CENTRAL BANK OF CYPRUS

ECONOMIC BULLETIN

DECEMBER 2018

NICOSIA - CYPRUS

Published by:
ECONOMIC ANALYSIS AND RESEARCH

Edited by:
Publications Section, General Administration

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Design and Interactive pdf:	FBRH CONSULTANTS Ltd, www.fbrh.co.uk

ISSN (online) 1986 -1060

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EUROSYSTEM

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Note: The cut-off date for data in this *Bulletin* is 22 November 2018.

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ABBREVIATIONS

BLS	Bank Lending Survey
BoE	Bank of England
BPM	Balance of Payments and International Investment Position Manual
CA	Current Account
CBC	Central Bank of Cyprus
CCB	Cyprus Cooperative Bank
CPPI	Commercial Property Price Index
Cystat	Statistical Service of the Republic of Cyprus
DLS	Department of Lands and Surveys
ECB	European Central Bank
EER	Effective Exchange Rate
EONIA	Euro Overnight Index Average
ESA	European System of Accounts
ESI	Economic Sentiment Indicator
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Union
FED	Federal Reserve
FOMC	Federal Open Market Committee
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IIP	International Investment Position
IFRS	Interational Financial Reporting Standard
IMF	International Monetary Fund
LFS	Labour Force Survey
MFIs	Monetary Financial Institutions
NEER	Nominal Effective Exchange Rate
NACE	Statistical classification of economic activities in the European Union
NFCs	Non-Financial Corporations
NPFs	Non-Performing Facilities
OPEC	Organisation of the Petroleum Exporting Countries
QE	Quantitative Easing
REER	Real Effective Exchange Rate
RPPI	Residential Property Price Index
SDW	Statistical Data Warehouse
SPEs	Special Purpose Entities
UK	United Kingdom
US	United States of America

Introduction

Economic growth continues to be strong despite the marginal slowdown. Developments before and after the purchase of the Cyprus Cooperative Bank (CCB) assets by Hellenic Bank and the subsequent withdrawal of its banking license caused a brief decline in some economic confidence indicators. Uncertainty related to the disposal of certain CCB activities seems to have caused a slowdown in the growth of deposits of Cypriot residents. In contrast, the decline recorded by deposits of non-Cypriot residents was partly due to stricter anti-money laundering guidelines issued to banks.

In addition to the above, tourist revenue recorded a significant slowdown despite a surge in tourist arrivals, while other services sectors faced some weakness, such as the IT industry and financial services, affected by the deleveraging of private sector loans. These developments resulted in an overall GDP growth of 3,6% in 2018Q3, a rate slightly below the original forecast. For the year as a whole, GDP growth is expected to reach 3,8%. This rate is among the highest in the euro area. The satisfactory performance of the economy is also reflected in the recent upgrade of Cyprus' sovereign rating to investment grade by three international rating agencies.

GDP growth was mainly driven by investment and the strong performance of private consumption. Large private investments, a significant proportion of which are financed by foreign capital, have already begun and are expected to be completed in the coming years. From a sectoral perspective, growth has been broad-based. The only exception is the financial and insurance activities sector reflecting the ongoing deleveraging of loans as the private sector's balance sheet consolidation process continues. The latter cannot be regarded as an entirely negative development since the deleveraging of loans helps reduce high private debt. Among the sectors which contribute to growth but nevertheless need careful monitoring, is the real estate sector, especially in Limassol, where prices and rents have been moving at a different speed compared to the other areas of Cyprus.

In line with the positive macroeconomic developments and according to data from the Labour Force Survey, unemployment in 2018Q2 decreased to 7,3% compared with 2015Q1, during which it peaked at 17,6%. This is the first time since 2011Q4 that a single-digit unemployment rate has been recorded. At the same time, employment continues to show strong positive growth, recording an annual increase of 3,8% for the whole of 2017 and 4,3% for the first half of 2018.

Based on CBC staff forecasts, as published in this *Bulletin*, strong GDP growth is expected for the period 2018-2021, driven mainly by domestic demand. The most recent data, as well as the improved expectations regarding the investment prospects in different sectors, confirm the positive expectations regarding the economy's performance. In 2018 GDP is expected to record an increase of around 3,8%. Economic activity next year is expected to slow down slightly, but will still register high growth rates.

As regards public finances, a strong fiscal surplus was recorded in 2018. The fiscal performance of Cyprus, in terms of overall and primary balance (which is the fiscal balance excluding interest payments), is currently regarded as satisfactory. The positive outcome reflects the prudent execution of the state budget, in line with increased revenues due to the growth of economic activity and other non-recurring revenue that resulted from the tax arrears scheme. However, the recent demands by various groups for higher public spending need to be resisted. Any increase in expenditures must be controlled and targeted to avoid fiscal deterioration. It is noted that the credit rating agencies have already discounted that the public debt will continue to decline significantly. Therefore, it is of utmost importance that the process of reducing the public debt continues, and that the expectations of sound public finances are fulfilled.

Inflation in Cyprus based on the Harmonized Index of Consumer Prices (HICP) continues to remain positive, although at subdued levels. More specifically, in the first ten months of 2018, HICP stood at 0,7% compared with 0,8% in the same period of 2017. In general, inflation in the first ten months of 2018 reflects, on the one hand, the significant increases in energy, unprocessed food and services prices on the back of the strong performance of tourism related categories. On the other hand, inflation remains subdued primarily due to the fact that the prices of non-energy industrial goods continued to record significant annual declines, mainly due to increased competition and the ongoing general corrective pattern in the prices of various products. The reduction in the prices of processed foods also had a marginally negative contribution to overall inflation during the period under review.

Regarding the banking sector, the challenge for Cypriot banks during 2018 continued to be the reduction of non-performing facilities (NPFs).

2018 could be described as a landmark year for the consolidation of bank balance sheets, first through the sale of NPFs and second through the purchase of specifics assets and liabilities of the CCB by Hellenic Bank, and of USB by Astrobank. Moreover, there were changes in the legal framework for the resolution of NPFs as well as the formation of the upcoming ESTIA scheme, which provides for the partial subsidisation of the loan tranches by the state and the banks for a certain category of borrowers. The CBC agrees with the targeted support of vulnerable groups within a structured social policy and in line with the sustainability of public finances. However, the CBC has already expressed its reservations on specific overgenerous terms of the ESTIA scheme (see. Box 1 p. 30). These concerns are based mainly on the possible creation of moral hazard which may be expressed through strategic defaults by borrowers who have the ability to serve their loans. This may be due to an expectation of further future state subsidisation or the view that the plan is unfair as it may be subsidising other strategic defaulters. Any such scheme should, therefore, assist in the overall effort of institutions and state authorities to create a culture of repaying debt obligations and not

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increase the risk for adverse effects.

The recent transfer of NPFs off the banks' balance sheets, improved the quality of their assets and also strengthened the confidence of investors and depositors. Despite the progress made, which will reduce the percentage of NPFs below 30%, Cyprus is still very far from European levels which average 3,6%.

It should be noted that the NPFs that are no longer on the bank balance sheets remain in the real economy. Private debt remains high and the combination of these two factors acts as a disincentive for the private sector to take on new loans.

The positive trend of GDP and the positive developments in relation to the banking sector should not lead to complacency or reduced efforts to maintain fiscal discipline and implement the structural reforms that are under way. Full implementation of these reforms is expected to give further impetus to growth, protect the economy against unexpected risks and, therefore, should be a high priority for policymakers.

Macroeconomic Developments and Projections

1. International Environment: main developments

- *Global economic activity continues to remain strong, albeit with signs of a slowdown.*
- *Downside risks for economic activity in the euro area prevail, mainly due to import tariffs imposed by the US and possible retaliation.*
- *Expectations of the strong and broad-based economic activity in the euro area continue, despite the slowdown recorded in individual sectors.*
- *Global inflation has increased, mainly due to higher oil prices.*
- *Euro area core inflation remains relatively subdued, with a gradual increase expected over the medium term.*
- *Depreciation of the euro exchange rate due to the euro area economic slowdown and consequent market expectations of a more gradual tightening of ECB monetary policy than originally expected.*
- *Increased oil prices since the beginning of the year, despite the temporary decrease observed in mid-October, due to the announcement of a possible increase in oil production.*
- *Further contraction in monetary policy through an increase in interest rates by the Federal Reserve. The ECB continued its expansionary monetary policy, despite its decision to end the net asset purchase in December 2018.*

1.1 External developments

GDP growth[1]

World economic indicators have recently weakened as the global business cycle

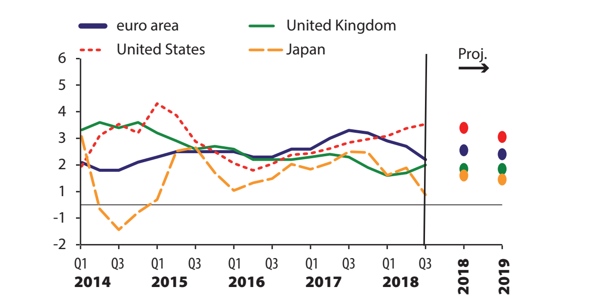
1. GDP projections are estimated as the average of the most recent projections from: The European Commission (European Economic Forecast, Autumn 2018) and the IMF (World Economic Outlook, October 2018).

entered its maturity stage. Global trade dynamics moderated in response to the actions and continuous threats in relation to the higher import tariffs imposed by the US and possible retaliation by the affected countries. Despite the above, short-term prospects remain stable. Global financial conditions remain supportive for growth in advanced economies with positive repercussions for emerging economies as well.

Economic activity in the euro area is somewhat weaker than expected but remains on a positive trend accompanied by a gradual increase in inflationary pressures (**Chart 1**). The risks associated with the growth prospects of the euro area economy are still assessed to be broadly balanced. At the same time, however, the risks associated with increased protectionism, vulnerabilities in emerging markets and the volatility of financial markets remain significant. Overall, the economy's key dynamics continue to support the convergence of inflation towards the ECB's target. Nevertheless, some recent very specific sectoral developments had an impact on the euro area's short-term growth. The ECB's monetary policy measures continue to support domestic demand. Private consumption has been boosted by the continued increase in employment and wage growth. Business investment is also supported by stable domestic demand, favourable financing terms and conditions and business profitability. Investment in real estate remains strong. In addition, the expansion of global activity is expected to continue to support euro area exports, albeit at a slower pace.

More specifically, following an increase of

CHART A.1 **GDP in selected countries**
(annual change %, seasonally adjusted %)



Source: Eurostat.
Note: The projections are for the year and are calculated as averages of the most recent projections from the European Commission and the IMF.

0,4% in the previous quarter, euro area GDP increased by 0,2% on a quarterly basis in 2018Q3, as was the preliminary estimate. The slowdown in GDP growth during 2018Q3 compared with 2018Q2 reflects the weakening of the German economy for the first time in three and a half years, and nil growth recorded by Italian GDP.

Among the largest economies in the euro area, the German economy declined by 0,2% in 2018Q3, following an increase of 0,5% in the previous quarter. This quarterly decline was the first to be recorded since 2015Q1 and it mainly reflects the decrease in both exports and household consumption. The Italian economy registered no growth after an increase of 0,2% in the previous quarter, recording the weakest performance since 2014Q4. In contrast, GPD growth in France was the strongest for almost a year (0,4% compared with 0,2% in 2018Q2), whereas GDP growth in Spain continued to increase at a steady rate (0,6%, same as 2018Q2).

On an annual basis, euro area GDP growth reached 1,7% in 2018Q3, following an increase of 2,2% in 2018Q2. In the European Union, GDP growth declined to 0,3% on a quarterly basis (against 0,5% in 2018Q2) and 1,9% on an annual basis (against 2,1% in 2018Q2).

In the US, prospects for economic activity remain strong. This is mainly due to positive contribution by private consumption expenditure, an increase in stock inventory, government spending, and private investment (excluding investment in residential real estate). GDP growth declined to 3,5% in 2018Q3 compared with 4,2% in 2018Q2, mainly due to the decline in exports and the deceleration in investment (excluding investment in residential real estate). At the same time, imports registered positive growth in 2018Q3, following the decline in 2018Q2. With respect to future prospects, the trade tensions between the US and China are expected to further adversely impact business activity and consequently investment expenditure. Prospects in the short term, however, remain strong, mainly supported by the macroeconomic fundamentals as well as by the pro-cyclical fiscal expansion.

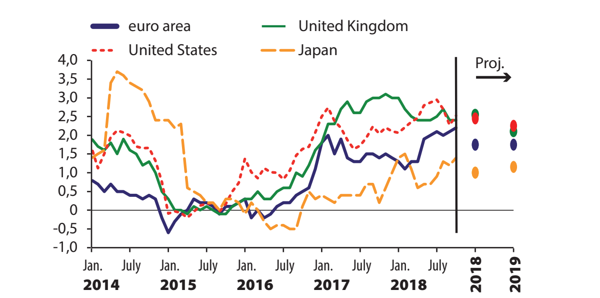
In the UK, annual growth remained strong (recording the highest rate within a year), after a weak start at the beginning of the year. More specifically, GDP growth reached 1,5% in 2018Q3 compared with 1,2% in 2018Q2. This was mainly due to positive developments in the services sector, and to a lesser extent, the construction sector. The downside risks for the UK economy include the broad global economic growth decline, the increased trade tensions and the uncertainty concerning Brexit and its subsequent repercussions.

Inflation[2]

Global inflation continued its upward trend during 2018Q3, mainly driven by increases in energy prices on account of the significant rise in oil prices compared with the corresponding period of 2017 (**Chart A.2**). Global core inflation (inflation excluding energy and food), however, continued to remain at lower levels compared with headline inflation, mainly reflecting moderate or, in some cases, zero real wage

2. Inflation projections are estimated as the average of the most recent projections from: The European Commission (European Economic Forecast, Autumn 2018) and the IMF (World Economic Outlook, October 2018).

CHART A.2 **Inflation in selected countries**
(annual change, %)



Sources: Eurostat, SDW (ECB).
Note: The projections are for the year and are calculated as averages of the most recent projections from the European Commission and the IMF.

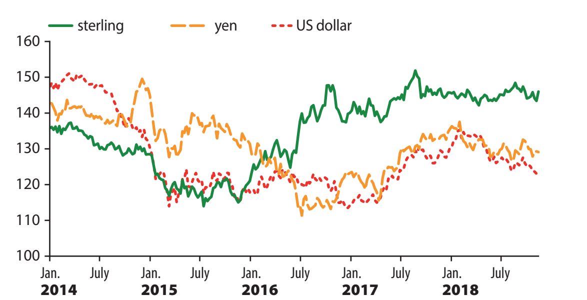
growth despite the tightening in the labour market and the closing of the output gap.

According to projections by international organisations and analysts, inflation in selected major advanced countries such as the US, Japan and the euro area, is expected to fluctuate around the same or even higher levels in 2018 compared with 2017 (**Chart A.2**, p. 15). This development is mainly due to the impact of increased oil prices. In the UK, inflation is expected to exhibit a slight deceleration in 2018 compared with 2017, mainly due to the elimination of the impact of sterling depreciation on inflation. With regard to 2019, inflation in most of the aforementioned advanced countries is anticipated to show stabilising or slightly decelerating trends. This is mainly due to the expected negative base effect in the energy category, despite the envisaged further wage growth and the expected further decline in global economic slack.

