CYPRUS

ECONOMIC & FINANCIAL OUTLOOK

ECONOMIC RESEARCH DIVISION

DECEMBER 2019

In 2019, Cyprus saw the sixth year of economic recovery since the 2012-13 banking crisis. Output growth, although decelerated in the first half of the year, remains strong, buoyed by professional services, foreign investment in construction and continued strength in private consumption, resulting in lower unemployment, close to pre-crisis levels, while inflation is subdued. Furthermore, the budget balance has improved further, thanks to prudent fiscal policy, leading to lower public debt.
At the same time, in the banking sector, the stock of Non-Performing Loans (NPLs) has dropped markedly. Thus, after 6.5 years, Cyprus has earned a sovereign rating upgrade to investment grade status, although a further reduction of NPLs is required. Challenges remain in order to sustain the growth momentum.

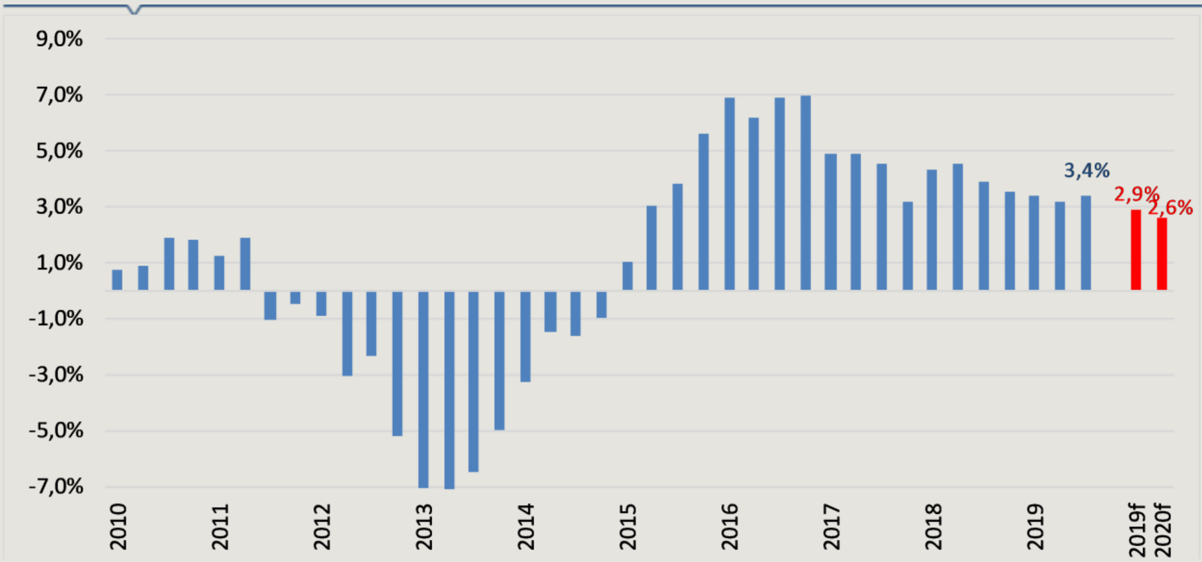
GDP is above pre-crisis levels – Growth, despite gradual deceleration, remains above potential

Real GDP grew by 3.3%, year-on-year, in the first nine months of 2019, at a slower pace compared to 2018 (4.1%). Growth was mainly supported by private consumption. Robust private consumption was related to subdued inflation and increased disposable income. Higher disposable income was the result of higher employment and the gradual abolition of wage cuts adopted during the crisis as of July 2018. As concerns the supply side, growth was broad-based, mainly driven by construction, trade, transport, hotels and restaurants, as well as professional, scientific and administrative activities.

According to the latest Statistical Service of Cyprus (CYSTAT) data, real GDP growth remained solid at 3.4%, on an annual basis, in Q3 2019, and was supported by domestic demand. Private consumption remained strong, up by 3.3% year-on-year, public consumption was higher by 24.3% and gross fixed capital formation rose by 8.9%. On the external front, exports strengthened by 1.6% year-on-year, while imports were lower by 3.0% year-on-year. Regarding the supply side, GDP growth in Q3 2019 was mainly attributed to the sectors of construction, information and communication, professional, scientific and technical activities, administrative and support service activities, as well as arts, entertainment and recreation.

GRAPH 1

Real GDP Growth (y-o-y), Q1 2010-Q2 2019



Sources: CYSTAT, European Commission

Positive economic developments led Cyprus to regain its sovereign rating status of investment grade while allowing the country to borrow from international capital markets on improved rates.

Growth is expected to continue to be supported by private consumption, while an upside for the growth outlook is provided by stronger acceleration of planned investment projects in tourism, energy, transport and education, as well as by the progress in exploiting offshore gas deposits.

