JUNE 2018

CYPRUS

ECONOMIC & FINANCIAL OUTLOOK

ECONOMIC RESEARCH DIVISION

Growth Surprises on the Upside

In March 2016, Cyprus successfully completed and exited the economic adjustment programme, winning international praise and achieving "success story" status, at least in macroeconomic terms. After an economic expansion by 3.4% in 2016, underpinned by a buoyant tourism sector, low interest rates and falling consumer prices, the economy continued its upward trend in 2017, beating market expectations. Economic growth reached 3.9% in 2017, which is the strongest growth rate since 2008 and one of the highest in the Euro Zone. It is worth mentioning that recovery is taking place against an international environment that, although relatively benign, still carries some uncertainty and poses geopolitical downside risks. According to the demand-side accounting (Graph 1), economic growth in 2017 exceeded expectations, driven mainly by:

i. Strong private consumption, which continues to benefit from rising wages and rapidly expanding employment;
ii. Solid export growth, deriving from exports of services linked to the ongoing tourism boom in Cyprus which coincided with a certain rebound in goods-exports;
iii. Strong investment, as gross fixed capital formation reached almost 23% of GDP in 2017 from 15% in 2013, lying above the EU average.

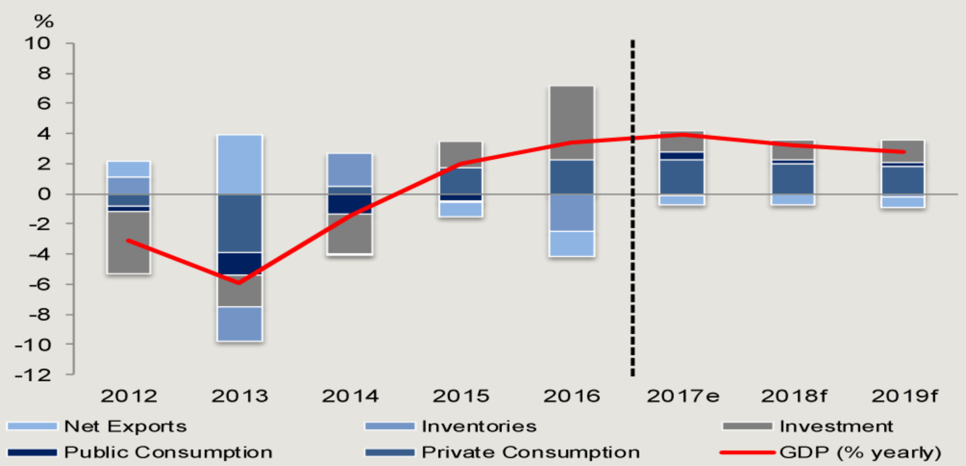
Rising employment and consumer confidence supported economic activity which increased by 3.8% y-o-y in the first quarter of 2018. Leading indicators point to a resilient growth in 2018 as a whole. Improving growth projections are mainly driven by favourable domestic and external factors shaped by, among other, the following developments:

Firstly, labour market conditions continued to improve as employment growth has gathered steam, increasing by 4.3% y-o-y in 2017 (Graph 2).

Secondly, there is a strong upward trend in domestic economic sentiment, particularly in services and among consumers, for which confidence has further increased, fueling economic activity growth in 2018 (Graph 2).

GRAPH 1

Contributions to Real GDP Growth - Demand Side



Sources:

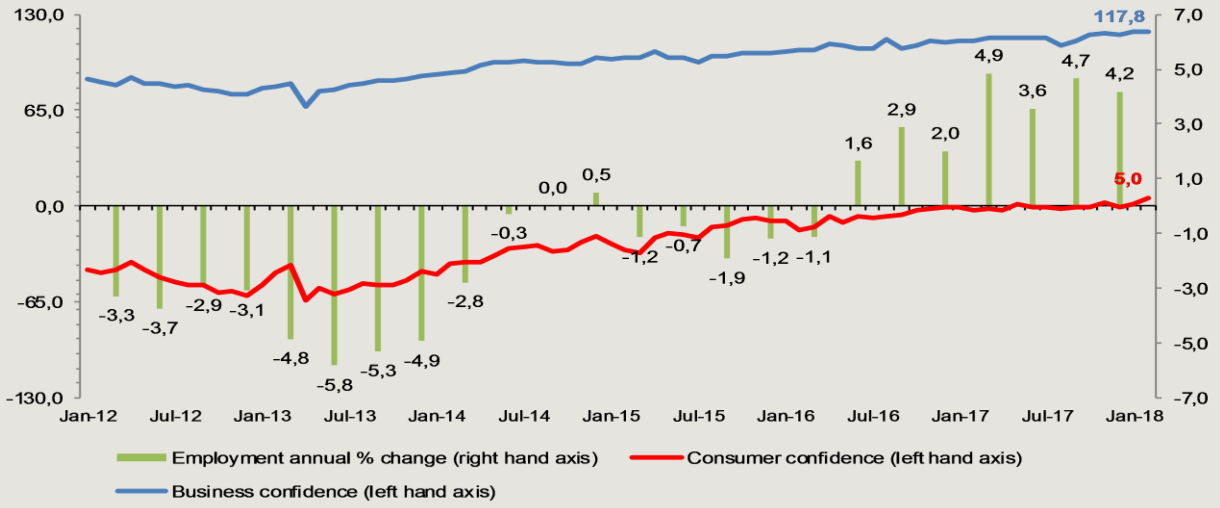
Eurostat, CYSTAT, European Commission

Thirdly, domestic financial conditions are improving supported by rising deposits and ongoing deleveraging (reduction of loan-to-deposit ratio), the low levels of lending interest rates and the ongoing recovery of the Cyprus Stock Exchange general index since December 2016 (Graph 3).

Finally, favourable external economic conditions. In 2017, growth in the EU and the euro area accelerated, the recovery of the Russian economy gained strength and the United Kingdom (UK) economy continued to expand, albeit at a slower pace than in 2016. Interest rates in the Eurozone remain at very low levels boosting lending and continue to point towards an optimistic outlook.