Exchange rates

The exchange rate of the euro against major currencies, with the exception of sterling, exhibited a downward trend between January 2018 and 16 November 2018 (latest available data) (**Chart A.3**). The depreciation of the euro mainly reflects market expectations for a more gradual implementation of a contractionary monetary policy by the ECB, given the deceleration in euro area GDP, and the persistence of euro area inflation below the ECB's target of close but below 2%. The euro exchange rate was also negatively affected by the political uncertainty pertaining in some

CHART A.3 **Euro exchange rate against selected currencies**
(weekly data, 2000=100)



Source: Bloomberg.
Note: A higher (lower) index level represents a nominal appreciation (depreciation) of the euro against the other currencies.

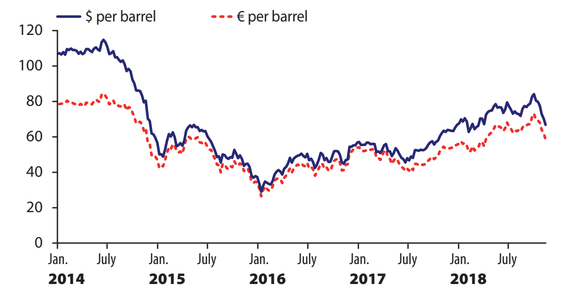
euro area member countries as well as the global trade tensions.

Specifically, between 29 December 2017 and 16 November 2018, the euro exchange rate depreciated by 4,9% against the dollar and 4,8% against the yen. As for the exchange rate of the euro against the sterling, it remained at the same level as in November last year, despite the relatively small fluctuations observed during the period under review. This development mainly reflects investors' expectations for a positive outcome in the Brexit negotiations.

Oil

In general, the price of Brent crude recorded a significant increase in 2018, despite the decrease observed since mid-October (**Chart A.4**). The increase was mainly due to the US sanctions on Iran and the subsequent decision by OPEC to decrease oil production. In addition, the general improvement in global economic activity and the subsequent increase in oil demand also positively impacted the price of Brent crude. Nevertheless, the recent announcements from Saudi Arabia and Russia for a potential increase in oil production, resulted in a fall in oil prices from mid-October onwards. According to the latest available data, the closing price of Brent crude oil stood at $66,76 per barrel on 16 November 2018, from $84,16 on 5 October 2018 (the highest price recorded since January 2018) and $62,70 on 17 November 2017.

CHART A.4 **Closing prices of oil (Brent)**
(weekly data)



Source: Bloomberg.

International official interest rates

In 2018 the major central banks, excluding the

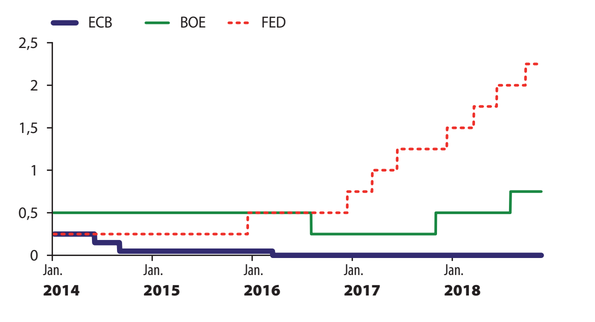
ECB, adopted a more contractionary policy stance. Specifically, the Federal Reserve increased its base rate range three times during 2018 (the upper limit increased from 1,50% to 1,75%, 2,00% and recently to 2,25%), and the BoE once (from 0,50% to 0,75%). The implementation of contractionary monetary policy by the respective central banks relates mainly to the increase recorded in inflation rates above the price stability target of 2% (**Chart A.5**). On the other hand, the ECB continued its expansionary monetary policy stance keeping its main refinancing operations rate unchanged at 0%.

1.2. Monetary developments in the euro area

Inflation

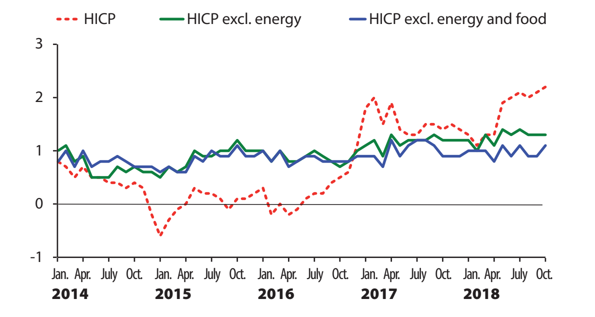
According to the latest available data, euro area inflation reached 2,2% in October 2018 compared with 2,1% in September 2018 (**Chart A.6**). The marginal acceleration of inflation in October 2018 was mainly driven by higher increases in both energy and services prices. In recent months, higher energy prices have had a major impact on overall euro area inflation. In addition, increases in non-energy industrial goods prices remain at very low levels. As a result, core inflation continues to remain relatively subdued (remaining unchanged compared with the first ten months of 2017). Over the medium term, a gradual increase in core inflation is expected, mainly supported by the ECB's expansionary monetary policy stance, the ongoing economic growth and a further gradual rise in wages.

CHART A.5 **Official interest rates**
(% per annum)



Sources: ECB, Fed, BoE.

CHART A.6 **Inflation in the euro area**
(annual change, %)



Source: Eurostat.

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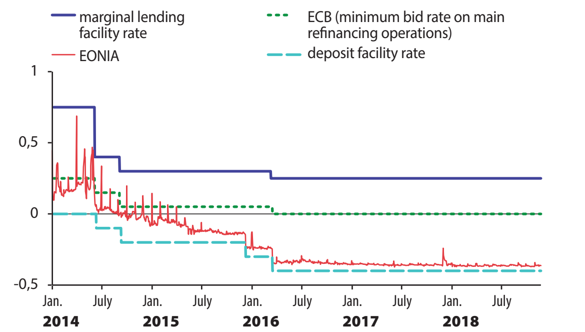
Given the current energy futures price contracts, HICP inflation is expected to fluctuate around the same levels in the coming months, mainly driven by energy prices. The euro area inflation projections by international organisations and analysts converge to a stabilisation of around 1,8% for both 2018 and 2019.

Reference rates and ECB intervention

The ECB kept its key interest rates unchanged in 2018 to 0,25%, 0% and -0,40% for the main refinancing operations rate, marginal lending facility rate and deposit facility rate, respectively. The EONIA curve also remained unchanged, indicating that markets do not expect any further change in the deposit facility rate (**Chart A.7**). Analytically, the EONIA closed at -0,36% on 22 November 2018. It should be noted that the ECB has continued to support money markets through standard liquidity providing operations and non-standard measures in order to support the return of the euro area inflation rate back to the medium-term target of below but close to 2%.

However, the ECB's quantitative easing programme, i.e. the purchase of bonds, was cut back from €60 billion to €15 billion per month as from October 2018, and is expected to last until December 2018. The asset purchase programme is expected to end in December 2018 given expectations of broad economic growth in the euro area. Nonetheless, the ECB announced its intention to continue to support the markets by reinvesting funds from maturing bonds.

CHART A.7 **ECB reference rates and EONIA**
(% per annum, daily data)



Source: Bloomberg.

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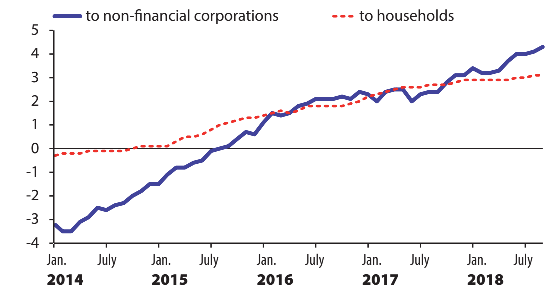
Credit expansion: loans

Loans to the euro area private sector have continued to record positive growth rates in 2018, attributed to both non-financial corporations (NFCs) and households (**Chart A.8**). This development mainly reflects banks' excess liquidity and low euro area lending rates, brought about by the ECB's expansionary monetary policy, as well as the easing of terms and conditions and credit standards applied by banks for the approval of new loans.

More specifically, according to the results of the euro area Bank Lending Survey (BLS), net loan demand has been continuously increasing between 2014Q1 and 2018Q3. At the same time, credit standards for loans to the abovementioned sectors have eased since mid-2014. According to the BLS, the participating banks expect credit standards for loans to households to further ease in 2018Q4 compared with 2018Q3, whereas those for loans to enterprises are expected to remain broadly unchanged. Net loan demand by both households and enterprises is expected to further increase in 2018Q4 compared with 2018Q3.

Despite the above positive monetary developments, the high level of NPFs in some member states continues to hinder credit growth dynamics in the euro area, with a negative impact on the real euro area economy. In this respect, an effective and successful solution to the NPFs problem is considered imperative.

CHART A.8 **Loans to the private sector: euro area**
(annual change %, seasonally adjusted data)



Source: SDW (ECB).

2. Domestic Developments

- *Subdued domestic inflation during the first ten months of the year, despite significant increases in energy prices.*
- *Finalisation of the acquisition of certain Cyprus Co-operative Bank (CCB) assets and liabilities by Hellenic Bank and conversion of the CCB into a cooperative asset management company (SEDIPES).*
- *Continuation of positive annual growth rates in the domestic private sector deposits.*
- *Contained annual growth rate of loans to the domestic private sector at around the levels of the previous year.*
- *Significant decrease in the level of NPFs based on the latest available data (July 2018) with expectations of a further decrease, partly due to the transfer of the CCB's non-performing facilities off the banking system to SEDIPES (September 2018 data).*
- *The downward trend of deposit interest rates continued.*
- *Further small reductions were recorded in lending rates to households whilst lending rates to NFCs stabilised at low levels.*
- *GDP continued expanding, albeit with a marginal slowdown, driven by positive developments in domestic demand.*
- *Further signs of declining unemployment.*
- *Continued gradual recovery in the real estate sector, with demand rising notably. Prices recorded relatively small increases, with the exception of Limassol where apartment prices rose significantly.*
- *Continuation of primary surpluses.*

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2.1 Domestic Prices, Monetary Aggregates and Labour Costs

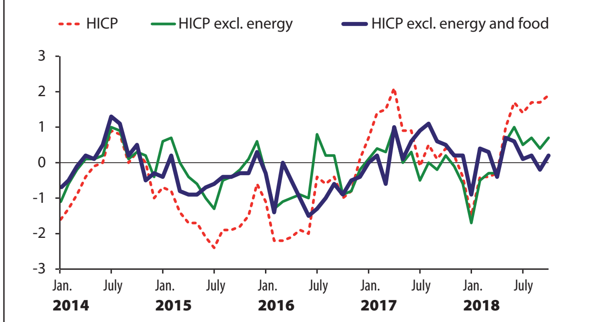
Inflation

Domestic headline inflation, as measured by the Harmonised Index of Consumer Prices (HICP), continues to remain positive, albeit subdued. Specifically, HICP inflation increased to 1,9% in October 2018 from 0,4% in the corresponding month of 2017. This development was mainly attributed to significant increases in energy prices.

With regard to the first ten months of 2018, HICP reached 0,7% from 0,8% in the corresponding period of 2017, amid mixed developments in the main inflation subcategories in the period under review. In general, the trend of headline inflation during the first ten months of 2018 reflects, on the one hand, the significant increases in energy prices, unprocessed food and services prices on the back of the strong performance of tourism related categories. On the other hand, the subdued trend of domestic HICP is mainly attributed to the fact that non-energy industrial goods prices continued to register significant yearly decreases. This is the result of increased competition (including off-season or mid-season sales/special offers as well as online competition) and the ongoing general corrective pattern in the prices of various products. Decreases in processed food prices also had a marginal negative contribution to the overall inflation during the period under review.

Inflation excluding energy registered a marginal increase of 0,1% in the first ten months of 2018 compared with a small increase of 0,2% in the corresponding period of 2017 (**Chart A.9** and **Table A.1**). Core inflation (inflation excluding food and energy), also registered a marginal increase of 0,1% during the first ten months of 2018 compared with 0,5% in the corresponding period of 2017 (**Chart A.9** and **Table A.1**). The downward trend in core inflation mainly reflects the significant negative impact of non-energy industrial goods prices, which largely offsets the positive impact of increased demand for domestic services (especially tourism related services) and strong domestic economic growth. It should be noted that, core inflation is important as it shows the general price trends excluding the impact of exogenous and volatile factors.

CHART A.9 **Inflation in Cyprus**
(annual change, %)



Source: Eurostat.

TABLE A.1 **Inflation in Cyprus**

		Annual change (%)				
	Weights[(1)]	Jan.-Oct. 2017	Jan.-Oct. 2018	Oct. 2017	Sep. 2018	Oct. 2018
HICP	1.000,00	0,8	0,7	0,4	1,7	1,9
Unprocessed food	70,16	0,6	0,8	2,5	6,7	5,1
Processed food	165,88	-1,1	-0,1	-2,0	0,0	0,3
Energy	84,01	9,6	7,1	2,9	16,3	16,8
Services	460,13	1,1	1,0	1,4	0,4	0,9
Non-energy industrial goods	219,83	-1,0	-1,8	-1,6	-1,3	-1,1
HICP excluding energy	915,99	0,2	0,1	0,2	0,4	0,7
HICP excluding energy and food	679,96	0,5	0,1	0,5	-0,2	0,2

Source: Eurostat.
(1) Based on the weight for 2018.

Monetary aggregates[3,4]

The banking sector in Cyprus was significantly reformed in 2018Q3 after the business transfer agreement between the CCB and Hellenic Bank. The remaining entity of the CCB has been transformed into a cooperative asset management company (SEDIPES), a legal entity without a banking license. The balance sheet items of the CCB that remained in SEDIPES and are outside the banking system include about one third of the NPFs of the total banking sector. This development is expected to place the banking sector on a healthier base, contributing further to the consolidation of the banks' balance sheets.

3. For a detailed explanation of the methodology and technical analysis of monetary aggregates, see Technical Notes on p. 72.
4. The analysis on monetary aggregates (deposits and loans) in this section of the *Economic Bulletin* focuses on domestic residents excluding SPEs. SPEs are included in the non-residents category.

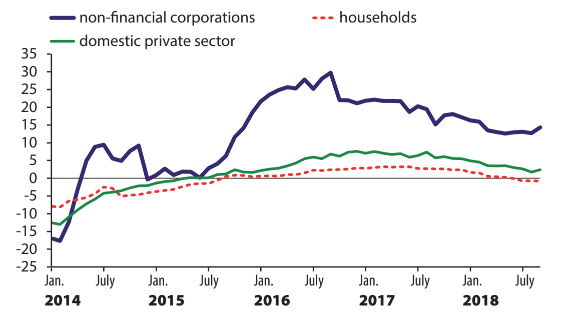
A positive development for the domestic banking sector, and particularly for the deceleration of NPFs, includes the sale of distressed assets by different banking institutions as well as the improvement of the relative legislative framework. The recent sale of loans and securitisation legislation as well as the amendments to the insolvency and foreclosure legal frameworks are expected to accelerate the effective management of NPFs.