On the other hand, downside risks stem from the high levels of NPLs for both households and corporations (among the highest in Europe), a no-deal Brexit, as Cyprus has close economic ties with the UK, weaker inbound tourism and the country's vulnerability to geopolitical developments. According to the European Commission (Autumn 2019 Economic Forecast, November 2019), real GDP is projected to remain well above the euro area average but decelerate gradually to 2.9% in 2019 and 2.6% in 2020.

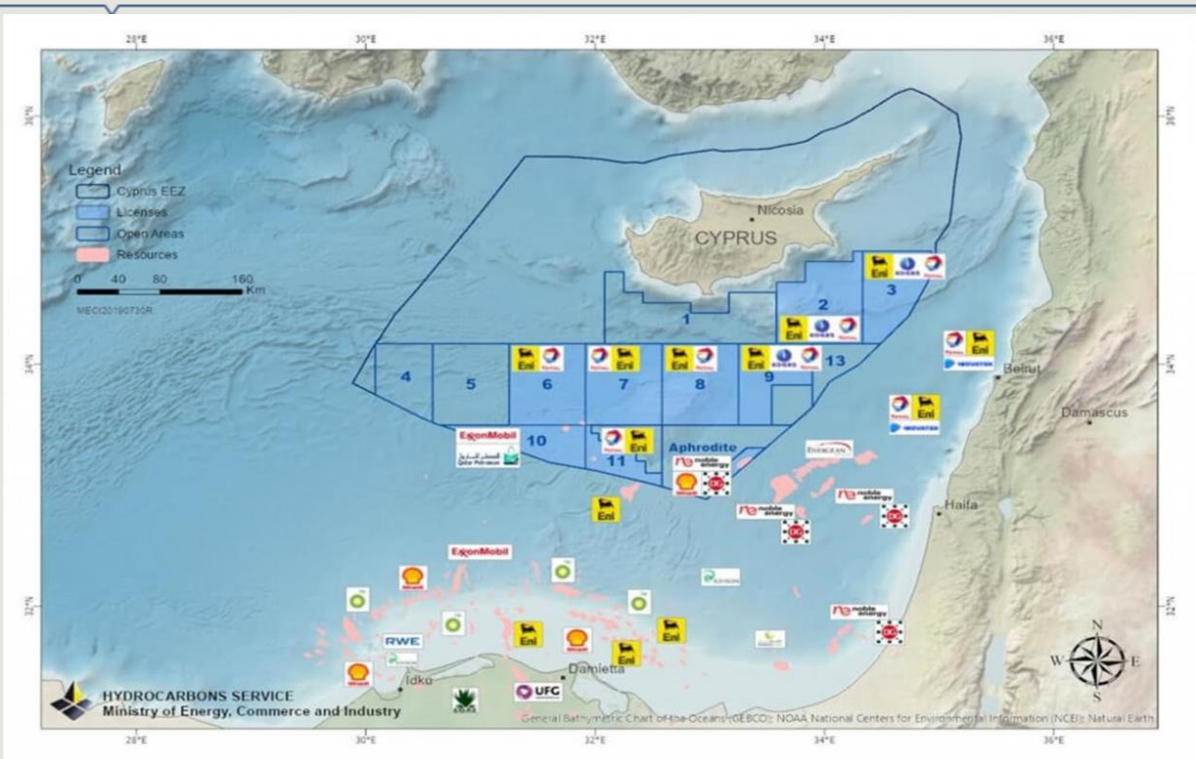
Energy: a potential growth engine

Cyprus' rapidly developing oil and gas sector has become one of the most promising for the country following the discovery of vast natural gas reserves in both the island's Exclusive Economic Zone (EEZ) and in its neighbourhood. The participation of major international oil and gas companies in Cyprus' EEZ has enhanced its profile as a major hydrocarbons player in the Eastern Mediterranean.

Regarding exploiting offshore gas deposits, Cyprus awarded the majority of its offshore blocks (blocks 2, 3, 6, 7, 8, 9, 10, 11 and 12) in its formally declared EEZ to some of the world's prominent oil companies; Italian ENI, French Total, Royal Dutch Shell, American ExxonMobil, American Noble Energy, Qatar Petroleum, South Korean Kogas, Israeli Delek Group. Oil and gas exploration started in 2011 in the Aphrodite gas-field in block 12, by American Noble Energy and Israeli Delek Group, with an estimated gas reserve of 4.54 trillion cubic feet (tcf) which was declared commercial in 2015. The next discovery was made in 2017 in block 11 but it was small, with gas deposits of less than 0.5 tcf. This was followed in 2018 by the discovery in the Calypso gas field in block 6 by Italian ENI. Finally, the most recent discovery, the Glaucus gas-field, took place in 2019 in block 10 by American ExxonMobil and Qatar Petroleum. This gas-field is estimated to hold about 5 to 8 tcf of gas. Calypso and Glaucus were discovered in geological formations similar to the giant Zohr gas-field discovered by ENI in 2015 in the Egyptian EEZ and adjacent to Cyprus' block 11 and confirm that the Zohr geological model extends more widely in the Eastern Mediterranean region.