GRAPH 2

Domestic Leading Indicators Continue to Improve: Hard and Soft Data

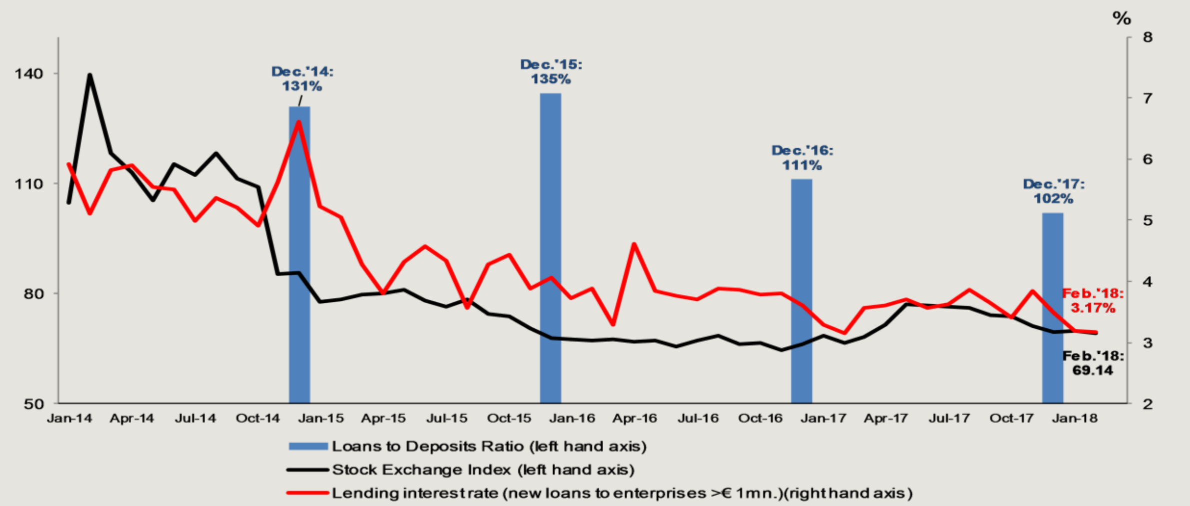


Sources:

Eurostat, CYSTAT, European Commission

GRAPH 3

Domestic Financial Conditions



Sources:

Central Bank of Cyprus, Bloomberg

On the political front, following the second round of the presidential elections in Cyprus, held in early February, outgoing President Nicos Anastasiades backed by the ruling Democratic Rally (DISY) party, was re-elected President for a second five-year term. According to his electoral programme, the President committed to introduce a new economic growth model with focus on strengthening small to medium sized business and promoting entrepreneurial innovation, as well as to continue delivering balanced budgets of a modern digital state.

Robust and Broad-based Growth set to continue in the Medium-term Horizon, 2018-2019

Regarding the supply side, the increase in GDP growth is broadly based and originates mainly from the sectors of hotels and restaurants, retail and wholesale trade, construction, and manufacturing (Graph 4). However, financial service activities recorded negative growth due to the ongoing deleveraging. It is expected that in 2018-2020, a robust broad-based growth will remain in place, supporting further declines in the unemployment rate and in non-performing loans (NPLs). It is projected that growth will moderate to 3.6% in 2018 and ease to 3.3% in 2019, driven by private consumption although at a weaker pace than at present and faster investment growth. Investment outlook is supported by large-scale private projects as well as new bank lending.

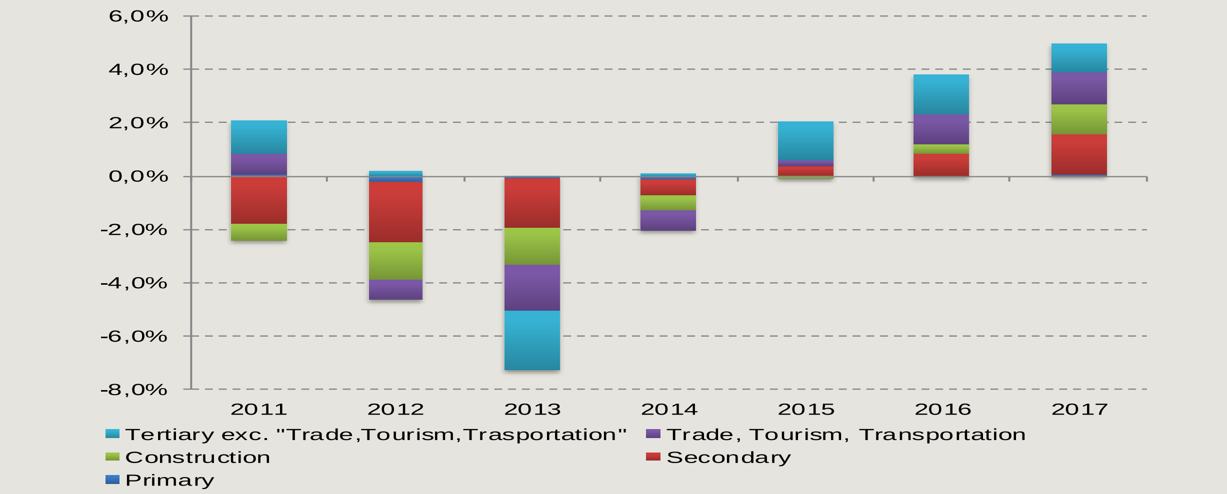
As seen in Graph 1, over the medium term, the growth rate is anticipated to ease from its post-crisis rebound as stepped-up debt servicing might curb private spending. This reflects a slower pace of private consumption growth as improved payment discipline, brought about by the banks' enhanced loan restructuring procedures, will lead to faster debt repayments. Investment is expected to maintain its momentum, supported by sustained capital inflows and new bank lending to competitive firms.

In addition to the sectors of tourism, business services and shipping, which are expected to remain the main drivers, a series of large private and public investments in tourism, gaming and higher education will also underpin robust growth. Furthermore, the citizenship-by-investment scheme was modified in order to attract investors interested in relocating their business headquarters and thus bolster the weakened property market.

Risks to the growth outlook are broadly balanced. The main downside risks include the still very high stock of non-performing loans, possible delays in the construction of tourism-related projects and the macroeconomic prospects of the UK, which is one of the country's key trading partners. Delays of NPLs reduction could prevent banking sector's ability to back economic growth through new lending. Upside risks pertain to the buoyant confidence leading to stronger domestic demand as well as to a higher-than-expected economic recovery in the rest of the EU, which could push growth above expectations, as well as if exploitations in hydrocarbons deposits in the Exclusive Economic Zone (EEZ) of Cyprus, prove financially viable.

