | 35.0 | 27.8 |
| Exports of Goods and Services (YoY%) | Constant Prices | Eurostat | 2.3 | 2.1 | 1.3 | 5.3 | -0.7 | -4.1 | 4.5 | 5.6 | -2.7 | 2.1 | 4.2 | 5.8 | 4.0 | 3.4 |
| Imports of Goods and Services (YoY%) | Constant Prices | Eurostat | 6.9 | 1.6 | 5.7 | 10.5 | 12.5 | -15.0 | 8.0 | -3.0 | -4.4 | -4.8 | 4.6 | 7.4 | 6.8 | 10.1 |
| GDP | Current Prices, SA ,mil | Cyprus Statistical Service | 13856.4 | 14822.3 | 16000.0 | 17511.6 | 19006.2 | 18673.5 | 19299.5 | 19731.0 | 19489.7 | 18140.5 | 17605.6 | 17742.0 | 18219.1 | 19213.8 |
| GDP (%YoY) | Current Prices, SA ,mil | Cyprus Statistical Service | 7.9 | 7.0 | 8.0 | 9.5 | 8.5 | -1.8 | 3.4 | 2.2 | -1.2 | -6.9 | -3.0 | 0.8 | 2.7 | 5.5 |
| **Labour Market** | | | | | | | | | | | | | | | | |
| Unemployment Rate | % active population | Eurostat | 4.6 | 5.3 | 4.6 | 3.9 | 3.7 | 5.4 | 6.3 | 7.9 | 11.9 | 15.9 | 16.1 | 15.0 | 13.0 | 11.1 |
| Labor Productivity | Real, Per employee, % Change | Eurostat | 0.6 | 0.1 | 2.6 | 0.4 | 0.3 | -1.8 | 0.8 | 0.3 | 0.1 | 0.0 | 0.4 | 0.5 | 0.1 | 0.3 |
| Unit Labor Costs | Index, 2010=100 | Eurostat | 82.3 | 87.7 | 89.1 | 90.4 | 93.0 | 100.2 | 100.0 | 101.8 | 103.4 | 97.9 | 94.0 | 92.4 | 91.6 | 91.8 |
| Unit Labour Cost Growth Total Economy | YoY% | Eurostat | 1.6 | 6.5 | 1.6 | 1.5 | 2.9 | 7.7 | -0.2 | 1.8 | 1.6 | -5.3 | -4 | -1.7 | -0.8 | 0.2 |
| **Short-term business statistics** | | | | | | | | | | | | | | | | |
| Economic Sentiment Index (ESI) | EoP, SA | EU Commission | 106.3 | 98.4 | 106.4 | 106.9 | 95.8 | 92.6 | 95.8 | 84.8 | 76.3 | 88.5 | 100.2 | 103.9 | 113.3 | 115.7 |
| Industry | EoP, SA | EU Commission | -36.4 | -26.2 | -31.8 | -40.8 | -39.2 | -40.5 | -46.7 | -61.3 | -43.9 | -20.2 | -10.0 | -4.0 | -0.4 | 8.7 |
| Construction | EoP, SA | EU Commission | -4.4 | -32.7 | 2.7 | -7.9 | -27.5 | -38.8 | -44 | -51.5 | -56.5 | -54.5 | -49.8 | -30.3 | -27.4 | -24.3 |
| Retail trade | EoP, SA | EU Commission | 3.3 | 5.2 | 0.7 | 11.2 | -12.8 | -22.5 | -22.6 | -29.0 | -31.8 | -19.1 | -10.6 | -1.6 | 8.5 | 10.0 |
| European Commission Services Confidence Indicator Cyprus | EoP, SA | EU Commission | 14.4 | 6.1 | 15 | 8.7 | 1.8 | -3.6 | 3.6 | -25.2 | -40.7 | -24.2 | 11.4 | 8.2 | 28.4 | 36.5 |
| Industrial Production General Index | NSA | Eurostat | 134.7 | 136 | 136.7 | 142.9 | 148.8 | 135.3 | 132.9 | 122.8 | 110.6 | 95.7 | 95.1 | 100 | 109.3 | 118.2 |
| Industrial Production General (%YoY) | NSA | Eurostat | 1.5 | 1 | 0.5 | 4.5 | 4.1 | -9.1 | -1.8 | -7.6 | -9.9 | -13.5 | -0.6 | 5.2 | 9.3 | 8.1 |