It should be noted that the above developments are not reflected in the growth rates of monetary aggregates, as they are not ordinary transactions. While affecting the outstanding amount of loans, they do not affect their growth rates, the calculation of which is based on the methodology followed by the ECB[5].

Domestic private sector deposits continued to record positive growth rates, albeit at a decelerating trend between 2017Q3 and August 2018, mainly due to the uncertainty that prevailed over the CCB prior to its agreement with Hellenic Bank. In September 2018 the annual growth rate of these deposits exhibited a partial acceleration. In particular, their annual growth rate stood at 2,4% in September 2018, compared with 5,5% in December 2017 and 5,7% in September 2017 (**Chart A.10**). The deposits of non-residents, on the other hand, recorded a negative annual growth rate of -14.9% in September 2018 from -2.1% in December 2017 and -0.2% in September 2017 (**Chart A.11**). The negative annual growth rates in non-residents' deposits are partly due to stricter guidelines followed by banks in the

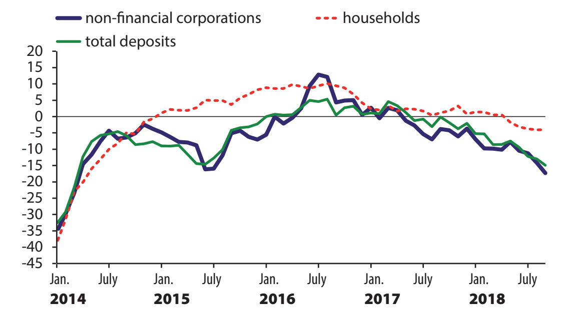
5. The growth rates of monetary aggregates are calculated from monthly changes adjusted for amounts that do not arise from transactions to reflect the changes attributed to net transactions (for more information see Technical Notes on p. 72).

CHART A.10 **Deposits of the domestic private sector**
(annual change, %)



Source: CBC.

CHART A.11 **Deposits of non-residents in Cyprus**
(annual change, %)



Source: CBC.

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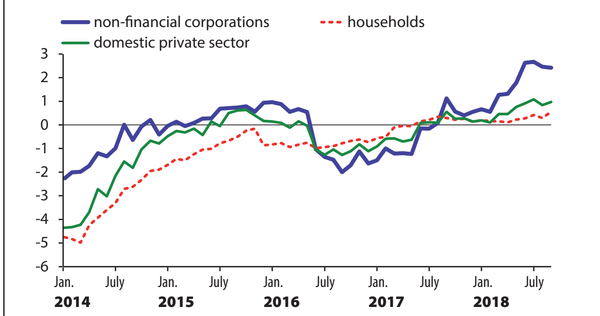
context of strengthening anti-money laundering practices. Their volatile nature is also noted as non-residents' deposits include companies' working capital.

Turning to the financing of the domestic private sector by MFIs, a stabilisation in new loan contracts was, in general, observed in the first nine months of 2018 compared with the corresponding period of 2017. At the same time, loan repayments, existing debt-for-asset swaps and the strict credit criteria adopted before 2015, continue to contain the annual growth of the sector's loans to positive but low levels, especially for households (**Chart A.12**). Specifically, the annual growth rate of domestic non-financial corporations' loans stood at 2,4% in September 2018, compared with 0,6% in December 2017 and 1,1% in September 2017 (**Chart A.12**). Domestic household loans recorded an annual increase of 0,6% in September 2018, compared with 0,1% in December 2017 and 0,3% in September 2017 (**Chart A.12** and **Table A.2**).

Furthermore, according to the 2018Q3 results of the Bank Lending Survey (BLS) an increase in net demand for loans both by households and enterprises has been recorded since the beginning of 2015. The increase in net demand for loans is mainly due to continued growth in economic activity, the small increase in wages and the historical low domestic lending rates. As regards banks' credit standards, they remained broadly unchanged in 2018Q3, around the levels of 2014Q4 across all loan categories (**Table A.3**, p. 26). The sustainment of tight lending conditions largely reflects the correction in banks' assessment for lending when compa-

CHART A.12 **Loans to the domestic private sector**
(annual change, %)



Source: CBC.

TABLE A.2 **Loans to domestic households(1),(2)**

	Outstanding balance as % of total(3)	Annual percentage change					
		2017 June	2017 Sep.	2017 Dec.	2018 Mar.	2018 June	2018 Sep.
Domestic households	100,0	0,2	0,3	0,1	0,2	0,3	0,6
1. Consumer credit	12,1	0,7	1,5	1,7	1,9	2,3	2,1
2. Lending for house purchase	57,0	-0,9	-0,6	-0,8	-0,7	-0,4	-0,1
3. Other lending	30,9	1,7	1,4	1,2	0,9	0,8	1,2

Source: CBC.
(1) Sectoral classification is based on ESA 2010.
(2) Including non-profit institutions serving households.
(3) As at the end of the last month available. Figures may not add up due to rounding.

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red with past practices. In particular, the current criteria for granting loans are, *inter alia*, closely linked to the customers' net income and not to the ability of providing assets such as real estate as collateral, a practice followed by banks in the past. At the same time, the tight lending conditions also reflects the high level of NPFs that continue to burden banks' portfolios, despite the downward trend they exhibit.

Specifically, between February 2015, when the absolute level of NPFs peaked, and July 2018 (latest available data), NPFs fell by €11,2 billion. Their downward trend can be attributed mainly to the sale of NPFs, their reclassification as debt instruments held for sale until the final supervisory approval, restructured NPFs successfully completing the probation period and their reclassification as performing. Additional factors include loan write-offs, repayments and debt settlement through swaps with immovable property. The level of total NPFs is expected to decrease further due to the transfer of Cyprus Cooperative Bank's NPFs off the banking system to SEDIPES, the strengthening of the relevant legal framework and the implementation of the ESTIA scheme.

In general, improved monetary aggregates support the real economy despite the challenges that the banking sector continues to face, particularly the relatively high stock of NPFs and their negative impact on credit supply. The consolidation of the sector continues steadily despite pressures associated, among other things, with possible increased provisions for NPFs, low interest income and high operating expenses.

TABLE A.3 **Summary of the October 2018 BLS results**

	Cyprus		Euro Area	
	2018 Q3	2018 Q4 (expectations)	2018 Q3	2018 Q4 (expectations)
Credit standards for loans				
Enterprises	Unchanged	Unchanged	Easing	Broadly unchanged
Households				
- *Housing loans*	Unchanged	Unchanged	Easing (slightly)	Easing
- *Consumer credit and other lending*	Unchanged	Unchanged	Broadly unchanged	Easing
Demand for loans				
Enterprises	Increase	Increase	Increase	Increase
Households				
- *Housing loans*	Increase	Increase	Increase	Increase
- *Consumer credit and other lending*	Increase	Increase	Increase	Increase

Sources: CBC, ECB (SDW).
Note: The above results list the changes in credit standards and loan demand that occurred in the last three months (in this case 2018Q3) and the changes that are expected for the next three months (i.e. 2018Q4). The measure used for the statistical analysis of this research is the diffusion index.

Box 1: Analysis of the financial position of households in Cyprus, 2010 and 2014

Data from the Eurosystem Household Finance and Consumption Survey (HFCS), wave 1 and 2

Introduction

The unprecedented economic and financial crisis that unfolded in Cyprus in 2013, had, among other things, a significant impact on the balance sheets of both banks and the non-financial private sector (households and NFCs). One example is the sharp increase recorded in non-performing loans (NPLs), in the context of already extremely high levels of household and NFC debt. Despite Cyprus's successful exit from the Memorandum of Understanding in March 2016 and the significant economic recovery in recent years, the level of NPLs and private debt continue to be two of the biggest problems and challenges that the economy needs to tackle. Although both NPLs and private debt have recently moderated (especially NPLs in the banking system), they continue to be disproportionately high.

The NPLs problem is twofold, since not only does it adversely affect the balance sheets of banks, but it also further worsens the financial position of heavily indebted households and NFCs. In fact, both NPLs and high private debt hinder the sustainability of economic growth and render the economy more vulnerable to unpredictable risks. In this respect, both issues warrant special attention and highlight the need for their effective resolution.

Brief history

In the mid-2000s, following the accession of Cyprus to the EU, a significant increase in lending by both residents and non-residents was observed[1]. On the demand side, the improved economic prospects after accession to the EU, resulted in increased borrowing, mainly channelled to private consumption and real estate. On the supply side, factors such as increased liquidity, lenient laws and regulations governing the banking system as well as the lax credit standards applied to loans, encouraged banks to engage in excessive lending. At the same time, the granting of new lending was based on the value of the loan collateral, especially real estate collateral, rather than on the borrower's income and their ability to service loans. As a result, and as shown in **Chart 1** (p. 28) household debt, as a percentage of GDP, increased significantly from 90,5% in 2006 to 127,8% in 2015, before being reduced to 107,5%[2] in 2017.

1. See Argyridou-Demetriou Ch., P. Karamanou and L. Cleanthous (2012).
2. It is noted that households' net debt, that is, taking into account their respective financial assets (mainly deposits), is negative as a percentage to GDP. This was mainly the result of Cypriot households choosing to borrow money in order to finance their expenses, whilst at the same time maintaining deposits as a safety net for unforeseen expenses. However, one cannot conclude that those households with high debt also have the corresponding deposits.

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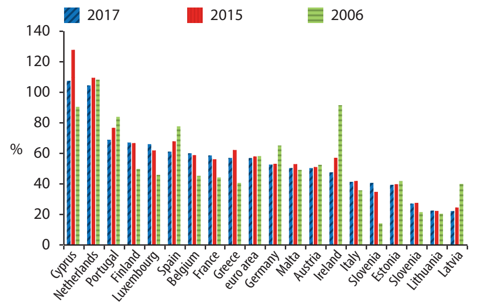
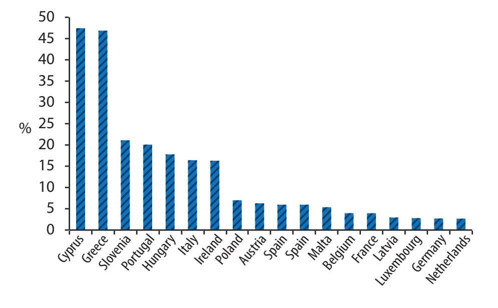
CHART 1 **Household debt as percentage of GDP**



Sources: Eurostat, National Accounts.

CHART 2 **Non - Performing Exposure (NPEs)**



Source: European Banking Authority, 2015.

Both in 2015 and 2017 Cypriot households had the highest percentage of debt to GDP in the euro area.

The high level of debt rendered Cypriot households extremely vulnerable to the effects of the crisis, which peaked in 2013. In fact, the crisis had a twofold impact on already highly indebted households. On the one hand, they were negatively affected by both the significant decline in economic activity, wages and jobs and, on the other, by the significant drop in the market value of real estate properties pledged as collateral for lending purposes. As a result, the trend of NPLs as a percentage of household loans increased excessively. A similar path was also recorded by NFCs' NPLs, although they do not form a part of the current analysis.

Chart 2 shows the level of NPLs in Cyprus and other EU countries in 2015. The comparison clearly depicts the magnitude of the problem in Cyprus.

This Box examines the overall financial position of Cypriot households, focusing on the high level of NPLs and household debt. For the purpose of this analysis, data was collected by the CBC in the first two waves of the Eurosystem Household Finance and Consumption Survey (HFCS) - that is, in 2010 and 2014. The HFCS is conducted approximately every three years in most euro area countries, including Cyprus[3].

The sampling survey

The Household Finance and Consumption Network (HFCN) was established in 2006, under the auspices of the ECB. It coordinates a network of researchers, statisticians and economists from the ECB, members of national central banks, including the CBC, and executives and experts from a number of national statistical institutes and universities. The

3. The HFCS third wave fieldwork (2017) has been completed and the analysis of the results is still in progress. The analysis and publication of the results is expected to be finalised by the end of 2019 for all Eurosystem countries participating in the survey.

survey is conducted through personal interview of household representatives[4] and is based on a harmonised questionnaire. Its aim is to record, measure and analyse financial and economic data in areas such as savings, investments, lending, consumption, financial transactions and retirement planning decisions, both at the individual and household level. The data is a valuable source of information both for the understanding of households' behaviour and the design and implementation of the appropriate monetary policy[5]. In the questionnaire for Cyprus, the CBC has added additional questions for Cypriot households, including questions regarding loans which are non-performing, specifically for "loans which are overdue for 90 days or more"[6].

The HFCS in Cyprus covers a large representative sample of households from all income and social levels (1.237 in 2010 and 1.289 in 2014), creating a valuable and rich source of information for many research topics[7]. The reference years of the two waves, 2010 and 2014 respectively, are of particular importance since they cover the period before and after the peak of the crisis in Cyprus, which resulted in the haircut of uninsured deposits in March 2013. In this respect, it is possible to analyse the impact of the crisis on the financial position and consumption behaviour of households in Cyprus. For example, one could examine the degree to which the crisis affected households of different income levels. Furthermore, one could also investigate the extent to which: (a) the reduction in household income in the aftermath of the crisis influenced the ability to meet private debt obligations and (b)whether in 2014 there were a number of households who had the financial ability to repay their loans but they strategically decided not to do so[8].

The financial position of households in 2010 and 2014

Table 1 (p. 30) summarises information on the overall financial situation of households in Cyprus, based on the responses of the participating households. Specifically, among the data collected are the households' credit obligations and assets, both

4. The FKP of the household is identified through a specific procedure, based on ECB guidelines, at the beginning of the interview. It is the person that is closer to the age of 45 years old, who is most knowledgeable on financial matters regarding both the household as a whole and the individual household members and can provide the required detailed information. (FKP=Financially Knowledgeable Person).
5. For more information please refer to https://www.ecb.europa.eu/pub/economic-research/research-networks/html/researcher_hfcn.en.html
6. Loans that are overdue by 90 days or more constitute the bulk of NPLs. Therefore, in this analysis it is used as a proxy for the overall trajectory of the NPLs growth.
7. It is noted that the anonymity of the survey participants is enshrined, thus strictly maintaining the confidentiality of the data.
8. The answer to this question, which is to investigate the potential existence of strategic defaulters, is not the objective of this box. This question is the topic of a broader study at the CBC, which, beyond the HFCS results, uses macroeconomic indicators of the Cyprus economy through econometric analysis.