GRAPH 4

Contributions to Real GDP Growth – Supply Side



Source: CYSTAT

Remarkable External Adjustment

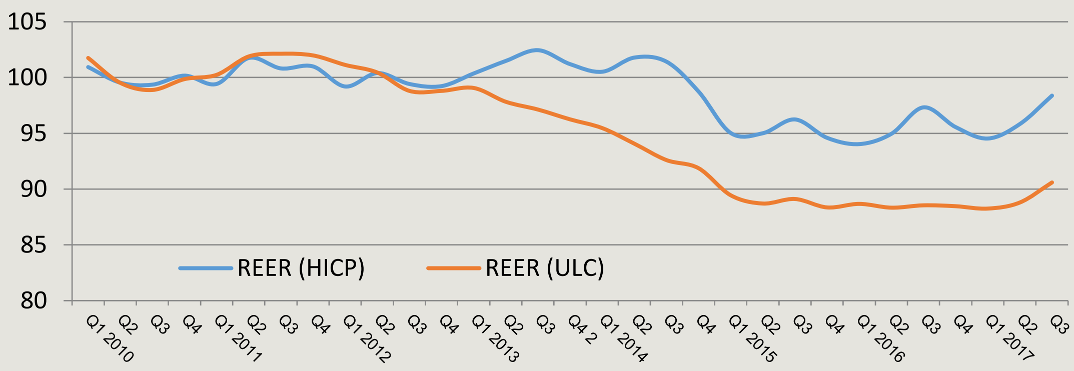
One of the legacies of the efficient Memorandum of Understanding (MoU) implementation is the spectacular improvement of competitiveness after 2013, evident in Graph 5. Falling prices and wages since the 2013 crisis have led to real effective exchange rate depreciation, in terms of consumer prices and unit labour cost, by 10 and 20 percent, respectively. These have attracted investment and have improved external imbalances. As depicted in Graph 6, external adjustment has continued during 2013-2015, supported by the gains in price competitiveness. In 2017, the overall current account deficit widened to 8.1% of GDP due to a large one-off ship import (a yacht).

In addition to the real effective exchange rate, a qualitative measure of competitiveness is the global competitiveness index developed by the World Economic Forum. The performance of Cyprus based on this index and compared with selected countries in the region, including Greece, is presented in Graph 7. It is worth noting that the country's global competitiveness ranking for 2017-2018 has improved for the first time in eight years.

Specifically, according to the "2017-2018 Global Competitiveness Index" report, Cyprus moved up 19 places, ranking 64th out of 137 economies. According to the report's data, this improvement is mainly attributed to the island's strengthening performance, following its "clean exit", in March 2016, from the three-year economic adjustment programme. Other conducive factors were the improved infrastructure, especially in air transport and tourism, as well as the increased absorption of the latest technologies.

GRAPH 5

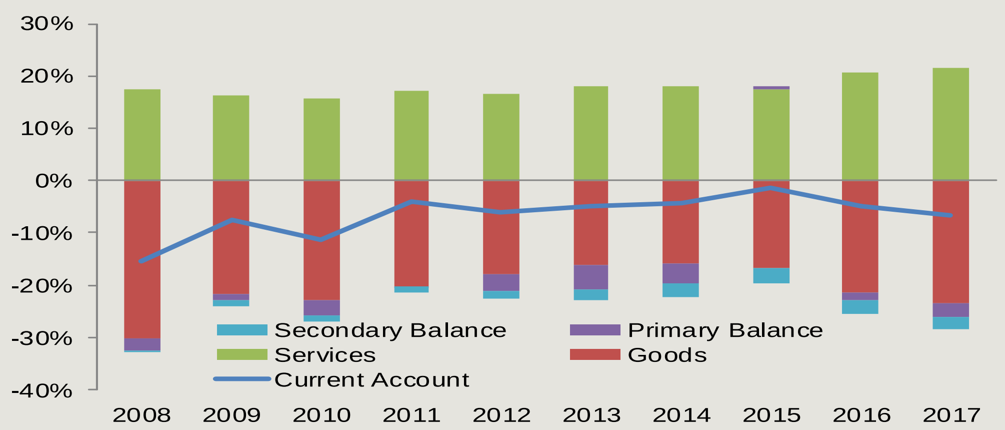
Competitiveness Gains on the back of MoU Implementation



Source: European Commission

GRAPH 6

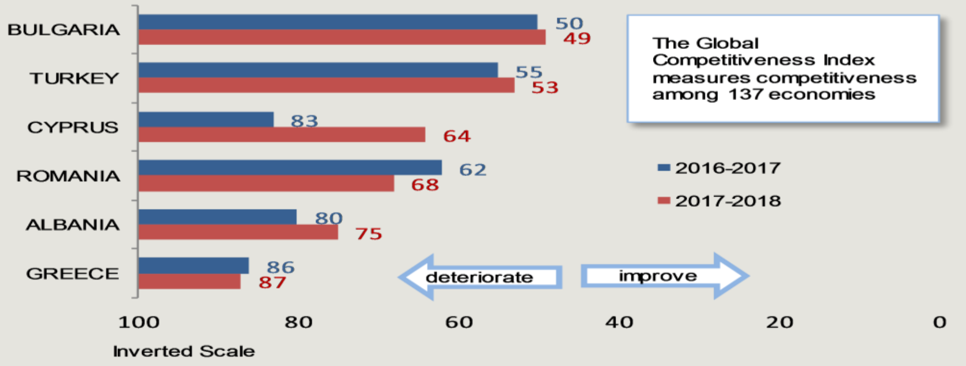
Current Account and its Components (as % of GDP)



Source: CYSTAT

GRAPH 7

Global Competitiveness Index Ranking



Sources:

World Economic Forum,

The Global Competitiveness Report 2017-2018

Strong Labour Market and Modest Inflation

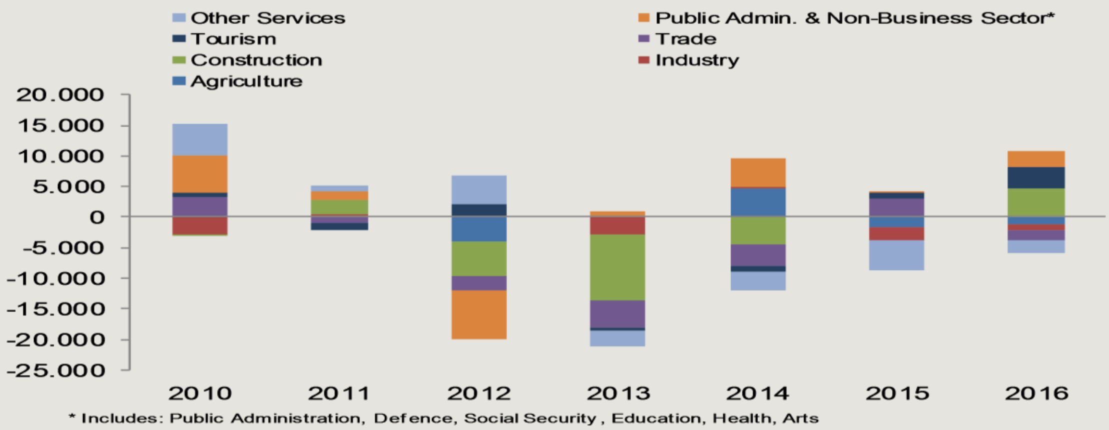
In 2017 with the exception of agriculture, all sectors contributed positively to job creation, with employment in the construction sector rising fast (Graph 8). Supported by economic growth, employment growth has gathered steam in 2017, increasing by 4.3% and driving unemployment rate down to 11.0% from 12.9% in 2016, as seen in Graph 9.