GRAPH 2

Cyprus offshore exploration blocks



Source: Cyprus Hydrocarbons Company (CHC) https://chc.com.cy/2019/09/18/block-7-licence-award/

In June 2019, the Cypriot government announced a production sharing agreement (PSA) for the development of the Aphrodite field, estimated to be worth Euro 8.35 billion. In 2020, ENI and Total plan to drill five more wells in their licensed blocks. France's Total and Italy's Eni are the biggest players in the island's energy exploration, holding exploration licenses for seven of the 13 blocks. Furthermore, Cyprus is fast developing into a regional fuel hub, operating a sophisticated oil-storage terminal in Vasilikos, the first of its kind in the Eastern Mediterranean, connecting Europe and the Black Sea with markets in the Middle East and Asia.

Although, the reserves' commerciality is still far from assured, the exploitation of Cyprus' hydrocarbon deposits necessitates stability in the region, which is threatened by recent geopolitical developments in the region and Turkey's disputes on Cyprus' rights to an exclusive EEZ and its offshore hydrocarbon deposits. Cyprus' main geopolitical challenge is to retain regional cooperation in a volatile neighbourhood.

Rapid employment increase supported by strong economic expansion

Employment has increased since 2015, driven by solid economic growth, mainly in the sectors that supported growth (construction, trade, transport, hotels and restaurants). The improved economic environment provided employment opportunities for the most vulnerable groups – youth and the long-term unemployed. In 2018, according to the European Commission, employment increased by 4.0% compared to 4.3% in 2017. Furthermore, underemployment fell to 12.6% in 2018 from 17.6% in 2017. At the same time, job vacancies increased by 1.5% in 2018 compared to an increase by 1.0% in 2017.

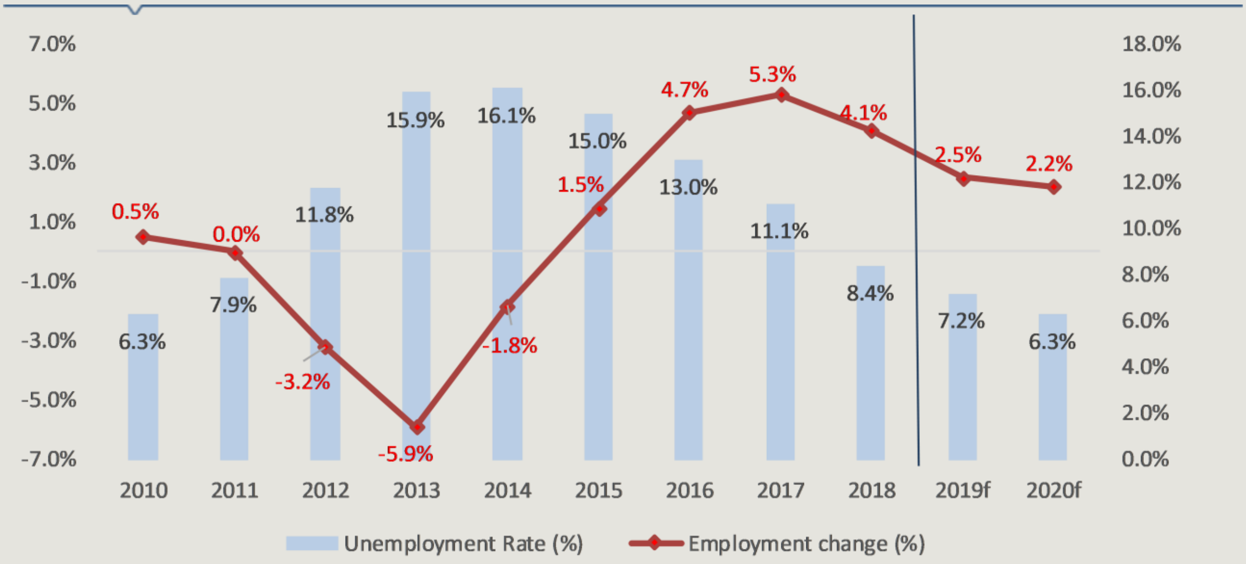
Rising labour demand has pushed down unemployment to a post-crisis low of 8.4% in 2018 vs 11.1% in 2017. As a result, in 2018, Cyprus registered the largest annual decrease of unemployment in the European Union. More specifically, although it remained high in 2018, youth unemployment declined to 20.2% from 24.7% in 2017. Furthermore, long-term unemployment (over 6 months) dropped to 2.7% in 2018, from 4.5% in 2017. During 2018, new part-time jobs decreased by 1.9% compared to 2017, while the vacancy rate increased on average by 1.5%, with the fastest job growth occurring in low-wage sectors (tourism and construction).

In the first eight months of 2019, the unemployment rate in Cyprus continued its downward course. Tellingly, in August 2019, unemployment in the country declined to 6.8%. This is the lowest rate recorded in eight years and below Euro area (EA19) average (7.5%), according to the latest Eurostat data. In August 2018, unemployment stood at 8.2%. However, it remains above its pre-crisis levels of nearly 4.0%, reflecting a persisting demand for skills.