TABLE 1 **Indicative data for the general financial condition of households in Cyprus: Eurosystem survey HFCS, 2010 and 2014**

	Wave 1 (2010)	Wave 2 (2014)
A. Households with no loans as a percentage of total population	**33,3**	**40,9**
Total household income (euro, average)	27.384	23.495
Deposits (euro, average)	32.741	28.207
Total liabilities (euro, average)	0	0
Total real assets (euro, average)	412.849	223.330
of which:		
value of HMR (euro, average)	181.002	108.531
value of other real assets	231.847	114.799
B. Households with loans as a percentage of total population	**66,7**	**59,1**
Total household income (euro, average)	51.530	35.040
Deposits (euro, average)	32.548	16.553
Total liabilities (euro, average)	116.058	129.216
Total real assets (euro, average)	676.035	430.504
of which:		
value of HMR (euro, average)	309.194	213.568
value of other real assets	366.841	216.936
B1. Households with 90 DPD (as a percentage of households with loans)	**10,8**	**27,0**
Total household income (euro, average)	37.082	23.561
Deposits (euro, average)	13.634	6.643
Total liabilities (euro, average)	160.732	193.947
Total real assets (euro, average)	530.600	399.997
of which:		
value of HMR (euro, average)	249.325	196.905
value of other real assets	281.275	203.092
B2. Households with performing loans (as a percentage of households with loans)	**89,2**	**73,0**
Total household income (euro, average)	53.282	39.286
Deposits (euro, average)	34.842	20.219
Total liabilities (euro, average)	110.641	105.268
Total real assets (euro, average)	693.671	441.790
of which:		
value of HMR (euro, average)	316.453	219.732
value of other real assets	377.218	222.058

Note: The categories A and B include all households without or with any kind of loan, respectively. In this respect, households with zero value of real assets might be included, resulting in lower mean values, where applicable.

financial (e.g. deposits) and real, including the estimated (by the owner) value of the main household residence. For verification of the data collected through the survey, the aggregate information on credit liabilities of households was compared with the officially published data on loans to domestic households and were found to be approximately the same[9]. In addition, when breaking down the value of the households' real assets derived from the survey data, it appears that the average value of the main residence is roughly the same as that calculated from other

9. The 2010 and 2014 HFCS findings for total liabilities (extrapolated in the total population) are in line with the official data, as indicated in Table 6.1. in the CBC's *Monetary and Financial Statistics*. https://www.centralbank.cy/el/statistics/money-and-banking-statistics-and-financial-accounts/data/«monetary-financial-statistics»-publication

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sources[10]. This also roughly holds for the aggregate amount of NPLs[11].

In contrast, when comparing the HFCS data on household deposits, a large deviation from the official published data on deposits by domestic households[12] was observed in both waves. Unlike in the case of loans, households were reluctant to reveal the true value of their deposits. A deviation, albeit to a lesser extent, is also apparent with the reported labour income of households[13]. With this in mind, any analysis in relation to these categories should be undertaken with great caution. Even if the analysis in relative terms, i.e. comparison of the change between 2010 and 2014, may contain useful information, any analysis in absolute terms could potentially entail large statistical errors. Similar problems relating to the verification of the value of deposits and income is also observed in the rest of the euro area countries participating in the survey.

Taking into consideration the above, some survey results are selectively presented below. Specifically, **Table 1** (p. 30) shows basic financial and economic statistics for specific household categories: those without loans (section A) and those with loans (section B). The first category comprises 33,3% of households in Cyprus in 2010 and 40,9% in 2014. The second category comprises 66,7% of households in 2010 and 59,1% in 2014. Moreover, subcategory B.1 presents data on households with loans that are 90 days or more past due (90 DPD) and subcategory B.2 presents data on households with performing loans.

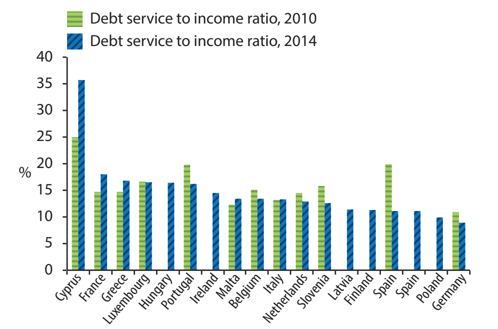
According to the table, in 2014 approximately one in four Cypriot households with loans (27,0%) defaulted on their credit obligations (90 DPD). Despite this, the value of these household's NPLs as a percentage of total loans was much greater, specifically more than 50%. The reason is that the outstanding balances of those households that were not repaying their financial obligations (with an average value of total credit obligations at €193.947) is almost double when compared with those who regularly serviced their debt (corresponding to €105.268).

It is also noteworthy that even before the crisis, a relatively large number of households had loans with 90 days past due

10. Specifically, based on the data used for the construction of the CBC Residential Property Price Index, the mean price of houses in 2014 in Cyprus amounted to €238.746, compared with a mean house price of €232.000 as recorded by the HFCS. This figure is relatively close to the weighted average published by the Royal Institution of Chartered Surveyors (RICS). The accuracy of the price for primary residence in the HFCS data seems to be related to the fact that the interviews were mainly conducted at the respondents' residences. This, however, may not necessarily hold for other household real assets, such as property other than the household main residence, cars, valuables etc.
11. The survey results, as regards the level of the outstanding loan balances of those households who registered loans in arrears of over 90 days, are in line with the corresponding CBC official published data for 2010 and 2014 when the total population is extrapolated from the survey results https://www.centralbank.cy/en//licensing-supervision/banks/aggregate-cyprus-banking-sector-data.
12. See Table 3.1 in the CBC's *Monetary and Financial Statistics.*
13. The underreporting of income per employee seems to be around 20% when compared with the national accounts data. It is also evident from the data that the underreporting is mainly related to self-employed individuals.

(90DPD). In fact, in 2010 about one in nine households with loans (10,8%) had loans with 90 DPD. However, based on the previous definition of non-performing loans in Cyprus, these loans were not necessarily considered to be problematic despite not being repaid, as the value of their collateral exceeded the outstanding amount of their loan. As mentioned above, prior to the crisis, lending practices were largely based on the value of the collateral of the loan rather than on criteria based on income and repayment ability. This is confirmed by **Chart 3**, which shows the monthly instalments on loans to the monthly income of households (ratio of debt instalments relative to household income) in Cyprus and in other euro area countries surveyed in 2010 and 2014. The much higher debt service to income ratio of the average household in Cyprus is an indication of the increased debt repayment difficulty[14] and highlights the need to come up with "unconventional" solutions to the problem of NPLs.

CHART 3 **Household debt service to income ratio**
(median value)



Source: ECB.

Wealth and income reduction due to the crisis

Table 1 (p. 30) outlines the general impact of the crisis on the financial position of households by comparing the relevant data between the two waves, 2010 and 2014, respectively[15]. Although the under-reporting of income and especially of financial assets in the survey affects the analysis in absolute terms, the comparative analysis between the two waves contains useful information with respect to change in the trend over the two reference years. In fact, one can see in the table the large reductions that Cypriot households suffered in both their income and the value of their financial and real assets between 2010 and 2014. The decrease in income can be attributed to the wage cuts imposed on both the private and public sector as well as to the increase in the unemployment rate. The significant decline in the value of real assets was the result of the reduction in the prices of real assets confirmed by the CBC Residential Property Price Index, which recorded a decrease of 22% for the period 2010-2014. At the same

14. The difference between Cyprus and other countries is so large, that even if we were to assume that the income recorded in the Cypriot survey is more underreported than in the other participating countries, it would still not change the overall conclusion.
15. The table presents weighted averages. In view of the existence of a high number of positive outliers, the corresponding median values are lower than the mean values. In certain circumstances, they are significantly lower due to the positive skewness of the distribution.

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time, the data show a drop in the value of financial assets, which is related to the haircut of uninsured deposits in the two major banks at the time and the use of liquid assets by households for consumption purposes in order to restore their level of disposable income[16].

Regarding household debt obligations, the percentage of households with loans, as already mentioned, decreased from 66,7% in 2010 to 59,1% in 2014, partly due to the netting off of loans following the resolution of Cyprus Popular Bank in March 2013 as well as regular loan repayments, at a time when new lending was nil. However, although there was a decrease in the number of loans from the first to the second wave of the survey, the average total outstanding amount of household debt increased from €116.058 in 2010 to €129.216 in 2014. This indicates that loan repayments at the time mainly involved small loan balances and that the impact of the capitalisation of accumulated interest was quite large, adding up to already high level of NPLs.

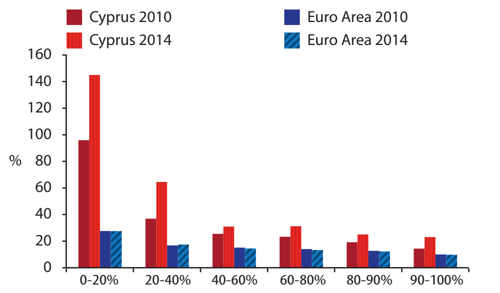
As regards households with 90 DPD loans, despite the major reductions they faced in their income and the value of their assets between the two waves, these households still own a considerable amount of real assets, including the main residence[17] and other immovable properties[18,19]. This, in conjunction with the fact that households with 90 DPD loans have, on average, a higher value of real assets than their total credit liabilities, shows that many households are able to service their debt obligations, either fully or partially, through the sale of real assets, other than their main residence.

The above conclusion, of course, also depends on the income class of households. If, for example, we focus our analysis on households with an income of below €40.000 per year, we find that their outstanding loan balances amounted to €177.375 in 2014, whilst the value of household total assets, in addition to the main residence, amounted to €156.864[20].

The fact that the financial position of low income households was more affected

16. It is remarkable to note that at the peak of the crisis consumption decreased by a lower level, than initially expected, partly due to the resolution of certain pension funds as well as due to the strong net financial asset position of households (European Commission, 2014).
17. It is noted that the weighted average of the value of the household main residence comprises of all households, including those who do not own a main residence. For these households, the market value of their "main residence" is nil, which implies that the weighted average in question is significantly below the weighted value of the main residence of those households that are homeowners.
18. Indicatively, while the value of real assets of households with performing loans decreased by approximately 36% in the second wave, the reduction in the households with 90+DPD was smaller, that is, approximately 25%. This potentially indicates that in the second wave, households with performing loans had chosen to liquidate more immovable property in order to serve their debt obligations.
19. Due to the significant differences between the financial assets of households recorded in the survey and those recorded in the published banks' balance sheets, a credible analysis cannot be made with regard to the level of deposits and other financial assets of households.
20. In relation to reference 13, survey data indicates that about one in three households declares ownership of real assets, other than the main residence with their value exceeding their total financial obligations.

CHART 4 **Debt service to income ratio per income bracket**
(median)



Sources: ECB, CBC calculations.

by the crisis is also confirmed by the analysis of the debt service to income ratio per income class (percentiles of the income distribution), as shown in **Chart 4**. The chart shows that 20% of households with the lowest income exhibited the greatest difficulty in repaying their debt obligations in 2014 with the said ratio far exceeding 100%. This implies that the monthly loan repayments of the aforementioned households were higher than their monthly income[21]. The respective ratio for households with an income of between 20% and 40% of the distribution almost doubled from the first to the second wave, but remained at relatively lower levels compared with the lowest income class. On the other hand, households with an income of between 40% and 100% of the distribution had a relatively lower debt service to income ratio, albeit much higher than in other euro area countries.

Concluding remarks

The above analysis focuses on data for 2010 and 2014. Since then, a number of bank-related reforms have taken place, with the aim of reducing NPLs, correcting past practices, strengthening the prudential framework and intensifying the deleveraging efforts by both banks and the private sector. This domestic effort was greatly aided by the significant drop in interest rates since April 2013 and the adoption of the *Foreclosure and Insolvency Law* in April 2015. Among other things, there was a significant increase in the restructuring of non-performing loans, especially in 2015, as well as in loan repayments, including debt settlements through assets swaps. Moreover, the amendments made in the legal framework for resolving NPLs in July 2018, as described in the current *Economic Bulletin*, are envisaged to contribute to their further reduction and reduce the gap between domestic and European levels.

In relation to the sale of NPLs and/or their transfer to specialised agencies, it is noted that despite the transfer of NPLs to an asset management company, these continue to weigh on the real economy. In fact, they are still part of the private debt figures, which remain quite high. It is thus vital to avoid complacency.

Based on the above analysis, it is evident that one of the main options for

21. An apparent consequence of the past practice of granting loans on the basis of the value of the collateral rather than the ability to repay.

reducing both debt and NPLs, is the use of debt for assets swaps. Nevertheless, careful monitoring is required so that the accumulation of real assets by banks are adequately controlled and kept at levels that ensure that their exposure to the real estate market remains viable. Despite the risks associated with this option, it should still be considered part of the solution for reducing the high level of NPLs. Given that the high level of NPLs is the result of past excess borrowing used for the acquisition of real estate, part of it should be resolved by debt settlements through debt for asset swaps. To this effect, the results of the HFCS may seem particularly useful.

The results can also be useful for the upcoming ESTIA scheme, which benefits both the state and banks, through the subsidisation of part of the loan balance for those private borrowers who have NPLs collateralised against their main residence. Even though the purpose of this analysis is not the evaluation of the ESTIA scheme, its target to reduce the current excessive debt of these borrowers and NPLs to more sustainable levels, given certain criteria and fiscal capacity, could be viewed as welcome. At the same time, however, the potential risk of moral hazard should be avoided. Such risk could potentially arise if borrowers who are able to service their loans choose to deliberately default because they expect a possible future state subsidisation for themselves or they deem the plan to be unfair benefiting strategic defaulters.

In conclusion, the ESTIA scheme (*this box is not about ESTIA*), as a method to address the serious problem of NPLs, is proceeding in the right direction and focuses on a class of NPLs which are complicated to resolve because they have as collateral the main residence of households. Nevertheless, based on the HFCS data, some parameters of the plan, such as the income criterion and the threshold for the value of the collateral, are deemed quite generous. This gives the impression that the aim of the scheme is not only to aid those who are socially vulnerable but also benefits strategic defaulters. The above considerations could be addressed through the formulation of more stringent criteria, without altering the contribution of the state.

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Interest rates

Interest rates in Cyprus declined for the fifth year in a row, in the context of the expansionary monetary policy followed by the ECB. The historically low domestic interest rates, coupled with favourable macroeconomic conditions, have supported the robust economic activity, the ongoing deleveraging efforts of the private sector as well as the banks' efforts to clean up their balance sheets. In addition, interest rates are the main tool for restructuring existing loans, both performing and non-performing.

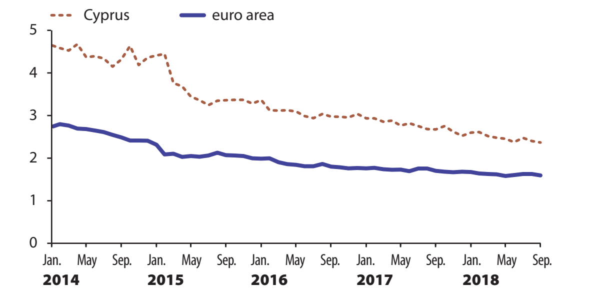
Analytically, the indicative domestic average interest rate[6] on new loans to households declined further, whereas interest rates to NFCs remained broadly unchanged. In particular, in September 2018, the average interest rate for housing loans dropped to 2,37% from 2,53% at the end of 2017 (**Chart A.13**). The cost of new lending to NFCs for amounts up to €1 million have fluctuated at around 3,60% since the end of 2017, standing at 3,52% in September 2018 (**Chart A.14**).

With respect to domestic deposit rates, the average[7] interest rate on new deposits for households and NFCs recorded a downward trend. In particular, the average interest rate for households declined to 0,62% in September 2018 from 1,17% at the end of 2017 (**Chart A.15**), whereas the corresponding rate for NFCs decreased to 0,83% from 1,32% (**Chart A.16**, p. 37).