Additionally, the labour market is recovering as Cyprus recently exited an extended period of deflation. In particular, as from December 2016, domestic inflation has turned positive (Graph 10) after four years being in negative territory. Inflation was driven mainly by energy prices and prices in the tourism industry.

The average harmonised inflation rate in 2017 was 0.7%. This level still falls short of the ECB's inflation target of below, but close to 2%. As both price and wage inflation are expected to remain in positive territory, the European Commission projects that the economy's output gap* is also going to turn positive in 2017 and 2018, indicating that the growth of aggregate demand is outpacing the growth of aggregate supply. Although harmonised inflation rate was weak in the first months of 2018, it is expected to rise modestly driven by higher energy prices and domestic demand resulting from wage growth.

GRAPH 8

Contribution of New Jobs per Sector (y-o-y change)



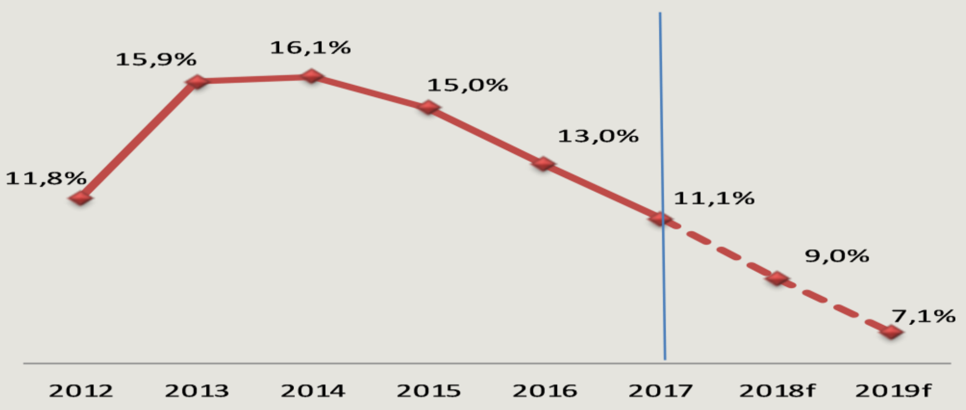
Source:

CYSTAT

*[1] Output gap is defined by OECD as actual minus potential GDP. In turn, potential GDP is defined as the level of output that an economy can produce at a constant inflation rate.

GRAPH 9

Falling Unemployment Rate

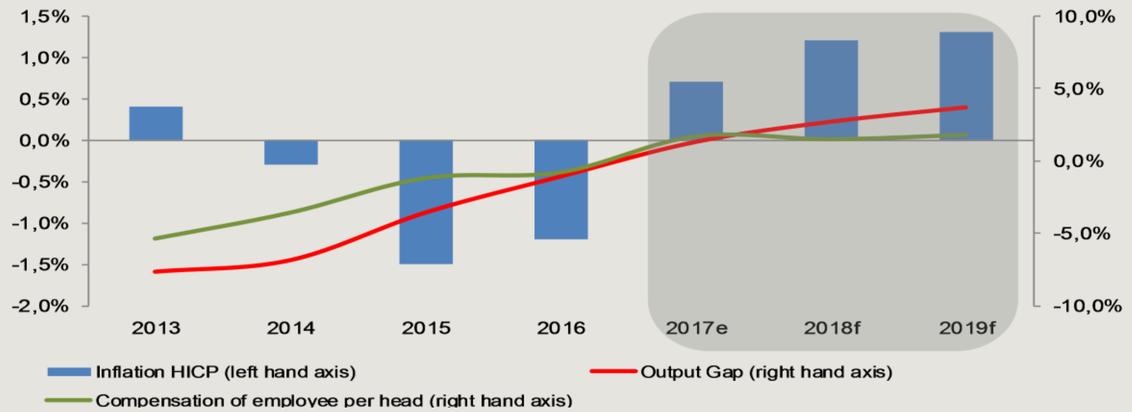


Source:

Central Bank of Cyprus, European Commission

GRAPH 10

Inflation, Compensation of Employee and Output Gap



Source:

European Commission

Expansionary Fiscal Consolidation in Sight: Credit Ratings and Confidence

It is noteworthy that the fiscal discipline imposed by the economic adjustment programme did not prevent the expansion of the Cypriot economy. In particular, the general government budget position in 2016 and 2017 turned out to be better than anticipated. The general government balance was improved further, reaching a surplus of 1.9% of GDP in 2017 from 0.5% of GDP in 2016 (Graph 11). The primary surplus of the general government (debt service payments not included) was also increased to 4.4% of GDP in 2017 and remains one of the highest in the euro area, driven by high revenue collection underpinned by favourable macroeconomic conditions and improving labour market conditions.

The rise in tax revenue was driven by major increases in indirect taxes (including VAT, excise taxes and taxes on imports). Total revenue increased by 1.4 percentage points of GDP, as a result of significant increases in revenue from both direct and indirect taxes and social security contributions. These gains are expected to be partially offset by the abolition of the immovable property tax and the termination of the temporary wage levy. Furthermore, the conclusion of gas exploration contracts for 2018-2019 will contribute to a rise in revenue (by 0.2% of GDP in each year).

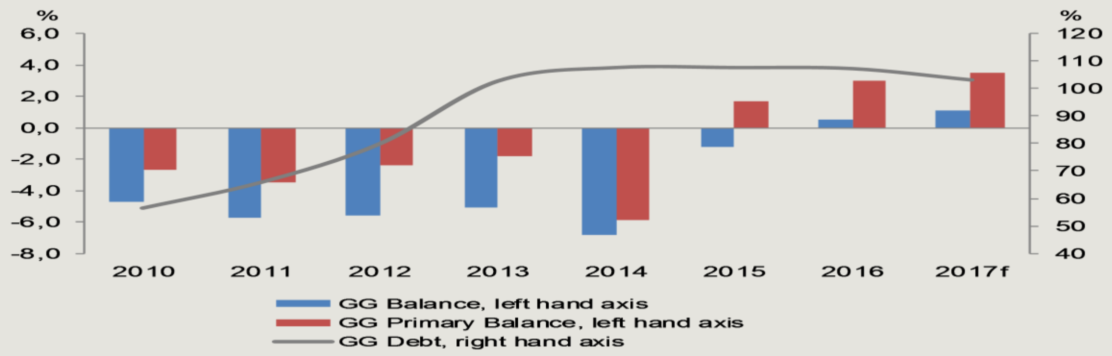
Additionally, the resulting improvement in the primary balance helped the public debt-to-GDP ratio to fall below 100% for the first time in five years in 2017, at 97.5%. As a result of the continuing primary surpluses and the expected positive nominal growth, general government debt is forecasted to decline further. However, in April 2018, the government deposited €2.35 billion at the state-owned Cyprus Cooperative Bank (CCB) in the form of government bonds mature between 15 and 20 years plus €150 million in cash in order to avoid serious repercussions for the banking system. The issuing of a state bond in support of the CCB could have an impact on the public debt to GDP ratio.