| European Commission Capacity Utilization Cyprus SA | SA | Cyprus Statistical Service | 69.9 | 72.5 | 66.7 | 71.2 | 69.4 | 63.0 | 63.9 | 58.1 | 53.7 | 50.8 | 54.5 | 61.1 | 59.6 | 59.1 |
| **Housing and Real Estate** | | | | | | | | | | | | | | | | |
| Building Permits | Number | Cyprus Statistical Service | 8252.0 | 9098.0 | 9794.0 | 9521.0 | 8896.0 | 8950.0 | 8777.0 | 7506.0 | 7172.0 | 5341.0 | 4933.0 | 5014.0 | 5354.0 | 5728.0 |
| Value of permits | mil € | Cyprus Statistical Service | 1994.6 | 2288.9 | 2473.4 | 2782.3 | 2904.6 | 2815.8 | 2639.5 | 2065.1 | 1632.3 | 1141.0 | 859.5 | 1071.4 | 1047.1 | 1719.8 |
| Area of permits | (Thousand Sqm) | Cyprus Statistical Service | 3015.7 | 3417.0 | 3507.5 | 3612.8 | 3689.1 | 3136.5 | 2917.9 | 2253.0 | 1499.9 | 1044.8 | 784.9 | 881.1 | 1157.6 | 1542.7 |
| Dwelling Units | Number | Cyprus Statistical Service | 15743.0 | 18770.0 | 18915.0 | 20486.0 | 20082.0 | 16688.0 | 14312.0 | 8839.0 | 5879.0 | 4141.0 | 2855.0 | 3197.0 | 3649.0 | 4939.0 |
| **Personal/Household Sector** | | | | | | | | | | | | | | | | |
| Credit for Consumption | mil € | ECB MFIs Statistics | | 2,577 | 2,848 | 3,118 | 4,261 | 4,770 | 3,390 | 3,371 | 3,341 | 3,039 | 2,794 | 2,792 | 2,583 | 2,486 |
| Lending for House Purchase | mil € | ECB MFIs Statistics | | 4,140 | 5,450 | 6,989 | 8,584 | 10,492 | 12,033 | 12,658 | 12,772 | 11,943 | 11,747 | 11,735 | 11,587 | 11,187 |
| Other Lending Cyprus | mil € | ECB MFIs Statistics | | 5,645 | 5,676 | 6,111 | 6,366 | 5,600 | 7,381 | 7,855 | 8,025 | 7,558 | 7,433 | 7,099 | 6,736 | 6,274 |
| Total MFI Loans to Non-MFIs Domestic Residents | Monetary & Financial Statistics | Central Bank of Cyprus | | 25,005 | 27,511 | 33,995 | 43,452 | 45,681 | 49,403 | 52,870 | 53,936 | 50,082 | 49,583 | 51,201 | 45,310 | 43,116 |
| Total deposits of Non-MFIs held with MFIs Domestic Residents | Monetary & Financial Statistics | Central Bank of Cyprus | | 24,874 | 27,401 | 32,294 | 39,462 | 41,012 | 45,379 | 43,748 | 43,317 | 32,973 | 32,283 | 32,868 | 36,586 | 37,807 |
| Gross Household Saving Rate | % of Gross Disposable Income | Eurostat | 8.7 | 11.5 | 11.6 | 6.2 | 5.0 | 9.2 | 6.5 | 6.4 | 3.7 | -1.8 | -6.3 | -5.0 | -2.3 | N/A |
| **International Trade & Balance of payments** | | | | | | | | | | | | | | | | |
| Current account balance (%GDP) | BMP6 | Eurostat | | | | | -15.5 | -7.7 | -11.3 | -4.1 | -6.0 | -4.9 | -4.3 | -1.5 | -4.9 | -6.7 |
| Current Account, Goods & Services Net Balance (%GDP) | BMP6 | Eurostat | | | | | -12.8 | -5.4 | -7.3 | -2.9 | -1.5 | 1.8 | 2.1 | 0.8 | -0.8 | -2.0 |