As a result, the spread between domestic and euro area deposit interest rates shrank further in 2018. In particular, since the end of 2017 and up to September 2018, the deposit

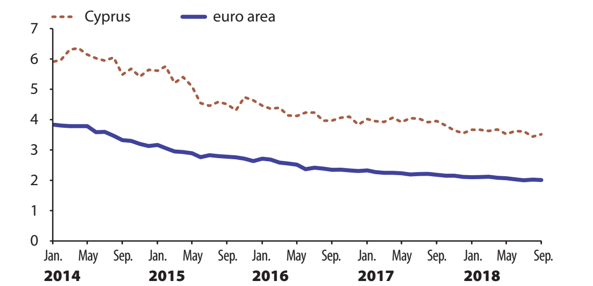
6. Euro-denominated loans from Cyprus MFIs with an initial rate fixation of up to one year.
7. Average interest rate with an agreed maturity of up to one year.

CHART A.13 **MFI interest rates on euro-denominated housing loans (new business) to euro area households (1)**
(% per annum, period averages)



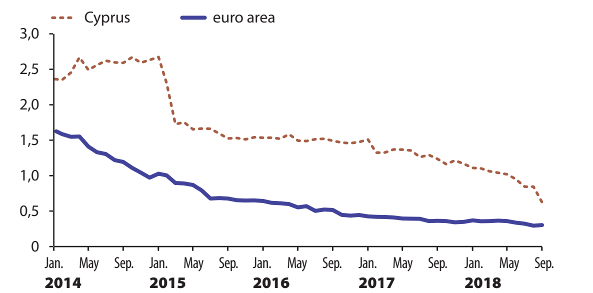
Sources: SDW (ECB), CBC.
(1) With floating rate and up to 1 year initial rate fixation.

CHART A.14 **MFI interest rates on euro-denominated loans (new business) up to €1 million to euro area non-financial corporations(1)**
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With floating rate and up to 1 year initial rate fixation.

CHART A.15 **MFI interest rates on euro-denominated deposits (new business) by euro area households(1)**
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With agreed maturity up to 1 year.

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interest rate spread for both households and NFCs decreased by 50 and 51 basis points, respectively. With respect to the lending rate spread, it remained broadly unchanged for both households and NFCs.

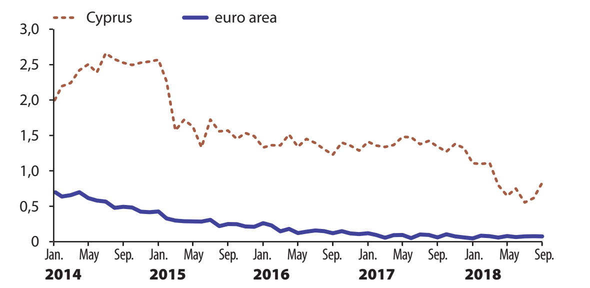
Summing up, the historically low interest rate environment, which is expected to continue prevailing, given the continuation of the ECB's expansionary monetary policy through the reinvestment of net asset purchases, continues to support the existing robust macroeconomic conditions. At the same time, the favourable interest rate environment contributes to the successful negotiation of existing loans arrangements between banks and the private sector. This is expected to be a decisive factor for the ongoing deleveraging efforts of the private sector as well as the efforts of banks to consolidate their balance sheets, with a further positive impact on the economy.

Labour costs

In line with the correction in labour market conditions, labour costs recorded a moderate increase in the 2018H1, following a marginal rise in the corresponding period of the previous year. Specifically, nominal compensation per employee increased by 1,4% over the period under consideration following a rise of 0,3% in the corresponding half of 2017 (**Chart A.17**). It is worth noting that compensation per employee recorded a cumulative decrease of 10,9% over the period 2013-2016.

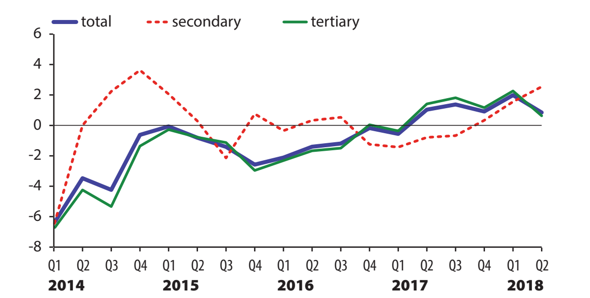
The aforementioned rise in labour costs is attributable to a small increase in compensation per employee in the public sector and

CHART A.16 **MFI interest rates on euro-denominated deposits (new business) by euro area non-financial corporations**[1]
(% per annum, period averages)



Sources: SDW (ECB), CBC.
(1) With agreed maturity up to 1 year.

CHART A.17 **Nominal compensation per employee by sector**
(annual change, %)



Sources: SDW (ECB), CBC.

to a larger rise in the private sector. Compensation per employee in the public sector recorded a year-on-year increase of 0,9%, mainly due to two factors: the resumption of the wage indexation policy based on the new system that has been adopted as well as the granting of pay rises to public healthcare staff. It should be noted that due to the gradual restitution of the crisis-era public wage and pension cuts as from 1 July 2018, compensation per employee in the public sector is expected to register a higher annual increase in the 2018H2 relative to the first half of the year. As regards the private sector, compensation per employee rose by 2% due to increases in specific sectors. Firstly, it is driven by developments in the tertiary sector (**Chart A.17**, p. 37), especially the financial and insurance activities as well as information and communication. The tertiary sector accounts for about 81% of total employment, with the relevant compensation per employee recording a rise of 1,4% in 2018H1. Secondly, a year-on-year rise of 2,1% was registered in compensation per employee in the secondary sector, specifically in the manufacturing sector.

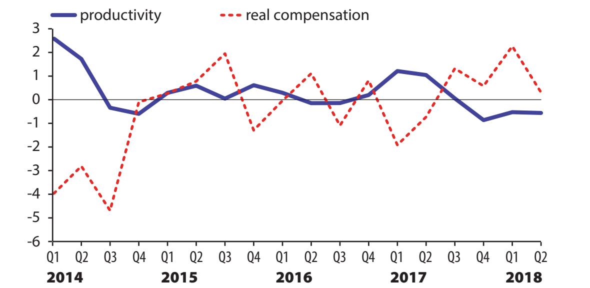
It should be noted that the aforementioned wage increases are moderate compared with the significant economic expansion observed and a development mainly attributable to the fact that there is still room for further correction in the labour market. In spite of the significant improvement in unemployment (see section on Labour market, p. 53), there is still a large number of unemployed.

Real compensation per employee increased by 1,3% in contrast to a decrease of 1,3%

in the corresponding half of 2017 (**Chart A.18**). This development was mainly due to the significant rise recorded in nominal compensation per employee as mentioned above. At the same time, domestic prices recorded a significant slowdown in 2017H1, which significantly impacted the aforementioned growth in nominal compensation per employee. Productivity, calculated as the change in real GDP per employed person, recorded a year-on-year decline of 0,5%, following an increase of 1,1% in the corresponding half of 2017 (**Chart A.18**).

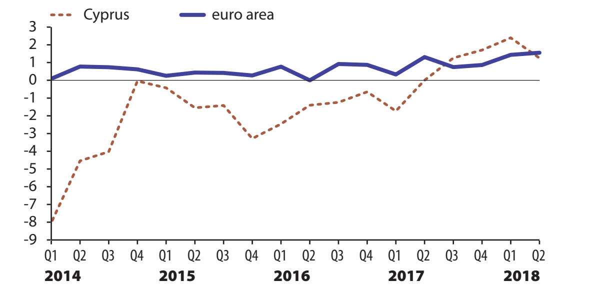
Unit labour costs, determined by the difference in the change in nominal compensation per employee relative to the change in productivity, recorded a year-on-year rise of 1,8%, compared with a decrease of 0,8% in the corresponding half of 2017 (**Chart A.19a**). The unit labour costs index is an important indicator of competitiveness for an economy relative to competitor economies, as it reflects the unit labour cost per unit of output. A review of the unit labour cost index over time reveals that it has been lower compared with the euro area since 2013. This demonstrates the improvement in the competitiveness of the Cyprus economy, following the measures adopted in the context of the economic adjustment programme, with a consequent decrease in the prices of goods and services. This led to a cumulative reduction in the index by 12,1% in the period 2013-2016. Specifically, the index was well below the corresponding euro area index in 2018H1 by around 17 percentage points (**Chart A.19b**).

CHART A.18 **Productivity and real compensation per employee**
(annual change, %)



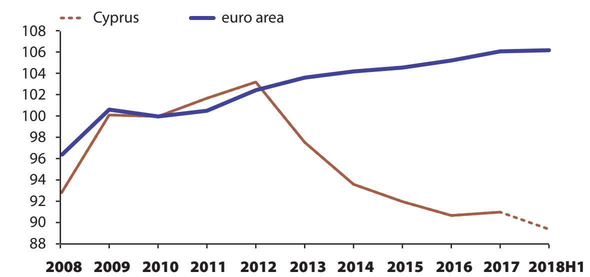
Sources: SDW (ECB), CBC.

CHART A.19(a) **Unit labour costs: Cyprus and the euro area**
(annual change, %)



Source: SDW (ECB).

CHART A.19(b) **Unit labour costs: Cyprus and the euro area**
(index 2010=100)



Source: SDW (ECB).

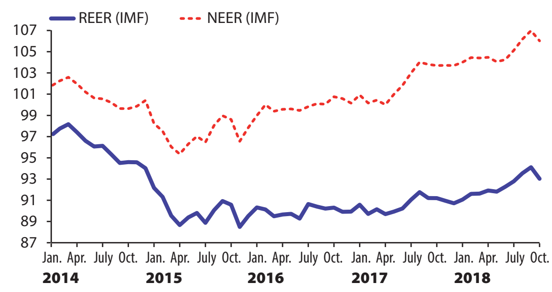
2.2 Domestic Competitiveness and the Balance of Payments

Effective exchange rate

Chart A.20 shows the effective exchange rate (EER) index of the euro in Cyprus, in nominal (NEER) and real (REER)[8] terms, as calculated by the IMF. During the first ten months of 2018, both indices strengthened. Overall, the trend of the REER index as well as the widening of the gap between the NEER and REER indexes was influenced by developments in the nominal value of the euro, but most importantly by domestic developments, in particular the lower inflation recorded in Cyprus compared with its trading partners.

The REER index, the inflation rate as well as the unit labour costs that have been analysed in the previous section, are important measures of the competitiveness of an economy. Lower unit labour costs and a lower REER in Cyprus compared with competing countries, suggest that domestic exports tend to be more price competitive. In general, inflation is related to, among other factors, to both variables mentioned above and therefore also reflects the degree of competitiveness of the Cyprus economy. The adoption of measures affecting salaries and other benefits both in the public and private sectors have reduced unit labour costs for the whole economy, thus improving competitiveness and supporting the recovery of the Cyprus economy in the medium term.

CHART A.20 **Real and nominal effective exchange rates (IMF weights)**
(Base year 2010=100)



Source: IMF.

8. The effective exchange rate index in Cyprus in real terms (REER) is calculated by taking into account the trade relations between Cyprus and its 26 main trading partners (countries).

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Balance of payments[9]

In 2018H1, the current account deficit recorded an improvement, reaching €391,1 million (3,9% of GDP), compared with a deficit of €707,9 million (7,5% of GDP) in the corresponding period of the previous year (**Table A.4**). This positive development is mainly attributed to the increase in exports of goods, in particular SPEs transactions. The current account deficit, adjusted for the impact of SPEs, reached €471,1 million (4,7% of GDP), remaining at about the same level of 2017H1 (**Table A.4** and **Chart A.21**). This development is due to an increase in the deficit of the goods balance, of the net primary and secondary income, which was offset by the increase recorded in the surplus of services.

More analytically, the trade deficit of goods decreased in 2018H1, reaching €1.713,8 million, compared with a deficit of €1.975,4 million in 2017H1, mainly due to the increase in exports of goods. This was primarily due to SPEs transactions and, to a lesser extent, the increase in exports of domestic goods (**Table A.4**). Moreover, imports of goods (excluding SPEs imports) increased, driven by the growth in imports of goods for home consumption, as a result of the improvement in domestic demand. More specifically, in line with the recovery of the domestic economic environment, car imports and imports of intermediate capital and consumer goods recorded significant increases, while oil imports registered a modest increase (**Table A.4**).

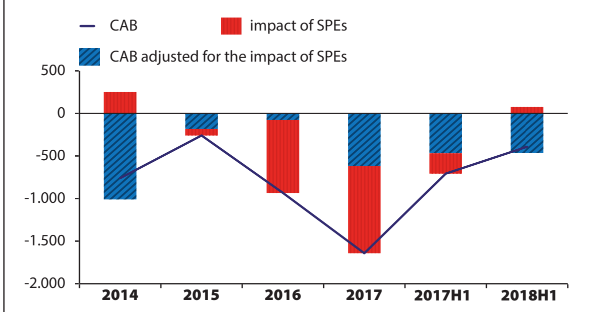
9. The external statistics data are significantly affected by the classification of SPEs as residents of Cyprus and, in particular, by those which are considered as economic owners of mobile transport equipment (mainly ships). The transactions of SPEs do not affect nor are affected substantially by the domestic economic cycle.

TABLE A.4 **Balance of payments (main categories)**

	2017 H1 (€ million)	2018 H1 (€ million)	Change (€ million)
Current account balance	**-707,9**	**-391,1**	**316,8**
Current account balance adjusted for the impact of SPEs	**-469,1**	**-471,7**	**-2,6**
Goods and services balance	**-316,1**	**85,2**	**401,3**
Trade balance	**-1.975,4**	**-1.713,8**	**261,6**
Exports of goods	1.330,0	2.030,3	700,3
of which:			
Exports of goods - SPEs	433,1	1.044,2	611,1
Imports of goods	3.305,4	3.744,1	438,7
of which:			
Imports of goods - SPEs	671,9	961,1	289,3
Services balance	**1.659,3**	**1.799,0**	**139,7**
Exports of services	4.413,6	4.472,8	59,2
Imports of services	2.754,3	2.673,8	-80,5
Primary income (net)	**-177,1**	**-251,5**	**-74,4**
Secondary income (net)	**-214,7**	**-224,8**	**-10,1**
Current account balance (% of GDP)	**-7,5**	**-3,9**	
Current account balance adjusted for the impact of SPEs (% of GDP)	**-5,0**	**-4,7**	

Sources: Cystat, CBC.

CHART A.21 **Current account balance (CAB)**
(€ million)



Source: CBC.

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The surplus of the services account increased further in 2018H1 and reached €1.799 million, compared with €1.659,3 million in 2017H1, as a result of the increase recorded in exports of services and the simultaneous decrease in imports of services. Exports of services is important for analysing the Cyprus economy, since Cyprus is a tourist destination and a business centre.

More specifically, exports of services (**Table A.5**) increased by 1,3% (€59,2 million) in 2018H1, reflecting rises in most of the main categories, except telecommunications, computer and information services (-€6,7 million) and insurance and pension services (-€12,8 million). It is noted that reductions were also recorded in the respective categories of imports. Increases were recorded in transport (€13 million), financial services (€5,1 million) and other business services (€2,5 million). Revenues from tourism, which are included in the travel category, recorded a significant increase of 3,8% (€39,4 million), mainly due to the increase in the number of tourist arrivals. Tourist revenues, on the other hand, recorded a deceleration in the first eight months of 2018 (see Tourism, p. 44).