However, according to Ministry of Finance, the general government's primary surplus (excluding debt servicing expenditure) amounted to €428.5 million or 2.1% of GDP, posting an increase of 45% compared with the respective period of 2017. Total revenue for the first three months of 2018 accelerated by 10.5% yoy reaching €1,819.5 million in Q1 2018, while total expenditure rose by €17 million compared with Q1 2017 amounting to €1.468 million.

All the aforementioned improvements in the fiscal front have led to an increase in confidence and creditworthiness of Cyprus, as reflected in Graph 12, where it can be seen that the country's credit ratings are improving faster than those of its peers. This is in turn reflected in the reduction of government bond yields, shown in Graph 13. The next assessment of credit ratings of the Cypriot economy for 2018 has been set for July 2nd (Moody's), September 14th (Standard & Poor's), October 19th (Fitch) and November 23rd (DBRS).

GRAPH 11

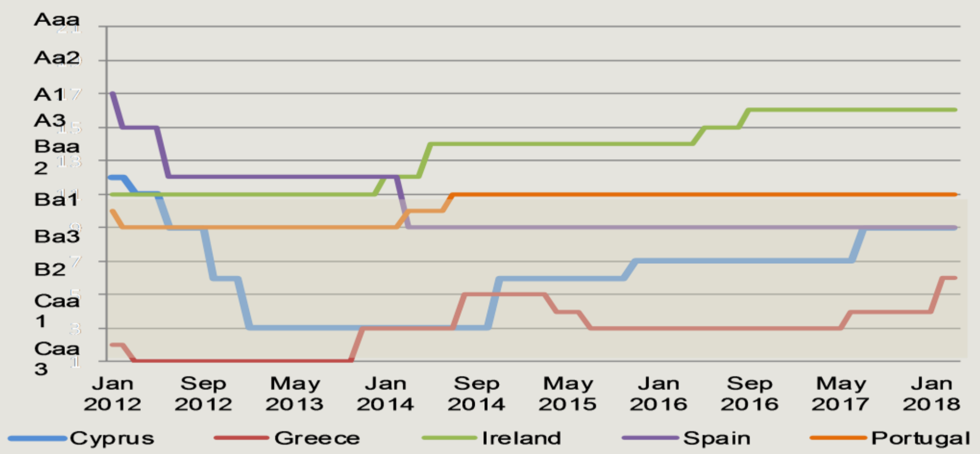
General Government: Balance, Primary Balance, Debt (% of GDP)



Source: European Commission

GRAPH 12

Credit Ratings improving faster than peers



Source: Bloomberg

Potential Long-term Growth Drivers

Growth momentum is expected to be sustained, given that drivers of long-term growth are already present. These include, among others, the following:

Firstly, the tender process for the first integrated luxury casino resort, which has been finalised with the government having signed a €550 million investment contract with a multinational consortium set to attract 300,000 tourists per year and creating around 11,000 jobs. Moreover, the legal framework provides for four "satellite" units in other locations.

Secondly, there are some significant projects present such as for the expansion of the Limassol marina and the construction of marinas in Agia Napa, Larnaca and Paphos, as a key part of tourism industry expansion.

Thirdly, the Republic of Cyprus signed contracts with the energy giants Exxon Mobil and Qatar Petroleum as well as with major European companies for the exploration of offshore hydrocarbons in Blocks 2, 3, 6, 8, 9, and 10, 11 and 12 of the EEZ. The drillings planned in Cyprus EEZ in 2018, mainly in block 10 by Exxon Mobil, would give a better depiction of the scale of natural gas resources. A deal is expected to be reached by the end of 2018, after Exxon Mobil and Qatar Petroleum have completed two exploratory drills in Block 10. In early February, Italy's ENI and France's Total have discovered a promising natural gas field in Block 6 Offshore Cyprus, which is the second substantive discovery in the Cypriot EEZ. The find looked geologically similar to the giant Zohr field off Egypt and confirms the extension of this field in the Cypriot EEZ, while additional studies will be carried out to assess the range of the gas volumes and define further exploration and appraisal operations. However, the exploitation of Cyprus' hydrocarbon deposits necessitates stability in the region which is threatened by the geopolitical developments in the region and Turkey's disputes on Cyprus' rights to an exclusive economic zone (EEZ) and its offshore hydrocarbon deposits.

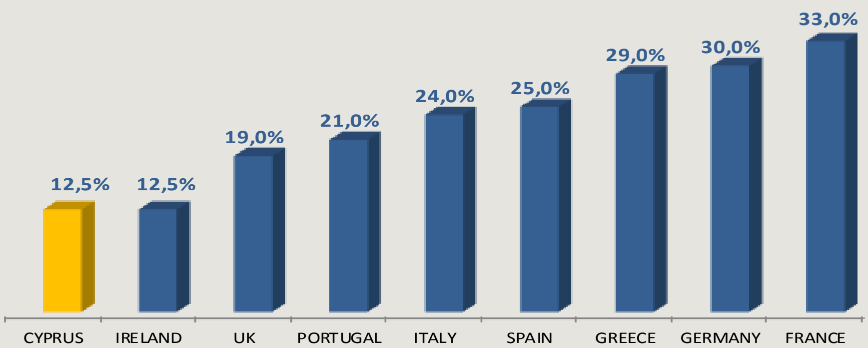
In addition, a project is also underway for an Israel-Cyprus-Greece underwater electricity cable. Greece and Cyprus gave the go-ahead in October 2017 and assuming that Israeli authorities will also approve the project, works are due to begin in 2018 and to last until 2022, while its first phase will have an estimated cost of around €3.5 billion. Another potential growth driver is the country's shipping industry, as Cyprus has the third largest merchant fleet in the EU.

Furthermore, Cyprus is characterised by highly skilled, educated and multilingual workforce. It has the highest number of University graduates to the population in the EU after UK and Ireland (age 15-64) according to European Commission (Education Training Monitor 2017).

Additionally, it has a portion of early leavers from education and training among young people aged between 18 and 24 that is much lower than the EU average. It is not a coincidence that public expenditure for education as a percentage of GDP is higher than the EU average, and that this applied even during the crisis years. Last but not least Cyprus, along with Ireland, has the lowest corporate tax rates in Europe (Graph 13).

GRAPH 13

Corporate Tax Rate, National Rate 2017 (%)



Source:

Deloitte, Corporate Tax Rates 2017

Real Estate Market: Signs of Recovery

The real estate market in Cyprus continues to stabilise amid signs of gradual recovery. The gradual increase of construction activity, in particular, shows that the property market has begun to experience a moderate recovery. Specifically, the index of production in construction, although recorded a significant annual gain in 2016, it continued to increase but at a slightly slower pace in 2017 (Graph 14).