Unemployment is anticipated to continue to decline due to the increase in employment, as robust growth will persist, supported by strong investment and consumption. The European Commission (Autumn 2019 Economic Forecast, November 2019) expects unemployment to gradually fall to 7.2% in 2019 and 6.3% in 2020.

GRAPH 3

Employment (y-o-y change), Unemployment Rate



Sources: Ministry of Finance, Eurostat, European Commission

Inflationary pressures are subdued

Annual HICP inflation remains low, despite solid growth and higher employment. This trend can be attributed to the wage cuts adopted during the crisis and the impact of the stronger euro on the prices of the imported goods on which the Cypriot economy strongly relies to cover domestic demand. Furthermore, a negative impact on prices is attributed to the increase in the number of discount stores, the extended periods of sales and competition from e-commerce. In 2018, HICP inflation was marginally higher (0.8%) than in 2017 (0.7%), driven by prices in transport, as well as in housing, water, electricity and gas.

In the first nine months of 2019, the average HICP inflation stood at 0.7%, compared to 0.5% in the corresponding period a year earlier. This was the result of the prices of non-energy industrial goods, which are explained by the volatility of the euro against foreign currencies, and technological advances.

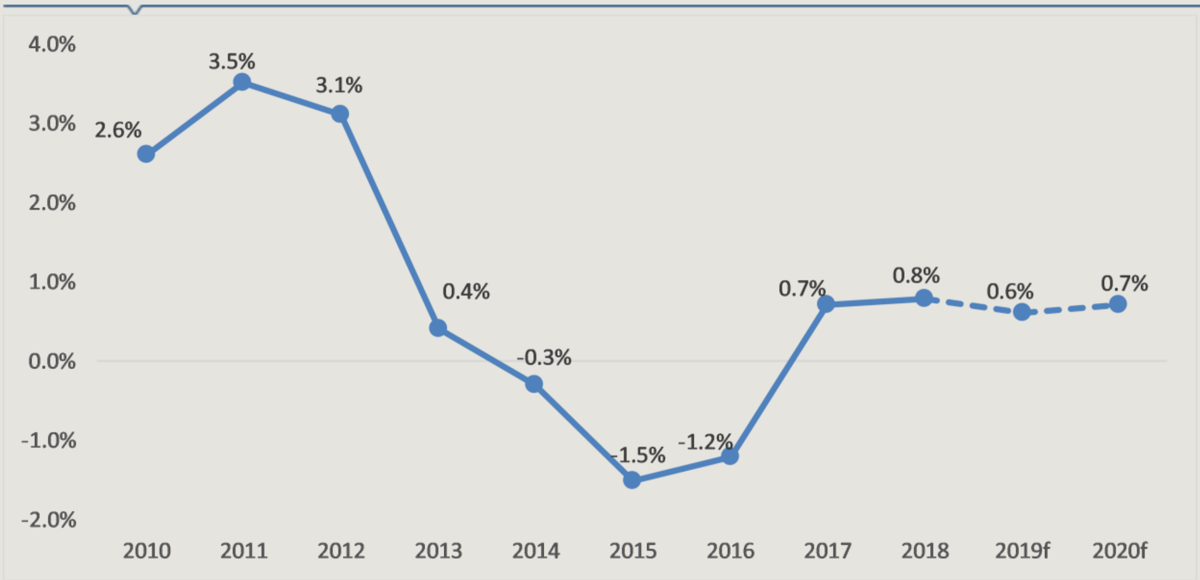
HICP inflation decreased sharply in September 2019, dipping to a negative -0.5%, according to the latest CYSTAT data, following August’s 0.6%. This reflects a fall in prices in transport, as well as in food and non-alcoholic beverages and an increase in prices in communication.
Although government wages are picking up, influences on the private sector remain restricted, resulting in weak inflationary pressures.

According to the latest Eurostat data, HICP inflation in September was lower than the Eurozone average (0.8%) and much lower than the EU average (1.2%).
Higher inflation in the first four months of 2019 was followed by subdued inflation in the May to September period, fluctuating between -0.5% and 0.6%, due to lower prices in housing, water, electricity and gas, as well as in food and non-alcoholic beverages.

HICP Inflation is expected to remain low in 2019 and 2020, affected mainly by energy prices and wage increases. The decline in domestic inflation in the first nine months of 2019 and the absence of upward pressures in international commodity prices (e.g. oil and food prices) support real activity, influencing the outlook favourably. According to the European Commission (Autumn 2019 Economic Forecast, November 2019), annual HICP inflation is projected to be marginally positive, at 0.6% in 2019 and 0.7% in 2020. Risks in relation to inflation are mainly associated with a further escalation of restrictive measures and tariffs to international trade, the impact of Brexit, higher oil prices and investment projects in the energy sector.