In 2018H1, imports of services (**Table A.5**) decreased by 2,9% (-€80,5 million), compared with the corresponding period of the previous year, mainly due to the reductions recorded in the categories of telecommunications, computer and information services (-€130,3 million) and other business services (-€24,3 million). The abovementioned decreases were mitigated to some extent by the increases recorded in the categories of transport (€46,9 million), travel (€19,2 million) and financial services (€35,2 million).

TABLE A.5 **Services balance (main categories)**
(€ million)

	2017H1	2018H1	Change
Services balance	**1.659,3**	**1.799,0**	**139,7**
Exports of services	**4.413,6**	**4.472,8**	**59,2**
of which:			
Transport	1.296,2	1.309,2	13,0
Travel	1.040,1	1.079,5	39,4
Financial services	1.031,6	1.036,7	5,1
Telecommunications, computer and information services	836,0	829,2	-6,8
Other business services	81,2	83,7	2,5
Imports of services	**2.754,3**	**2.673,8**	**-80,5**
of which:			
Transport	800,0	846,9	46,9
Travel	521,9	541,1	19,2
Financial services	472,6	507,8	35,2
Telecommunications, computer and information services	522,4	392,1	-130,3
Other business services	225,0	200,7	-24,3

Source: CBC.

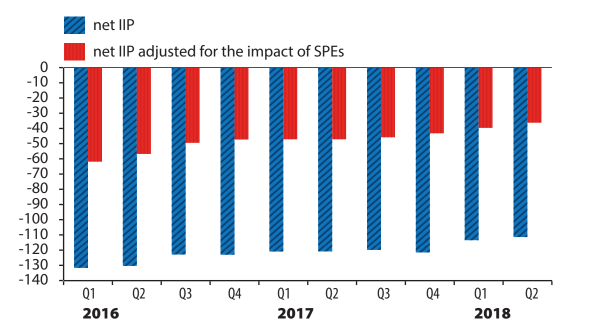
The primary income account (which mainly includes income from employment and investment) recorded a larger deficit, reaching €251,5 million, compared with €177,1 million in the corresponding period of the previous year. The widening of the deficit is mainly attributed to the category of direct investments. The deficit in the secondary income account (which mainly includes current transfers) deteriorated marginally (**Table A.4**, p. 41).

The current account deficit in 2018H1, was mainly covered by borrowing in the private sector.

The net international investment position (IIP) in 2018H1 was negative standing at -€22,6 billion (-111,4% of GDP) (**Chart A.22**). The IIP was negatively affected by the inclusion of the economic transfer of mobile transport equipment (mainly ships) by SPEs registered in Cyprus. These companies have significant financial liabilities, in particular loans which are mainly associated with the purchase of ships. While these loans have a direct impact on the net IIP, the respective real assets (ships) do not, thus creating an imbalance in the figures reported. As these companies are financed entirely by non-domestic banks, they do not constitute a substantial risk to the Cypriot financial system.

Adjusted for the impact of SPEs, the net IIP in 2018H1 drops by 75,2 percentage points, standing at -€7,3 billion or 36,2% of GDP, a percentage close to the threshold set by the European Commission. An improvement was also registered compared with the -€9,2 billion (-47,1% of GDP) recorded in the corresponding period of the previous year (**Chart A.22**).

CHART A.22 **Net International Investment Position (IIP)**
(as a percentage of GDP)



Sources: Cystat, CBC.

Tourism

Tourism constitutes one of the most important pillars of the Cyprus economy. The tourism industry had to overcome many challenges in 2018, therefore, a decelerated growth was recorded. More specifically, the Cyprus tourism industry had to cope with the return of major competitor destinations such as Turkey, Egypt and Tunisia. However, the quality of the tourism product not only remained high but has also been upgraded through hotel renovations and new infrastructure, such as the construction of marinas and luxurious hotels. Furthermore, the temporary casino in Limassol started its operation in late June (the permanent site will be ready in 2021).

More specifically, in the first ten months of 2018, tourist arrivals increased by 7,8% reaching 3,7 million tourists, compared with the corresponding period of the previous year (**Table A.6**). Regarding individual markets, arrivals from the United Kingdom increased by 6,1% reaching 1,2 million tourists. Arrivals also increased from other important markets, such as Greece, Sweden, Ukraine and Lebanon. Although, arrivals from Russia decreased by 4,9% reaching 0,8 million tourists, the decrease was smaller than originally expected. Additionally, arrivals from Israel decreased by 11,4% to 0,2 million tourists and from Germany by 1,8% to 0,2 million tourists.

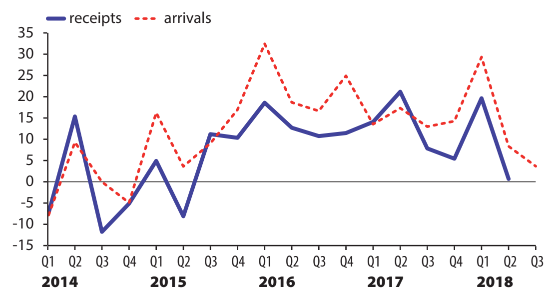
In the first eight months of 2018, revenues from tourism, registered a relatively small annual increase of the order of 2,4%, as a consequence of the 5,2% decrease in per capita expenditure (**Chart A.23**). This is

TABLE A.6 **Tourism**

	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2016	3.186,5	2.363,2	741,6
2017	3.652,1	2.639,1	722,6
annual % change	14,6	11,7	-2,6
2017 Jan. - Aug.	2.517,9	1.845,7	733,0
2018 Jan. - Aug.	2.719,6	1.889,7	694,8
annual % change	8,0	2,4	-5,2
2017 Jan. - Oct.	3.408,5	NA	NA
2018 Jan. - Oct.	3.673,4	NA	NA
annual % change	7,8	NA	NA

Source: Cystat.

CHART A.23 **Tourist arrivals and receipts**
(annual change, %)



Source: Cystat.

attributed to both the decrease by 3,3% in the daily per capita expenditure and the decrease in the average length of stay from 9,4 days to 9,2 days (**Table A.6**, p. 44). It is noted that the strengthening of the euro against foreign currencies, like the rouble and sterling, contributed significantly to the drop in the daily euro per capita expenditure.

Despite the fact that the winter and autumn months contribute less than the summer months, the significant rise that was recorded in September and October suggests that the efforts made to mitigate the issue of seasonality have been successful.

2.3 Domestic Demand, Production and the Labour Market

Quarterly national accounts[10]

The positive developments in economic activity continued in 2018H1. According to official data, the Cyprus economy recorded a growth rate of 3,9% in the period under consideration, compared with 4,4% in 2017H1 (**Table A.7**). Based on the latest preliminary data in 2018Q3, there was a slight slowdown in economic growth to 3,6%. For the first nine months of 2018, GDP recorded a year-on-year growth of 3,9% (seasonally adjusted data).

Private consumption recorded a significant rise, as was also the case with exports and imports of goods and services (which were affected by transactions of SPEs), while a

TABLE A.7 **National accounts in real terms by category of expenditure**
(annual change, %)

	2015	2016	2017	2017H1	2018H1
GDP	2,0	4,8	4,2	4,4	3,9
Private consumption	2,4	4,5	4,1	4,2	4,1
Public consumption	-0,5	-0,8	3,1	4,1	-1,0
Gross fixed capital formation	13,8	41,8	26,8	9,6	-14,5
Exports of goods and services	5,2	4,6	6,0	1,7	11,7
Imports of goods and services	8,4	6,6	12,2	6,7	5,4

Source: Cystat.

10. With the introduction of the ESA 2010 and BPM6 statistical methods, total exports and imports of Cyprus as well as gross fixed capital formation include, inter alia, the transfer of economic ownership of mobile transport equipment (mainly ships) by SPEs, which affect the aforementioned GDP expenditure sub-categories. However, given the double entry accounting system they do not affect the level and growth rate of GDP.

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decline was observed in gross fixed capital formation (also affected by transactions of SPEs) (**Table A.7**, p. 45). Specifically, private consumption rose by 4,1%, driven mainly by the decrease in unemployment, the increase in wages and, more generally, the increase in disposable income as well as the increase in lending to consumers. The increase recorded in exports and imports of goods and services, 11,7% and 5,4%, respectively, is attributable to the inclusion of the transfer of economic ownership of mobile transport equipment (mainly ships) by SPEs. Gross fixed capital formation decreased by 14,5%, also influenced by the impact of SPEs as well as other non-recurring factors[11].

After the relevant GDP sub-categories are adjusted for the impact of SPEs, it emerges that growth in 2018H1 was primarily driven by the increase in private consumption, and, to a lesser extent, by the increase in gross fixed capital formation in the private sector. Growth in gross fixed capital formation decelerated in 2018H1, following a significant increase recorded in the corresponding half of the previous year due to the completion of various projects. Many of these projects have foreign investors and/or are financed by pre-sales, hence there is no corresponding increase in domestic lending. Exports adjusted for SPEs recorded a small increase in 2018H1, mainly due to the deceleration observed in tourism receipts (see Tourismand **Chart A.23**, p. 44). It should be noted that there was a decrease in revenue from financial services as well as the telecommunications, computer and information services sectors. Imports

11. Specifically, these relate to a base effect because of the leasing of aircraft (which are recorded on the imports side) in 2017 by the airline Cobalt.

adjusted for the impact of SPEs registered a significant slowdown due to a deceleration in imports for goods and a small decline in imports for services.

From a sectoral point of view, growth is broad-based (**Table A.8**). The sectors with the most important contribution to GDP growth in 2018H1 were trade, transportation, hotels and restaurants (with the total contribution of the aforementioned sectors reaching 1,3 percentage points), construction (0,8 percentage points units) and professional, scientific and administrative activities (0,7 percentage points). A negative contribution was recorded only in the financial and insurance activities sector (0,2 percentage points), owing to ongoing loan deleveraging in the context of the consolidation of the banking sector (**Table A.8**).

Recent economic indicators point to continued growth in domestic demand, albeit at a decelerating pace. Specifically, the Economic Sentiment Indicator (ESI) (**Table A.9**) increased to 113,2 in October 2018 from 107,8 in June 2018 and 115,7 in December 2017. It should be noted that the lowest level of the ESI during 2018 was recorded in June on account of the transitory impact on economic activity associated with the uncertainty that prevailed in the banking system until the finalisation of the Cyprus Cooperative Bank transaction. VAT receipts (as compiled on a cash basis and including relevant refunds as well as non-recurring VAT receipts resulting from the tax arrears scheme) recorded a year-on-year increase of 19,5% in the first nine months of 2018.

Several other economic indicators reflect the positive developments in private consum-

TABLE A.8 **Weighted contributions to real GDP growth by economic activity**
(percentage points)

	2015	2016	2017	2017H1	2018H1
GDP (%)	2,0	4,8	4,2	4,4	3,9
Construction	-0,1	0,6	1,1	1,1	0,8
Trade, transportation, hotels and restaurants	0,1	1,4	1,7	1,6	1,3
Financial and insurance activities	1,0	-0,2	-0,5	-0,6	-0,2
Professional, scientific and administrative activities	0,4	0,7	0,4	0,4	0,7
Other sectors[1]	0,6	2,4	1,5	1,9	1,3

Source: Cystat.
Note: (1) Main sectors included are those of agriculture, manufacturing, public administration, education and health as well as information and communication.

TABLE A.9 **Business and consumer surveys: confidence indicators**
(for sub-indices: difference between percentage of positive answers and percentage of negative answers)

	2017 Dec.	2018 Mar.	2018 June	2018 Sep.	2018 Oct.
ESI	115,7	114,8	107,8	115,0	113,2
Industry	9	6	-3	11	10
Services	37	36	16	32	26
Consumer	-1	2	-3	-6	-5
Retail trade	10	13	6	0	3
Construction	-24	-16	-15	-11	-8

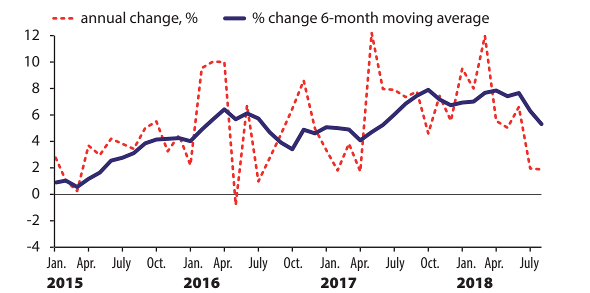
Source: European Commission.
Note: Seasonally adjusted data.

ption. The turnover index of retail trade (**Chart A.24**) recorded a significant improvement of 6,1% in the first eight months of 2018. Moreover, registrations of motor vehicles (**Chart A.25**) continued their upward trend, registering a year-on-year increase of 14,3% in the first ten months of 2018. Regarding credit card payments, spending by Cypriot cardholders in Cyprus recorded an annual rise of 33,4% in the January-October 2018 period (**Chart A.25**). Adjusted for payments associated with government services and petroleum products, credit card spending recorded a smaller increase of 13,5% in the first ten months of 2018 due to the introduction of the mandatory electronic payment of various direct taxes (effective as of 1 March 2018).

As previously mentioned, private sector investment projects have made an important contribution to the improvement in the domestic economic climate. Several indicators in relation to the real estate market point to rising activity in the construction sector as well as increasing demand for real estate (see Real estate market, p. 49 and **Table A.10**). Major projects have been completed or are in the stage of implementation and include various residential, commercial and mixed developments, marinas and hotels. At the same time, the improvement in investors' expectations regarding investment opportunities in the areas of energy, tourism and transport has created positive prospects for the Cyprus economy (see Macroeconomic Forecasts).

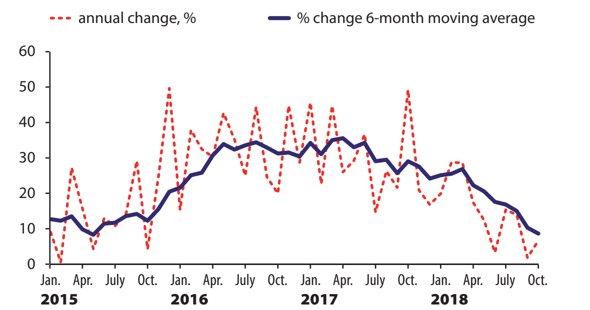
In relation to the external demand for services, tourism receipts registered a positive, albeit decelerating, growth due to the

CHART A.24 **Retail sales (excluding motor vehicles)**
(Base year 2015=100)



Source: Cystat.

CHART A.25 **Registration of motor vehicles**



Source: Cystat.

TABLE A.10 **Real estate sector**
(annual change, %, unless otherwise stated)

	Jan.-Oct. 2017	Jan.-Oct. 2018	Oct. 2017	Sep. 2018	Oct. 2018
Sales contracts (total)	19,2	19,5	21,1	14,1	5,6
Sales contracts (locals)	11,1	na	6,1	na	na
Sales contracts (foreigners)	44,8	na	65,2	na	na
Building sentiment indicator (average of index)	-26,2	-14,2	-28,3	-11,1	-7,7
Property price expectations for the next 3 months (average of index)	3,8	11,0	7,4	23,5	11,2
Price index of construction materials	0,1	1,7	0,3	2,3	2,3

Sources: Cystat, Department of Lands and Surveys, European Commission.