The number of authorised building permits, which constitutes a leading indicator of construction activity, has recorded an annual increase of 8% in 2017. The upward trend continues into 2018, with the total number of building permits posted an 8.2% yearly change in January 2018.

In addition, the sentiment index on building activity, which is published by the European Commission and is a leading indicator for the housing market, has been steadily improving during the last three years, rising from -60 in 2013 to -19 in February 2018.

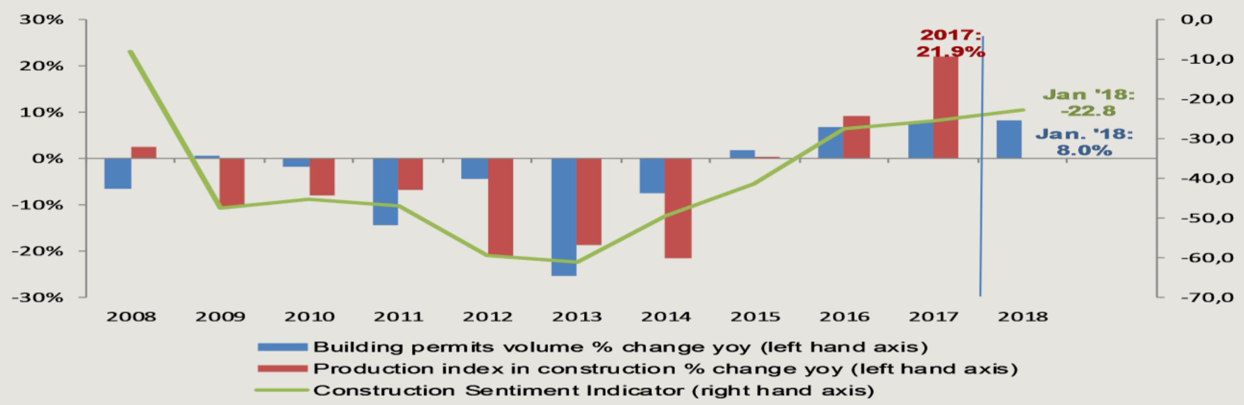
Moreover, demand for properties continues to increase, reaching the respective level of 2012, as shown in Graph 18. Indicatively, according to the Department of Lands and Surveys, sales contracts recorded an annual increase of 23.7% in 2017, attributed to increased demand by residents (20.5% y-o-y). The increase in the number of sales contracts continues in 2018 (Jan.-Apr.2018: 38% y-o-y).

Demand for the major urban centres of Nicosia, Limassol and Larnaca, for example, is originating primarily from locals, while demand for real estate in Paphos and Famagusta is coming from foreigners. The latter does not come as a surprise, given that its location, natural beauty, climate and membership in the EU, make the island highly appealing to foreigners as a residential destination. Foreigners are also benefited by Cypriot's government initiative regarding the Cypriot Citizenship Programme.

Furthermore, property sales have been encouraged by the reduction in Property Transfer Fees and the abolition of the Immovable Property Tax (as of 1 January 2017). Banks' smooth implementation of the new foreclosure law has also contributed to the gradual increase in property prices. Residential property prices recorded an increase in 2017, for the first time since 2009 (1.1%).

GRAPH 14

Construction Activity, Leading Indicators and Expectations

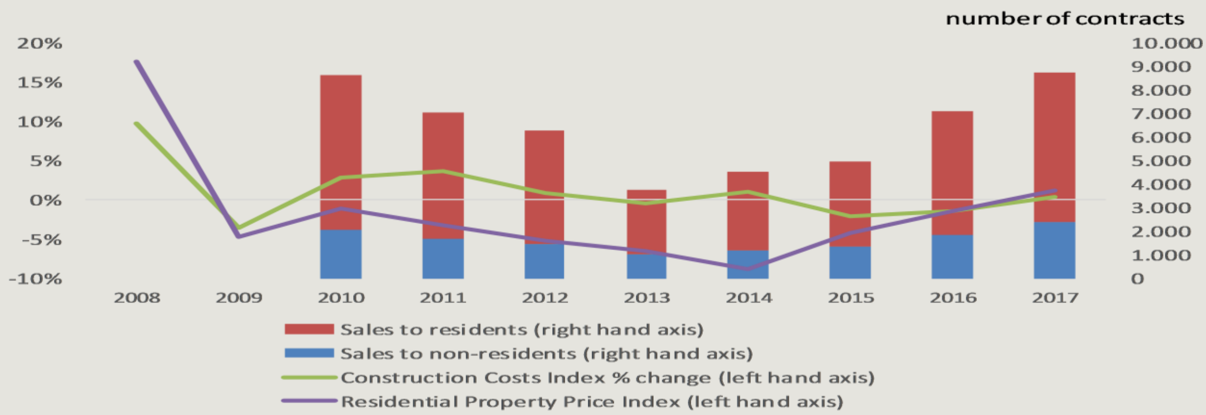


Sources:

Central Bank of Cyprus, CYSTAT

GRAPH 15

Residential Property Prices, Sales and Construction Costs: Upward Move is expected



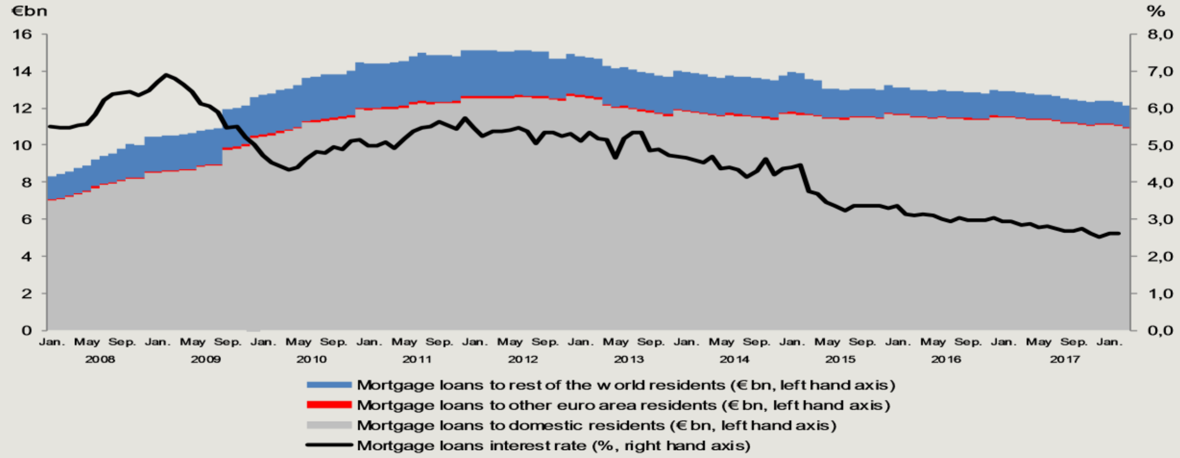
Sources:

CYSTAT, Department of Lands and Surveys

Finally, the aforementioned demand and price increases are in line with the available data on new housing loans, which stood at €494.5 million in Jan.-Sept. 2017 compared to €367.5 million in Jan.-Sept. 2016. Moreover, the evolution of total outstanding loans seems to be slightly above €12 billion. Increased demand for properties is also supported by the low interest rates for new housing loans which have continued their downward trend, falling to 3.33% in March 2018 compared to 4.93% in 2013, as well as the current lending standards.