GRAPH 4

HICP inflation



Sources: Ministry of Finance, European Commission

Fiscal performance allows public debt to decline

Fiscal developments in Cyprus are notably positive, driven by solid economic growth. In 2018, the general government surplus, excluding the impact of the one-off measures related to the sale of the Cyprus Cooperative Bank (CCB), stood at 3.5% of GDP, higher than the 1.8% posted in the previous year. This increase derived from a restraint in expenditure, as well as from higher indirect tax revenues and social security contributions resulting from the strong economic environment and rising employment. Including the impact of the one-off measures for the sale of CCB, the general government surplus turned into a deficit of 4.8% of GDP in 2018.

According to the latest data of the Ministry of Finance, in the first eight months of 2019, the general government surplus stood at 3.2% of GDP compared to 2.4% in the corresponding period of 2018. The 2018 budget trends in revenues and expenditures continue in the current year; revenues increased by 12.0% year-on-year, while expenditures were 9.6% higher. The general government surplus is expected to remain large, as a result of:
a) High revenues, reflecting the strong economic growth and the further improvement in the labour market and
b) Restrained public expenditures, although expenditures will be negatively affected mainly by the gradual reversal of wage cuts, adopted during the crisis, as of July 2018.

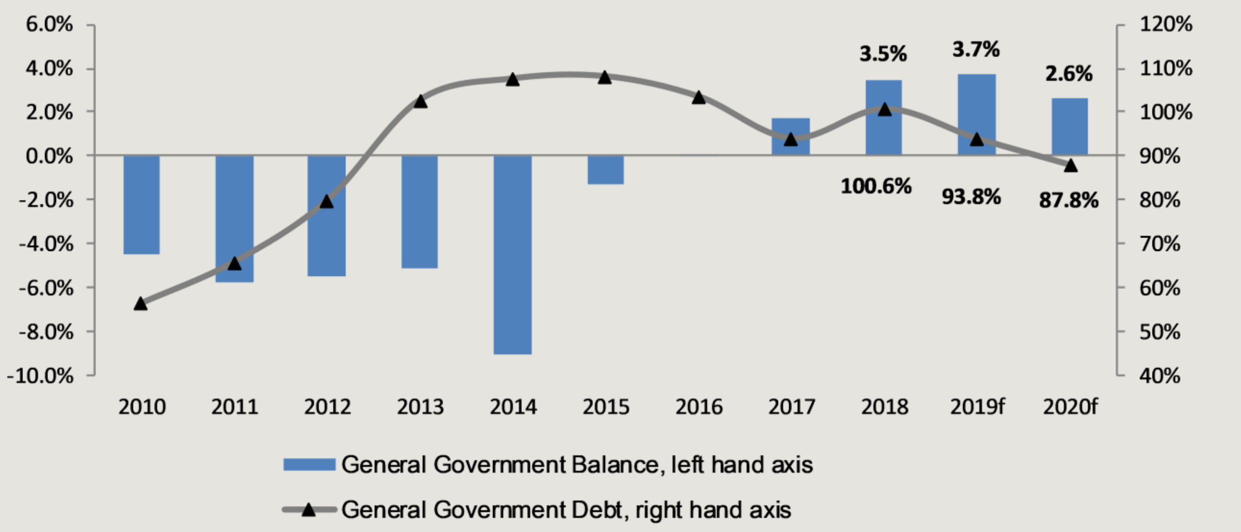
The European Commission (Autumn 2019 Economic Forecast, November 2019) projects that the general government surplus will reach 3.7% of GDP in 2019 and will decline further to 2.6% of GDP in 2020, albeit decelerating GDP growth. This improvement is due to the improving labour market and a sizeable increase in social security contributions in 2019.

In 2018, public gross debt rose to 100.6% of GDP from 93.9% in 2017, as a result of the issuance of domestic bonds amounting to Euro 3.2 billion (15 % of GDP) to resolve Cyprus Cooperative Bank. Public gross debt is projected to decline over the next years, thanks to a sizable primary surplus and robust real GDP growth. According to the European Commission (Autumn 2019 Economic Forecast, November 2019), the gross public debt-to-GDP ratio is expected to decrease progressively to 93.8% in 2019 and 87.8% in 2020. However, public gross debt in Cyprus is amongst the highest in the EU, amplifying the country's vulnerability to possible exogenous shocks, although this risk is to some extent fairly contained due to its moderate medium-term financing needs (below 7% of GDP by 2021) and Cyprus' current sovereign credit rating.

Risks to the fiscal outlook are tilted to the downside. There are uncertainties concerning the fiscal implications of Administrative Court decisions ruling the unconstitutionality of public-sector wage and benefit reductions during the financial crisis, as well as the potential fiscal impact of the country's healthcare reform, as the Law obliges the State to finance any potential losses of public healthcare providers in the first five years of introduction of the national health system (NHS) through the Health Insurance Organisation (HIO).