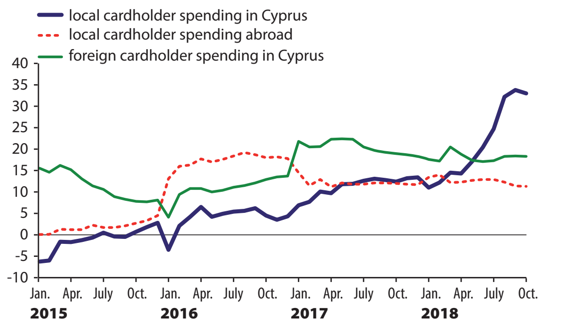
previously mentioned decrease in per capita expenditure per person. However, spending by foreign credit cardholders in Cyprus recorded an increase of 18,3% in the first ten months of 2018 (**Chart A.26**). In the field of professional services, the latest data for 2018 relating to new company registrations in Cyprus (increase of 12,4% in the first nine months of the year) point to the comparative advantage that Cyprus continues to have in this area.

Furthermore, the granting of new viable loans and the intensification of efforts to reduce NPFs, in the context of the ongoing efforts of both the private and the banking sector to deleverage and adjust their balance sheets, have contributed to the positive GDP path. Specifically, new lending to households and non-financial corporations stabilised in the first nine months of 2018, approximately at the level recorded in the corresponding period of the previous year. At the same time, the settlement of outstanding loans through debt-to-asset swaps and cash repayments constrain the growth of loans to the domestic private sector to positive but low levels (**Chart A.13**, p. 36). Overall, the gradual consolidation and restructuring of the banking system (see Monetary aggregates) has acted to support economic growth and strengthen the Cyprus economy against unexpected or exogenous shocks.

Real estate market

The real estate sector in Cyprus continued to recover in the first ten months of 2018, in line with the recovery of the wider economy and the ongoing consolidation of the banking

CHART A.26 **Credit card spending**
(cumulative annual % change from January)



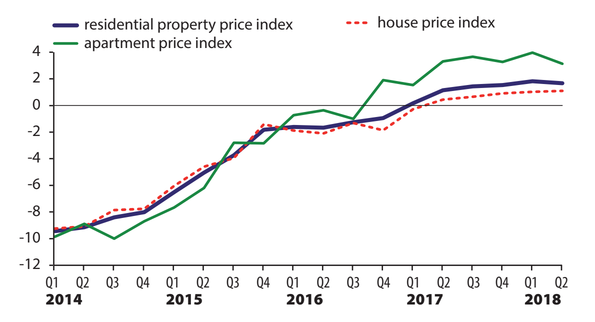
Source: JCC Payments System Ltd.

system. Despite the overall picture of recovery, most indicators slowed down during the 2018 summer months, largely due to the events preceding the sale of the CCB, which, due to the temporary uncertainty, influenced market confidence to some extent. However, recent indicators show that market confidence has returned and the recovery continues. The real estate sector at this stage is funded by foreign investment (including pre-sales and partly by new sustainable lending.

The contribution of the construction sector to GDP corresponded to 4,4% in the first half of 2018, recording the highest rate since 2013 (3,6%), but lower than the historically high rate of 2008 (10,6%). It is important to note that, according to Cystat data, for the period 2013-2016, when data are available, the construction of residential buildings accounted for 45% of the total value of all new constructions in Cyprus, while the remaining 55% refer to non-residential buildings and civil engineering projects. This shows that the construction activity observed in Cyprus is not only due to residential projects but also to productive infrastructure projects such as marinas, offices, shopping centres, casinos, etc.

The moderate increase in immovable property prices continued in the first half of 2018. According to the CBC Residential Property Price Index (RPPI), house prices recorded a quarterly increase of 0,6% and 0,3%, and an annual increase of 1,8% and 1,7%, in 2018Q1 and 2018Q2, respectively (**Chart A.27**). The largest increase in sub-indices in the first and second quarters of

CHART A.27 **House and apartment price indices**
(annual change, %)



Source: CBC.

2018 was recorded in the Limassol apartment index (6,9% and 6,1%, respectively). It should be noted that the comparatively large increases recorded in apartment prices in Limassol are isolated in certain areas of the city, mainly in the coastal area. Despite the fact that the major increases affect only specific areas, the CBC is of the view that it is necessary to monitor developments.

Based on more recent indicators, the RPPI is expected to grow further. Specifically, according to data of sales contracts published by the Department of Lands and Surveys (DLS), sales recorded an annual increase of 19,5% for the period January - October 2018 (**Table A.10**)[12]. The largest number of foreign buyers in the period January - October 2018 was in Paphos (42,3% of the Pancyprian sales accounted for by foreign buyers), the second largest was in Limassol (28,5%) and the third in Larnaca (18,2%). Nicosia and Famagusta received little interest from foreign buyers, with 5,3% and 5,7% of the market share, respectively. In Paphos, 56% of foreign buyers were European citizens, while in Limassol and Larnaca, 77% and 79%, respectively, were third-country citizens. It is most likely these high figures are related to the investment scheme for obtaining a Cypriot passport.

With regard to borrowing, according to the CBC Bank Lending Survey (**Table A.3**, p. 26), demand for housing loans continued to increase, although in the third quarter demand was slightly contained relative to the last five quarters, something which is possibly associated with the events preceding to the sale of the Cooperative Bank. It is expected that as long as the low interest rate

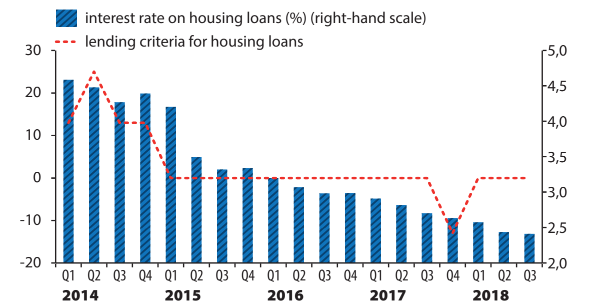
12. The codification of the DLS for the categorisation of local and foreign property buyers has changed since 2018 and, therefore, it cannot be compared with the corresponding data in the previous year.

environment continues (**Chart A.28**), demand for lending will continue to increase. It is also noted that the lending criteria have now ceased to be tightened (**Chart A.28**), but remain at the already tight levels of the previous quarters (more information on lending in the market is available in the section "Monetary aggregates" in Chapter 2.1, p. 22 of this *Bulletin*). The impact on the real estate market as well as the ability of banks to lend in an environment of high NPL ratios, is one of the main challenges of the sector. The impact of the ESTIA scheme, the management of real estate accumulated in the balance sheets of banks through loan restructuring, and the more frequent use of the tool of foreclosures on the real estate market remains uncertain.

The index of production in construction, published by Cystat, recorded an annual growth of 19,5% and 13,1% in 2018Q1 and 2018Q2, respectively. At the same time, the number of authorised building permits registered an annual increase of 9,1% in the period January - August 2018. The number of authorised building permits for dwellings increased by 7,6% during this period, while for non-residential buildings it increased by 1,6%, which indicates that land developers expect increased demand for residential real estate in the future.

According to the European Commission's Business and Consumer Surveys, the index of property price expectations averaged 11,0 in the period January-October 2018, compared with 3,8 in the corresponding period of 2017 (**Table A.10**, p. 48). Similarly, other relevant indicators of the real estate market are

CHART A.28 **Lending criteria and interest rate on housing loans**
(annual change, %)



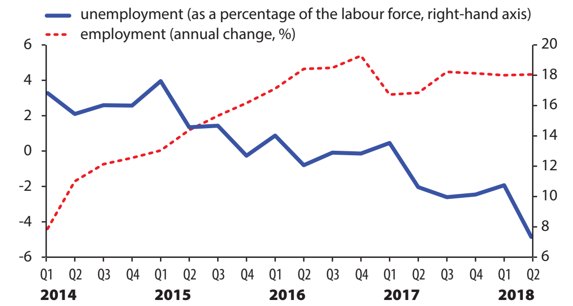
Source: CBC.
Note: The higher the positive number in the lending criteria series the tighter the criteria.

included in these surveys, so close monitoring of developments is important. A more detailed analysis of the above is included in the CBC's quarterly Residential Property Price Index[13].

Labour market

In line with the ongoing positive developments in economic activity, employment recorded a significant year-on-year increase in 2018H1. Specifically, employment recorded a significant increase of 4,3% over the period under consideration, following a rise of 3,2% in 2017H1 (**Chart A.29**). The improvement in employment was mainly driven by the sectors of trade, transportation, hotels and restaurants, construction as well as professional, scientific and administrative activities. According to the Labour Force Survey (LFS), this improvement is mainly attributable to the employment of Cypriots. Total hours worked recorded a year-on-year increase of 4,2%, further to a rise of 3,1% in the corresponding half of the previous year. As a result, hours worked per employed person decreased by 0,2% in 2018H1, following a decline of 0,2% in the corresponding half of the previous year. The aforementioned marginal reduction in hours worked per employed person is evident from the LFS and is related to the increase in the share of non-standard employment[14] in the years following the financial crisis and, specifically, part-time work and employment associated with temporary contracts.

CHART A.29 **Unemployment and employment**



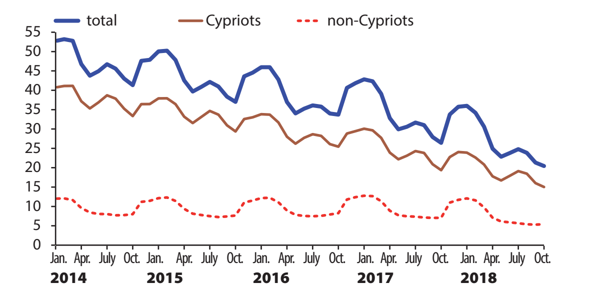
Source: Cystat (LFS).

13. Available at: https://www.centralbank.cy/en/publications/residential-property-price-indices.
14. The term non-standard employment is associated with forms of employment that deviate from the standard work practices whereby the employee provides his / her services within the office space provided by the employer and fulfils the total weekly / daily working time as provided for by relevant legislation.

As a consequence of the aforementioned developments, there was also a significant correction in unemployment. According to LFS data, the unemployment rate reached 7,3% of the labour force in 2018Q2, compared with 10,6% in the corresponding quarter of the previous year (**Chart A.29**, p. 53). This is mainly attributable to the decrease in the number of unemployed Cypriots, which is in line with the aforementioned rise in employment of Cypriots. It should also be noted that the unemployment rate in Cyprus declined below the euro area average in the quarter under consideration. At the same time, youth unemployment declined to 17,9% in 2018Q2, compared with 25,3% in the corresponding quarter of 2017. Youth unemployment constitutes only about 1,5 percentage points of the overall unemployment rate for the quarter in question. According to EUROSTAT data concerning the harmonised unemployment rate (seasonally adjusted data), the percentage of unemployed reached 7,4% in September 2018, compared with 10,2% in the corresponding month of 2017. The downward trend in unemployment is also confirmed by the number of registered unemployed (**Chart A.30**), which recorded a year-on-year decrease of 22,7% in October 2018 (from 26.436 to 20.447 persons).

An important development is associated with the reduction in the number of long-term unemployed given that, in periods with persistently high unemployment, the long-term unemployed find it harder to reintegrate into the labour market. According to LFS data, the unemployment rate with a duration of six

CHART A.30 **Registered unemployment**
(number of unemployed, thousands)



Source: Cystat.

months and over fell to 4,1% in 2018Q2, compared with 6,8% in the corresponding quarter of 2017 (**Chart A.31**). The number of registered unemployed with a duration of six months and over also registered a decrease of 4.455 persons in October 2018, compared with the corresponding month of the previous year. Overall, all relevant economic data suggest that the labour market, in line with the positive developments in economic activity, is recovering steadily.

CHART A.31 **Unemployment by duration**
(as a percentage of the labour force)

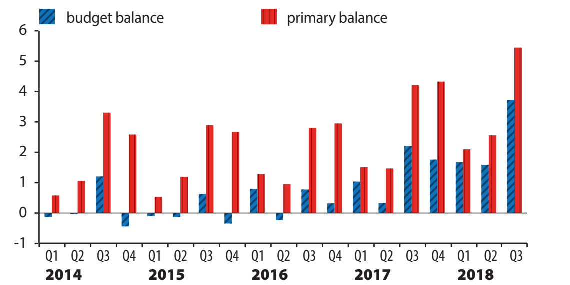
Source: Cystat (LFS).

2.4 Domestic Fiscal Developments

According to preliminary data published by Cystat, the strong fiscal performance continued in the first nine months of 2018 (**Chart A.32**). Specifically, a budget surplus of 3,7% of GDP was recorded compared with a surplus of 2,2% in the corresponding period of 2017. At the same time, the primary balance as a percentage of GDP registered a surplus of 5,4% in the period under consideration, compared with a surplus of 4,2% in the corresponding period of the previous year (**Chart A.32**).

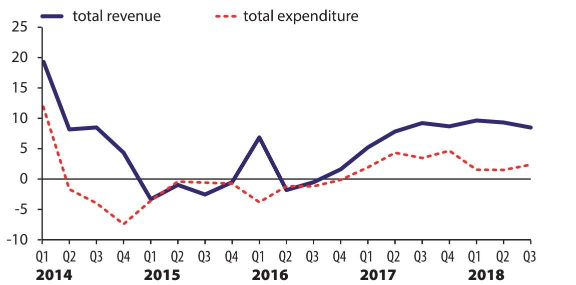
The aforementioned improvement in the budget balance was mainly driven by the significant increase in revenues. Total revenue recorded an increase of 8,5% in the first nine months of 2018 (**Chart A.33** and **Table A.11**, p. 56), primarily due to the rise of 12% in taxes on production and imports (indirect taxes), with the most significant contribution stemming from VAT receipts, which increased by 19,5%. This development reflects the buoyant performance of important sectors of the economy (tourism, professional services,

CHART A.32 **Budget and primary balances of the general government**
(cumulative for the period as from Q1 as a percentage of GDP)



Sources: Cystat, CBC.
Note: The budget and primary balance of the general government for 2014Q1 and 2015Q4 does not include the €1,5 billion and €175 million, respectively, equity injection to restore the capital base of the Cooperative Central Bank.

CHART A.33 **Total revenue and expenditure of the general government**
(cumulative for the period as from Q1, annual change, %)



Sources: Cystat.
Note: Total expenditure of the general government for 2014Q1 and 2015Q4 does not include the €1,5 billion and €175 million, respectively, equity injection to restore the capital base of the Cooperative Central Bank.

construction) and, in turn, the improvement in domestic demand as well as non-recurring revenues resulting from the tax arrears scheme. At the same time, revenues from social security contributions and current taxes on income, wealth, etc. (direct taxes) recorded significant year-on-year increases of 9,3% and 5%, respectively, due to the rise in employment and wages. The increase in direct taxes is also attributable to the increase in deemed dividend distribution, resulting from improvements in corporate profitability.