| Current Account, Primary Income Net Balance (%GDP) | BMP6 | Eurostat | | | | | -2.5 | -1.3 | -3 | 0 | -3 | -4.7 | -3.6 | 0.6 | -1.6 | -2.5 |
| Current Account, Secondary Income Net Balance (%GDP) | BMP6 | Eurostat | | | | | -0.3 | -1.0 | -1.0 | -1.1 | -1.4 | -2.1 | -2.7 | -2.9 | -2.5 | -2.2 |
| Imports of Goods (%GDP) | BMP6 | Eurostat | | | | | 42.2 | 34.7 | 36.8 | 35.5 | 33.6 | 31.2 | 31.9 | 33 | 35.5 | 36.4 |
| Exports of Goods (%GDP) | BMP6 | Eurostat | | | | | 12.0 | 13.1 | 13.9 | 15.3 | 15.6 | 15.0 | 15.9 | 16.2 | 14.2 | 12.9 |
| Imports of Services (%GDP) | BMP6 | Eurostat | | | | | 20.7 | 19.4 | 20.7 | 20.4 | 21.3 | 25.7 | 28.1 | 30.8 | 30.0 | 30.1 |
| Exports of Services (%GDP) | BMP6 | Eurostat | | | | | 38.1 | 35.7 | 36.3 | 37.6 | 37.8 | 43.7 | 46.1 | 48.3 | 50.5 | 51.7 |
| Financial Account (%GDP) | BMP6 | Eurostat | | | | | -18.5 | -8.4 | -8.6 | -1.2 | -2.1 | -1.9 | -7.1 | -1.6 | -7.4 | -2.1 |
| **Government Finance & Debt** | | | | | | | | | | | | | | | | |
| General Government Deficit (-) or Surplus (+) (% GDP) | including Coops banks' recap | Cyprus Statistical Service | -3.7 | -2.2 | -1.0 | 3.2 | 0.9 | -5.4 | -4.7 | -5.7 | -5.6 | -5.1 | -9.0 | -1.3 | 0.3 | 1.8 |
| General Government Debt EDP Procedure (% GDP) | | Cyprus Statistical Service | 64.1 | 62.8 | 58.7 | 53.5 | 45.1 | 53.8 | 56.3 | 65.7 | 79.7 | 102.6 | 107.5 | 107.5 | 106.6 | 97.5 |
| **Prices** | | | | | | | | | | | | | | | | |
| CPI (%YoY) | Annual Average | Cyprus Statistical Service | 2.3 | 2.6 | 2.5 | 2.4 | 4.7 | 0.3 | 2.4 | 3.3 | 2.4 | -0.4 | -1.4 | -2.1 | -1.4 | 0.5 |
| Cyprus HICP All Items (% YoY) | Annual Average | Eurostat | 1.9 | 2.0 | 2.2 | 2.2 | 4.4 | 0.2 | 2.6 | 3.5 | 3.1 | 0.4 | -0.3 | -1.5 | -1.2 | 0.7 |
| **Tourism** | | | | | | | | | | | | | | | | |
| Tourist & Excursionist Arrivals | Number | Cyprus Statistical Service | 2,349,007 | 2,470,057 | 2,400,919 | 2,416,075 | 2,403,744 | 2,141,187 | 2,172,993 | 2,392,223 | 2,464,903 | 2,405,387 | 2,441,231 | 2,659,400 | 3,186,531 | 3,652,073 |
| Revenue From Tourism | mil € | Cyprus Statistical Service | 1,678,419 | 1,718,302 | 1,755,252 | 1,858,106 | 1,792,787 | 1,493,246 | 1,549,801 | 1,749,306 | 1,927,600 | 2,082,400 | 2,023,400 | 2,112,100 | 2,363,400 | 2,639,100 |
| **Market Indicators** | | | | | | | | | | | | | | | | |
| 10Y Gov Bond Yield Rate | %, EMU criterion series | Eurostat | 6.3 | 4.1 | 4.3 | 4.6 | 4.6 | 4.6 | 4.6 | 7.0 | 7.0 | 6.0 | 6.0 | 3.9 | 3.6 | 1.6 |
| Cyprus Stock Exchange Index | EoP, Composite Index | | 1012.27 | 1704.76 | 3900.39 | 4820.72 | 1101.42 | 1597.23 | 1055.21 | 295.94 | 114.86 | 103.31 | 85.70 | 67.75 | 66.41 | 69.50 |