GRAPH 5

General Government Balance, Public Debt



Sources: Ministry of Finance, European Commission

Current account deficit to widen further

In 2018, the current account deficit improved to Euro 1,460.9 million (7% of GDP), down from Euro 1,642.5

million (8.4% of GDP) in 2017, as a result of higher exports of goods due to the transactions of Special Purpose Entities (SPEs), which mainly operate in shipping. SPEs are responsible for a very large income flow between resident and non-resident institutional units. Trade in goods and hence the balance of the current account is affected by the registration and deregistration of ships and aircraft, which is generally relatively large compared to the size of the economy.

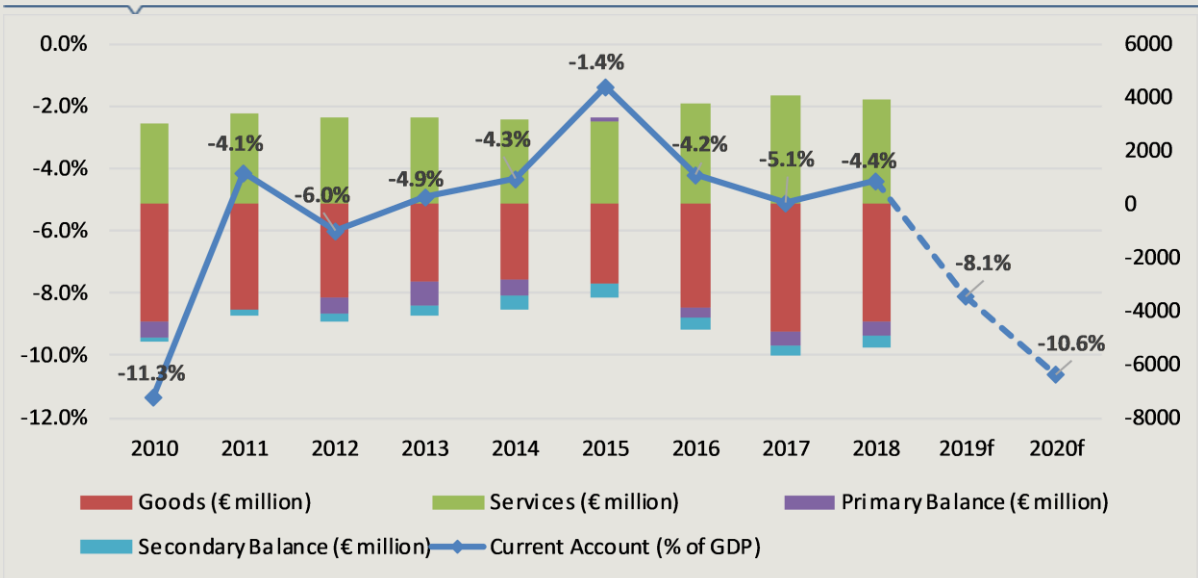
In general, activities of SPEs accounted for about half of the current account deficit (Central Bank of Cyprus-Economic Bulletin, June 2019). Excluding SPE transactions, the current account deficit stood at Euro 932.6 million (4.5% of GDP) in 2018', compared to Euro 618.4 million in 2017 (3.1% of GDP). The annual increase of the current account deficit was due to the widening of the trade deficit and the decline of the services surplus. More specifically, imports of goods were higher, driven by domestic demand, while financial service exports were lower, due to a new European Securities and Markets Authority (ESMA) regulation. The current account gap in 2018 was covered mostly by private-sector financing and to a smaller degree by government lending.

On the basis of Central Bank of Cyprus data, the current account deficit increased to Euro 591.3 million (2.7% of GDP) in Q1 2019 from Euro 148.8 million (0.7% of GDP) in Q1 2018, as a result of the higher trade deficit. Adjusted for SPE transactions, the current account deficit stood at 3.3% of GDP in Q1 2019, from 2.4% of GDP in Q1 2018. Cyprus constantly has a negative trade balance for all the main product groupings of trade in goods. Historically, the main contributors to Cyprus' trade surplus in services are travel (generally tourism), financial services and transport (typically shipping).

The current account deficit is expected to increase, as a result of higher imports due to the projected robust consumption and investment. According to the European Commission (Autumn 2019 Economic Forecast, November 2019), the current account deficit is forecast to gradually rise to 8.1% of GDP in 2019 and 10.6% in 2020.

GRAPH 6

Current Account Balance and its Components (as % of GDP)



Sources: Central Bank of Cyprus, European Commission

Tourism continues supporting the economy

Cyprus' economy is heavily reliant on the services sector and more specifically on the tourism industry. Tourism, one of the pillars of the Cypriot economy, has been on an upward trend for a long time; over the last three years, it has recorded a marked expansion, in terms of both arrivals and revenues in line with growing demand in international tourism.