GRAPH 16

Housing Loans and Mortgage Interest Rates



Source: Central Bank of Cyprus

Tourism: 2017 was the most successful year ever recorded

The tourism sector is one of the pillars of the Cypriot economy and in 2017 a record number of tourist arrivals and revenues were recorded. Based on CYSTAT's data, tourist arrivals reached 3.65 million visitors in 2017, representing an annual increase of 14.6% (Graph 17). Furthermore, data on tourist receipts for 2017 show an increase of 11.7% compared with 2016 (Graph 17). Based on pre-bookings to date, and given the geopolitical conditions prevailing in the neighbouring countries and that arrivals in the first two months of 2018 increased by 22.5% y-o-y, total arrivals for the entire 2018 are expected to exceed last year's historical high.

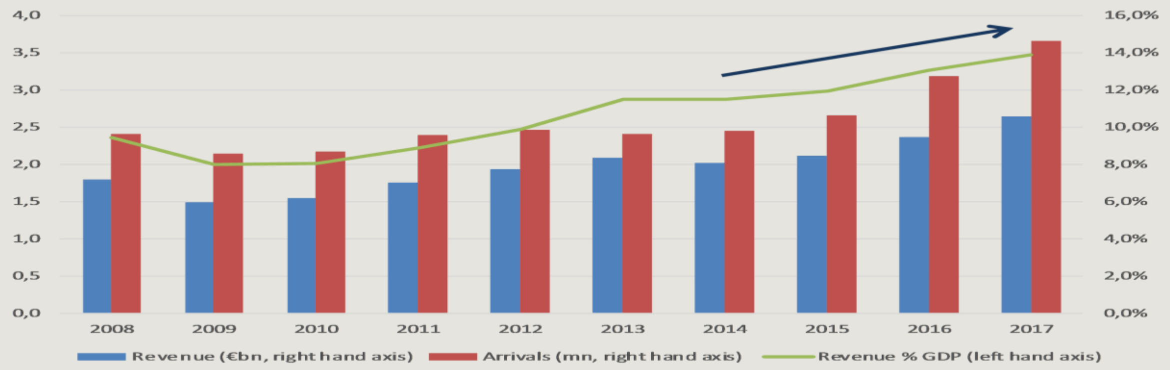
Evidently, the conditions that prevailed in the external environment contributed positively to this increase, as neighbouring competitor countries were adversely affected mainly by geopolitical tensions. Furthermore, the extension of season and better flight connectivity contributed to the increase in arrivals. However, the efforts to diversify tourists' origins by increasing tourist arrivals from more European countries, the Middle East and Asia, not only contributed to the success of the tourism sector, but also supported the sustainability of the sector's performance. The geographical diversification of tourists arriving in Cyprus is shown in Graph 18.

In 2017, arrivals from the UK increased by 8%, despite the weakened performance of the British pound versus the Euro, while arrivals from Russia increased by 6%. It should be noted that arrivals from the UK continue to register increases. At the same time, increases in arrivals were also recorded from other markets, such as Germany, Israel and Lebanon.

For the period of January – March 2018 tourist arrivals numbered 369.438 compared to 285.693 in the corresponding period of 2017, posting an increase of 29.3% and exceeding the total arrivals ever recorded during the first quarter of the year.

GRAPH 17

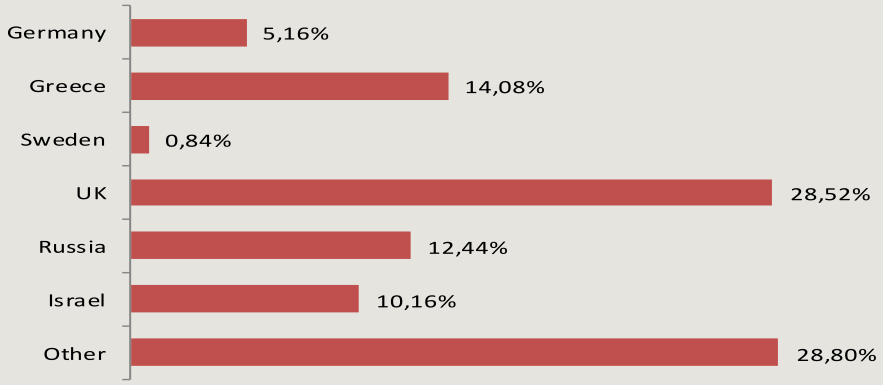
Tourist Arrivals (million) and Tourism Revenues (in € bn and as % of GDP)



Source: CYSTAT

GRAPH 18

Tourist Arrivals by Country of Origin, 2017



Source: CYSTAT

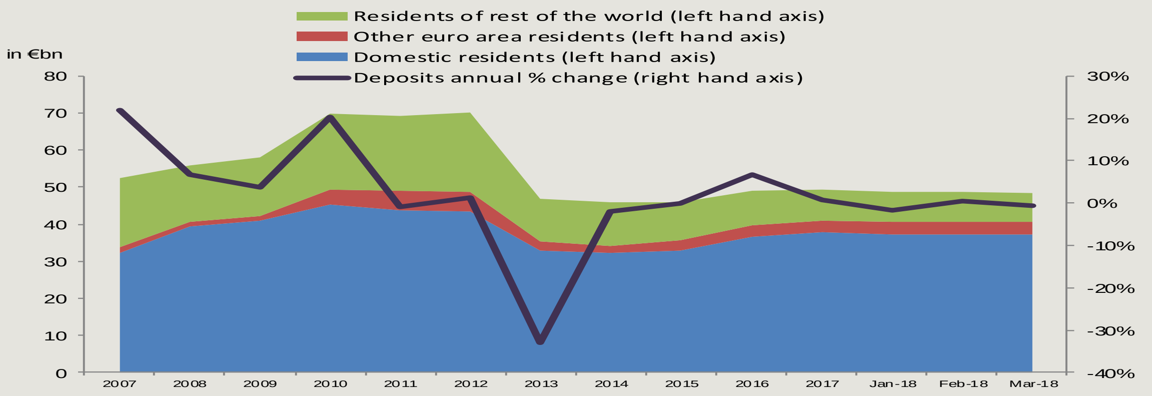
Banking Sector Soundness and Challenges Ahead

The continued inflow of deposits, albeit at a more moderate pace, underlines the ongoing stabilisation of the domestic banking system and is consistent with the positive domestic growth dynamics. As can be seen in Graph 19, deposits in 2016 increased for the first time since the 2013 bail-in, on the back of firming confidence and the still relatively high – although moderating – interest rates. Deposit inflows come mainly from domestic residents. At the same time, total credit is continuing to contract (Graph 20), with the annual growth rate of loans to domestic non-financial corporations standing at -8.5% in December 2017 from -17% in 2016. As regards the annual growth of loans to domestic households, this was moderately negative at -5.3% at the end of 2017. Increasing deposits followed by shrinking credit has left banks with ample liquidity and extensively declining loan-to-deposit ratios (also shown in Graph 3). As a result of the above, reliance on ELA (Emergency Liquidity Assistance) has been eliminated.