In 2018, tourist arrivals were the highest ever recorded in a period of one year, as a historic high of 3.94 million tourists visited Cyprus. Notably, tourist arrivals increased by 7.8% y-o-y in 2018, as tourists from the United Kingdom, which accounted for one-third of total tourist arrivals, rose by 5.9%. On the other hand, a decrease was recorded for tourists from Russia (21% of total tourist arrivals) by 5%, Germany - due to the bankruptcy of two airlines servicing the German market - and Israel. At the same time, in 2018, tourism revenues decreased by 2.7% y-o-y as a result of the lower per head expenditure of tourists. This was due to the fall in the number of days spent, and to the lower per day and per head expenditure, as the euro strengthened against the Russian rouble and the British pound. However, the quality of the tourism product was upgraded through hotel renovations and new infrastructure, such as the construction of marinas and luxury hotels.

According to the latest CYSTAT data, in the first nine months of 2019, tourist arrivals increased by 0.6% (3.26 million tourists) y-o-y, mainly due to higher arrivals from Israel, Ukraine, United Kingdom and Norway. Notably, tourist arrivals in Cyprus both in the first nine months of 2019 and in September were the highest ever recorded in this period and in this month. Tourism revenues decreased by 2.5% y-o-y, in the first seven months of 2019, in line with tourist arrivals that fell by 0.1%. As a result of these developments, in July 2019, the average expenditure per person declined to Euro 765.84, from Euro 790.64 in the same month a year earlier. On the other hand, per day average tourist spending rose to Euro 80.61 compared to Euro 79.86 for the same month last year. However, spending by foreign credit cardholders in Cyprus increased by 14% in the first nine months of 2019.

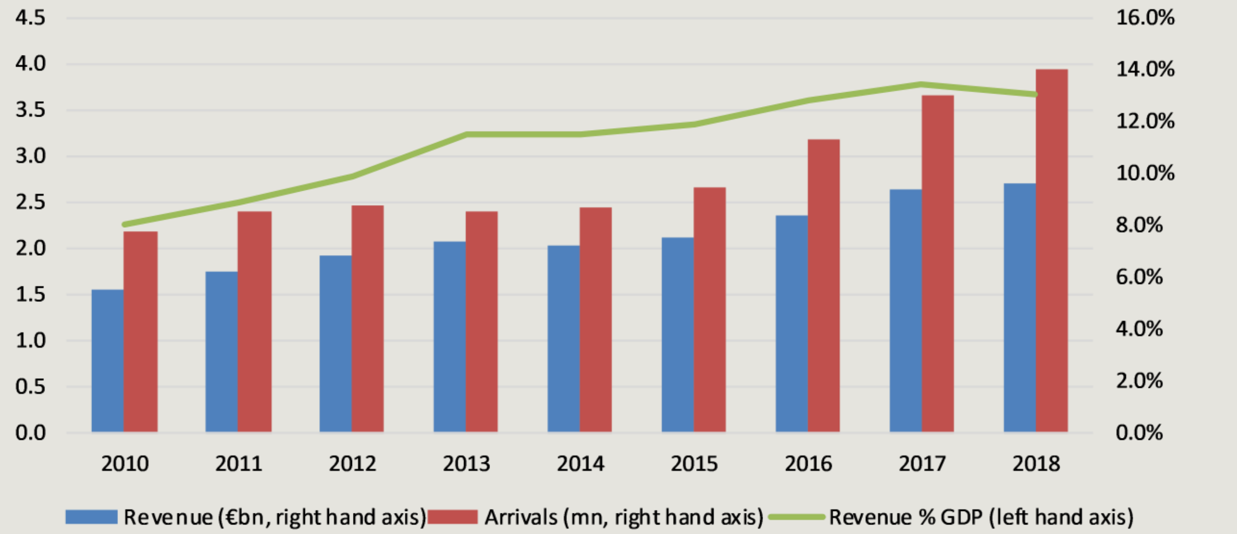
The establishment of a Ministry dedicated to tourism was a significant step by the government of Cyprus in 2019, in order to ensure its strong focus on the tourism industry. The new ministry, in conjunction with the implementation of a new national agenda for tourism, will support Cyprus' rebranding in the coming years. Interestingly, the new tourism agenda is the most comprehensive restructuring of the sector since 1960 and is targeted to opening new mass and niche markets, new legislation for the classification of hotels, as well as to confronting issues of seasonality.

Tourism in Cyprus is expected to attract new interest and be stimulated thanks to the upgraded tourism product, as tourism-related real estate and infrastructure continues to be one of the most attractive investment opportunities in the country. Various strategic large-scale projects are currently underway, such as luxury resorts, golf courses, luxury marinas in all major seafront cities and Cyprus' first-ever integrated luxury casino resort.

On the basis of available data and the expectations for the last quarter of 2019, tourism arrivals and revenues are not expected to record a significant change from the previous year. Notably, significant support for increasing arrivals so far this year came from hotel decisions to operate from March, instead of April or May. However, tourism in Cyprus faces several challenges, arising from the UK's withdrawal from the EU, as Cyprus has historically had close economic ties with the UK, the slowdown of the economic expansion in the Euro area and the recovery of the major competitor destinations, such as Turkey, Egypt and Tunisia.

GRAPH 7

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



Source: CYSTAT

The real estate market remains on an upward trend

The real estate market (construction+real estate activities) contributed 1.3% to GDP in 2018, while the construction sector's contribution to GDP was 1.2%. The issuance of new building permits reveals a steady growth in numbers and in value over the last few years. The majority of building permits issued in 2018 concerns residential developments (70% of total volume), with a total value of €1.3 billion.

In 2019, the real estate market in Cyprus continues to experience a recovery, which started in 2016 and is supported by higher demand for properties, increased building activity, new loans and foreign investment. It is noteworthy that building activity is broadly based, as it includes both residential projects, as well as productive infrastructure projects such as marinas, offices, shopping centres, casinos, hotels and renewable energy source projects. Despite the significant recovery of the real estate market and strong economic growth, with some exceptions, real estate prices have exhibited modest increases.

The favourable conditions in the real estate market are depicted in the sentiment index on building activity, published by the European Commission. This index has steadily followed an improving course during the last years, rising to -2.5 in September 2019 from -11.1 in September 2018 and -24.3 in December 2017.

The recovery in the real estate market is reflected in the production in construction index, which increased by 17.3% in 2018 compared to 2017, while this index increased by 16.6%, y-o-y in Q2 2019.

Strong demand for properties is indicated by the 15% increase in sales contracts (Department of Lands and Surveys) y-o-y in the first nine months of 2019, at a markedly higher rate than in 2018 (6%). The higher growth rate of sales contracts was that of Paphos (26%). It is noteworthy that in Cyprus there is an increased demand for properties by foreign buyers (45% of sales contracts).

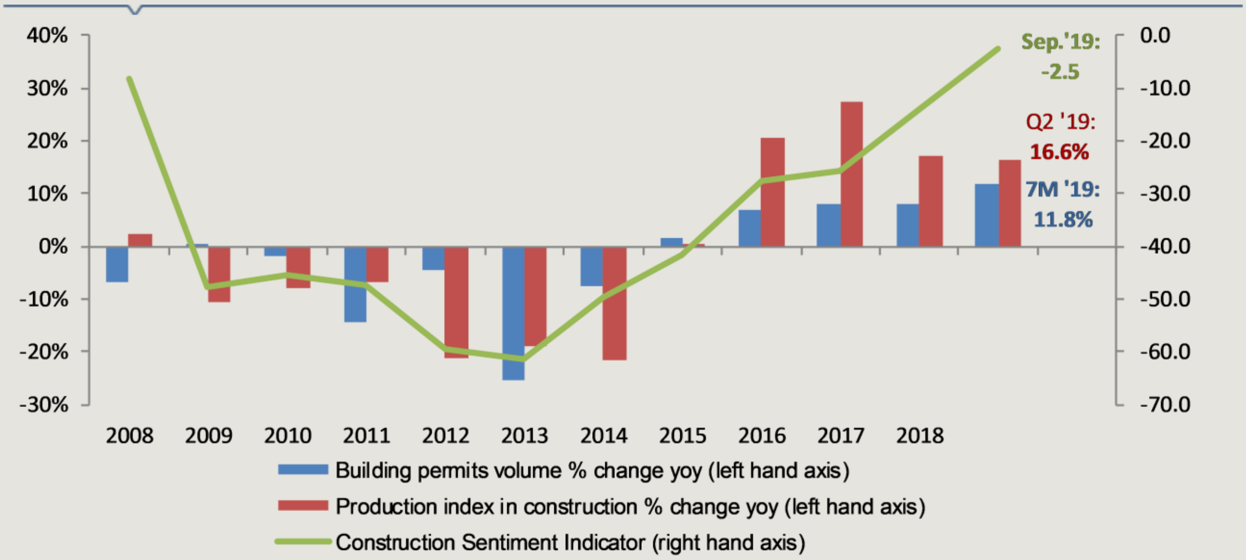
At the same time, the continuation of the upward trend of authorised building permits indicates that building activity is expected to continue in the future. More specifically, the number of authorised building permits increased by 11.8% y-o-y in the first seven months of 2019, compared to 11.6% in 2018.

Residential property prices increased by 1.6% y-o-y in 2018, up from 1.1% in 2017. Famagusta and Limassol presented the higher growth of residential property prices, by 3.6% and 3.1%, respectively.

The recovery of the real estate market is supported by new housing loans that have been increasing in the last years, on the back of low and declining housing loan interest rates. More specifically, in the first nine months of 2019, new housing loans reached Euro 674.9 million, up from Euro 631.7 million in the corresponding period of 2018. Strict lending criteria, as those implemented before 2015, indicates that the new loans will be viable. On the other hand, outstanding housing loans continue on a downward trend, as a result of deleveraging.

GRAPH 8

Building permits, Production Index in Construction, Construction Sentiment Indicator



Sources: CYSTAT, Eurostat

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