It is noted that the negative growth in loans does not seem to be in line with the economy's pace of domestic growth. This can be attributed to the fact that the deleveraging of existing loans is outpacing the increase in new loan contracts, thus incorrectly implying that economic growth is not being supported by private sector financing. In reality, since December 2014, there has been a sustained gradual increase in new loan contracts, contributing to domestic economic growth.

GRAPH 19

Private Sector Deposits (in € bn)



Source:

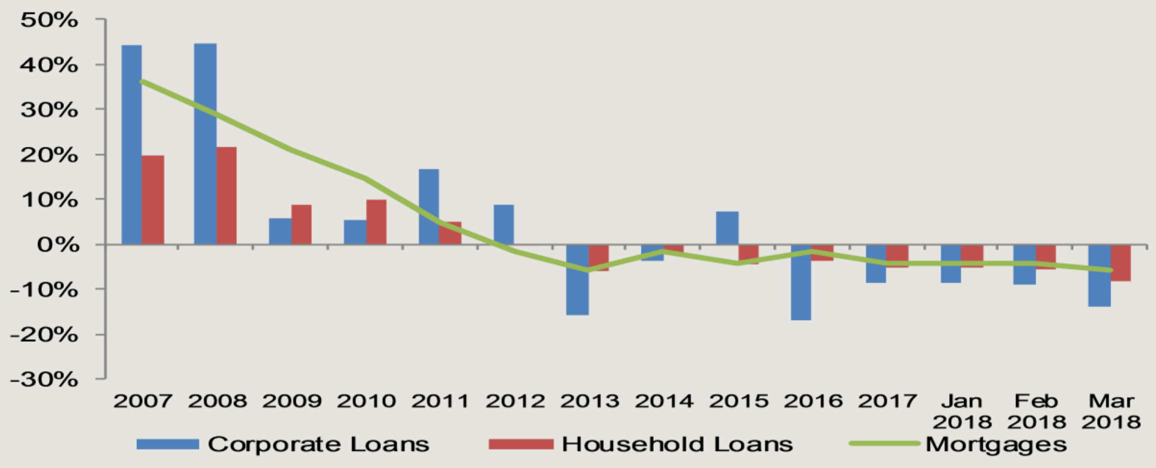
Central Bank of Cyprus

At present, the efficient and timely management of NPLs is the most important challenge ahead for the banking sector and the domestic economy in general, given that Cyprus has by far the highest NPLs-to-GDP ratio in the European Union. The NPLs from the end of 2016 to the end of 2017 were reduced by € 3.2 billion. The reduction of the stock of NPLs which is underway should be accelerated, as the decrease recorded thus far is below expectations given the current pace of economic growth. In principle, the decrease in NPLs is positively related to (i) increased repayments, (ii) successful loan restructurings reclassified as performing and loan write-offs, and (iii) settlement of debt through swaps with immovable property.

A positive aspect of the Cyprus banking system is its coverage ratio (as measured by the European Banking Authority), which has been consistently increasing to converge with the EU average (Graph 21) during the last three years.

GRAPH 20

Credit Expansion (annual % change) (Households include mortgages, consumer and other loans)

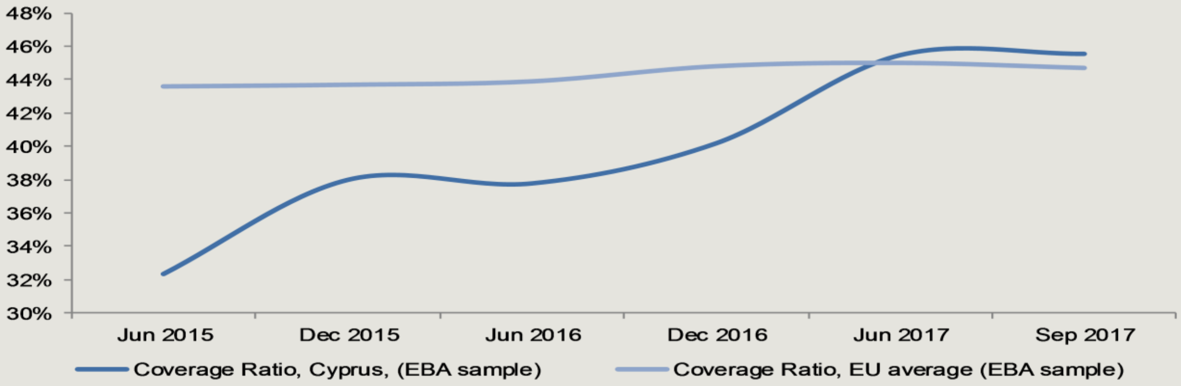


Source:

Central Bank of Cyprus

GRAPH 21

Coverage Ratio converges to EU average



Source: European Banking Authority (EBA), Risk Assessment Reports of the European Banking System (Nov 2017 & Dec 2016) and Risk Dashboard Reports.

Notes: The data is based on the sample of banks, which is regularly adjusted to take into account bank-specific developments; for example, banks that ceased activity or underwent a significant restructuring process are not further considered. The sample of banks is unbalanced and reviewed annually.

The sample of banks used to calculate the Q3 2017 indicators include for Cyprus: Bank of Cyprus Holdings Public Limited Company, Cooperative Central Bank Ltd, Hellenic Bank Public Company Ltd and RCB Bank Ltd.

According to the Central Bank of Cyprus, the coverage ratio, i.e. Total accumulated impairment (provisions) / Total non-performing facilities, for all credit institutions operating in Cyprus (domestic operations only) on a consolidated basis, stands at 46.8% in December 2017.

ALPHA BANK

Economic Research Division

11 Sophocleous Street

GR 105 59 Athens

T +30 210 517 8963, F +30 210 348 7873

Email:AlphaBankEconomicResearch@alpha.gr

Web site: http://www.alpha.gr