At the same time, total expenditure (**Chart A.33**, p. 55 and **Table A.11**) recorded an increase of 2,4% in the first nine months of 2018, partly offsetting the rise in total revenue. This was mainly owing to year-on-year increases of 3% in social benefits (including pensions) and the 3,3% increase in compensation of employees resulting from the rise in the number of public sector employees and wage increases (see Labour costs).

The supplementary budget adopted by Parliament on 16 November 2018 provides for additional appropriations, including operating expenditure, social benefits, grants to semi-governmental organisations and defence expenditure. The burden on the budget balance associated with the approval of the supplementary budget is estimated at 1,4% of GDP. Although these expenditures will not derail public finances from the target surplus of 2,9% of GDP, it should be noted that any increases in spending should be controlled and targeted, and not undermine the credibility of fiscal policy. On 21 November 2018, the European Commission published its positive opinion

TABLE A.11 **Accounts of general government**

	Jan.-Sep. 2017 (€ million)	Jan.-Sep. 2018 (€ million)	Change %
EXPENDITURE			
Intermediate consumption	449,2	479,9	6,8
Compensation of employees	1.625,1	1678,1	3,3
Social transfers	1.863,4	1918,9	3,0
Interest	393,4	355,6	-9,6
Subsidies	27,7	30,3	9,4
Other current expenditure	330,7	330,5	-0,1
Gross fixed capital formation	215,2	227,8	5,9
Other capital expenditure	34,7	35,5	2,3
Total expenditure	**4.939,4**	**5.056,6**	**2,4**
Total expenditure as a % of GDP	**25,2**	**24,5**	
REVENUE			
Taxes on production and imports	2.161,9	2.422,1	12,0
Current taxes on income, wealth, etc	1.292,3	1.356,4	5,0
Social contributions	1.224,3	1.338,2	9,3
Other current resources	141,7	141,5	-0,1
Sales	376,0	408,4	8,6
Capital transfers received	67,4	87,0	29,1
Property income	107,0	72,7	-32,1
Total revenue	**5.370,6**	**5.826,3**	**8,5**
Total revenue as a % of GDP	**27,4**	**28,2**	
Surplus (+) / Deficit (-)	**431,2**	**769,7**	
Surplus (+) / Deficit (-) % of GDP	**2,2**	**3,7**	

Sources: Cystat, CBC.

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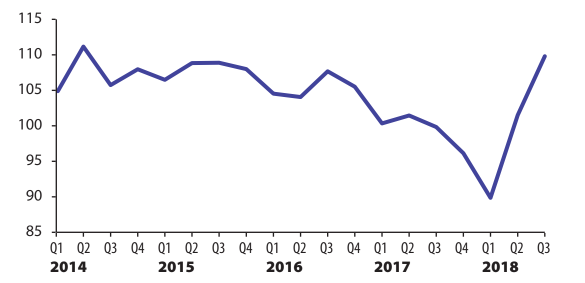
on the state budget projection for 2018, which is in line with its autumn forecasts.

Public debt registered a significant increase of 14 percentage points from December 2017 to September 2018, but it is expected to continue its downward trend. Specifically, and according to latest preliminary data, the general government consolidated gross debt-to-GDP ratio reached 109,8% in September 2018. This was mainly due to the special bonds issuance amounting to €3,19 billion for the CCB, in the context of the sale of part of its assets (**Chart A.34**). The increase in public debt was attributable to the issuance of a ten-year bond amounting to €1,5 billion in September 2018, following the upgrading of Cypriot government bonds to investment grade by Standard & Poor's. Public debt is expected to continue on its significant downward trajectory in the coming years, reflecting the projected strong fiscal surpluses, significant economic growth and the early full repayment of the outstanding long-term loan to the CBC in December 2018. It should be noted that the rating agencies have already discounted a significant reduction in public debt, thus any derailment will have a serious impact on the credibility of fiscal policy.

CHART A.34 **General government consolidated gross debt**
(as a percentage of GDP)



Sources: Cystat, CBC.

3. Macroeconomic Forecasts for the Cyprus economy

- *Strong GDP growth expected for the period 2018-2021.*
- *Continued growth in domestic demand, particularly from investment.*
- *Gradual increases in the prices of goods and services in the coming years.*
- *Upside risks relative to the baseline GDP scenario, especially for 2021, and balanced risks for inflation.*

The Cyprus economy is expected to continue to record strong GDP growth rates in the coming years, reflecting the good performance of key economic sectors and, consequently, continued growth in domestic demand. In the first nine months of 2018, growth was broad-based stemming from virtually all sectors of production, with the exception of the banking sector. This is attributable to the ongoing deleveraging of household and business loans, which is nevertheless necessary to reduce the high level of private debt. In 2018 growth is expected to reach around 3,8% in the baseline scenario. GDP growth is expected to register significant, albeit slightly decelerating, annual increases in the period 2019-2021. The GDP growth path mainly reflects the positive developments foreseen in domestic demand. It should be noted that the projected GDP growth rate for 2021 assumes only a moderate impact from the operation of the casino.

The CBC's updated forecasts for the GDP growth path have been revised slightly downwards compared with the previous set of projections published in the June 2018 *Economic Bulletin*. This is due to a significant revision of historical data, which points to an important upward correction in the GDP level in previous years. For the current year, the marginal downward revision in GDP growth is also attributable to the transient impact of the uncertainty that prevailed in the banking system in the first nine months of 2018, with consequent repercussions on economic activity. With the finalisation of the deal between the CCB and Hellenic Bank, uncertainty seems to have subsided. In the June 2018 CBC forecasts, the rate of economic growth was expected to peak in the period 2018-2021 while, with the new set of historical data, the highest GDP growth rate was recorded in 2016 with a slight deceleration foreseen until 2020.

Regarding inflation, prices are expected to register gradual increases over the next few years. This reflects the positive developments in domestic economic conditions, particularly in the services sectors, as well as the expected continued gradual increase in wages.

The CBC's updated HICP inflation forecasts have been revised slightly downwards compared with the previous projections published in the June 2018 Economic Bulletin, albeit with differences in the inflation sub-categories. In particular, HICP inflation excluding energy and food (core inflation) has been revised downwards compared with the previous set of projections, in line with the GDP path and the new inflation data available. In contrast, forecasts for both energy and food prices have been revised upwards, with the forecasts for HICP remaining broadly unchanged.

An important development is the return of the sovereign rating to investment grade. The strong GDP growth rates and the improvement in the labour market, in line with the ongoing and gradual restructuring of the banking sector, have strengthened the climate of confidence in the Cyprus economy. This has been confirmed by the recent upgrading of the sovereign rating to investment grade by Standard & Poor's, Fitch Ratings and DBRS.

National accounts[15]

According to latest available preliminary data, GDP recorded year-on-year growth of 3,9% (seasonally adjusted) in the first nine months of 2018. The GDP path reflects positive developments across almost all sectors of production. Based on latest available data, and in conjunction with leading economic indicators, the Cyprus economy is projected to expand by 3,8% in 2018 (**Table A.12**).

Real GDP growth in 2018 reflects the foreseen positive developments in domestic demand. Specifically, private consumption in 2018 is expected to increase by 3,6%, on top of the 4,1% rise in 2017, primarily reflecting the increase in disposable income, mainly owing to the increase in employment and, to a lesser extent, the growth in wages

TABLE A.12 **National accounts projections in real terms**
(annual change, %)

	2017	2018f	2019f	2020f	2021f
GDP	4,2	3,8	3,7	3,2	3,3
Private consumption	4,1	3,6	3,1	2,7	2,9
Public consumption	3,1	1,2	0,6	0,7	1,0
Gross fixed capital formation	26,8	-7,5	12,8	9,2	9,1
Exports of goods and services	6,0	6,1	2,7	2,3	2,7
Imports of goods and services	12,2	4,3	3,9	3,1	3,7

Sources: Cystat, CBC.

15. Due to the volatility in imports and exports of mobile transport equipment (mainly ships), it is extremely difficult to forecast the aforementioned series. Therefore, it is assumed that the level of transactions associated with these series for the years 2018-2020 remains at the 2017 levels. Consequently, the rate of change in imports and exports, as well as in gross fixed capital formation, adjusted for the impact of transactions in mobile transport equipment, does not differ relative to the unadjusted series.

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(**Table A.12**, p. 60). As regards public consumption, an increase of 1,2% is projected, compared with a rise of 3,1% in 2017, primarily attributable to wage growth, coupled with the envisaged rise in public employment (**Table A.12**, p. 60). Gross fixed capital formation is expected to register an annual decline of 7,5% in 2018, in contrast to an increase of 26,8% in the previous year, mainly driven by the transfer of economic ownership of mobile transport equipment (mainly ships) by SPEs, as well as certain non-recurring factors (**Table A.12**, p. 60). Adjusted for the impact of SPEs, gross fixed capital formation in 2018 is projected to record positive, albeit decelerating, growth compared with the significant increase observed in 2017 on account of the assumed conservative implementation rate for investment projects in the baseline scenario.

As is the case with domestic demand, net exports made a positive contribution to economic growth in 2018. Exports of goods and services are projected to increase by 6,1% in 2018, following a 6% growth in 2017, partly driven by the transactions of SPEs (**Table A.12**, p. 60). Adjusted for the impact of SPEs and other non-recurring factors, exports are foreseen to register a deceleration in 2018 compared with the previous year. This is driven by the slowdown in the growth of tourism revenues, due to the decrease in expenditure per person, as well as due to the foreseen reduction in revenues from the financial services as well as revenues from the telecommunications, computer and information services sectors. At the same time, imports of goods and services are

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forecast to increase by 4,3% in 2018, further to a rise of 12,2% in 2017, also partly owing to the transactions of SPEs (**Table A.12**, p. 60). Adjusted for the aforementioned transactions as well as other non-recurring factors, imports of goods and services are foreseen to continue to register a slowdown in 2018 compared with 2017, owing to imports of intermediate, consumer and capital goods, in line with projected developments in domestic demand.

In contrast, the continuous efforts of the domestic private sector to deleverage its outstanding loan balances, in conjunction with the banks' efforts to consolidate their balance sheets and reduce their stock of NPFs, act as a constraint on economic growth. Specifically, the ongoing consolidation of the financial sector and the intensification of the efforts by the competent authorities for a significant and swift address of the high stock of NPFs was profound throughout 2018. In short, the transfer of a significant amount of NPFs off the banks' balance sheets following the CCB deal and the planned sale of loans by other banks to non-monetary and financial institutions, are underlined. At the same time, the authorities proceeded to improve the framework governing the functioning of the banking system via the adoption of relevant revised legislations in July 2018. Furthermore, the expected adoption of the ESTIA scheme, despite concerns over its selection criteria (see **Box 1**, p. 27), is also expected to contribute to the unwinding of household NPEs.

Other positive advances include the continuation of the granting of new viable loans within the first nine months of 2018 at around the same levels of 2017. This development is supported by historically low interest rates and robust economic activity. The provision of new lending is expected to increase future economic growth further. At the same time, wage growth is expected to have a positive impact on household savings, thus further reducing the level of NPEs and increasing economic prospects.

In the period 2019-2021, real GDP growth is expected to be driven by the continued growth in domestic demand. A continued expansion in GDP is projected in the coming years butat a decelerating rate, reaching 3,3% in 2021 (**Table A.12**, p. 60). Specifically, private consumption is expected to register an annual growth of 3,1% in 2019, 2,7% in 2020 and 2,9% in 2021, partly due to the recovery in disposable income and the reduction in unemployment. The increase in private consumption is constrained to a certain extent by the projected acceleration in loan repayments owing to the adoption of the aforementioned measures aimed at reducing the level of NPEs (**Table A.12**, p. 60). Gross fixed capital formation is foreseen as registering a rise of 12,8% in 2019, followed by an annual increase of around 9% per annum in 2020 and 2021 (**Table A.12**, p. 60). This is primarily driven by the improvement in investors' expectations regarding the investment prospects opening up in the areas of energy, tourism and transport. Significant private sector investments projects amounting to over €3 billion, with a large share of funding secured via foreign capital, have already commenced and are scheduled to be completed by 2021. These include renewable electricity generation infrastructure, various residential, commercial and mixed developments, marinas, hotels and the casino, all of which are are expected to provide a boost to the Cyprus economy in the coming years. The casino is a major project, which will enrich the tourist product, further extend the tourism season and create new jobs.

In order to encourage investments, the government adopted legislation in July 2018 allowing the establishment of investment funds in Cyprus. To this end, the legislation provides for a modern legal and regulatory framework, based on European directives, for the expansion of the sector in question, and which is expected to broaden the range of financial instruments available to businesses.

With regard to public consumption, marginal annual increases are foreseen in the period 2019-2021, mainly reflecting increases in wages (**Table A.12**, p. 60).

Net exports are expected to contribute negatively to real GDP growth in the period 2019-2021 due to the import content of domestic demand. Exports are projected to increase by 2,7% in 2019, 2,3% in 2020 and 2,7% in 2021 (**Table A.12**, p. 60). Following the slowdown foreseen in 2018, tourism is projected to record an improved performance in the medium-term, given the extension of the tourism season, the increase in accommodation capacity as well as the diversification of the tourism product (including the casino.

Regarding the maritime sector, efforts to strengthen it through improvements to the cluster of related services and the existing infrastructure (including ports) as well as the enhancement of Cyprus' reputation as a shipping centre seem to have borne fruit. The establishment of a Deputy Ministry of Shipping (as of 1 March 2018) as well as of Tourism (as of 1 January 2019) are expected to provide a further boost to the maritime and tourism sectors. A significant contribution is also expected from the telecommunications, computer and information services sector. More generally, improvements in competitiveness, partly owing to the significant reduction in wages and production costs of companies in recent years, are contributing to the positive export performance. At the same time, total imports, which are significantly affected by imports of intermediate, consumer and capital goods, are forecast to increase by 3,9% in 2019, 3,1% in 2020 and 3,7% in 2021, in line with the projected growth in domestic demand, particular investment (**Table A.12**, p. 60).

Inflation

Prices are envisaged to record small increases in 2018. Specifically, HICP inflation is expected to reach 0,8% compared with 0,7% in 2017 (**Table A.13**). This is mainly attributable to increases in the prices of services related to tourism as well as oil, which are partly offset by the continued significant decline in non-energy industrial goods prices. HICP excluding energy is expected to reach 0,2% in 2018 compared with 0,1% in 2017 (**Table A.13**). Core inflation, i.e. HICP excluding energy and food, is projected to reach 0,1% in 2018 compared with 0,4% in 2017 (**Table A.13**).

TABLE A.13 **Inflation projections**
(annual change, %)

	2017	2018f	2019f	2020f	2021f
HICP	0,7	0,8	1,1	1,6	1,7
HICP excluding energy	0,1	0,2	0,9	1,7	1,9
HICP excluding energy and food	0,4	0,1	0,8	1,6	1,8

Sources: Cystat, CBC.

Further gradual increases in prices are expected in the period 2019-2021. Overall HICP inflation is expected to reach 1,1% in 2019, 1,6% in 2020 and 1,7% in 2021, mainly driven by the projected positive path of domestic economic activity and further gradual increases in wages (**Table A.13**, p. 65). At the same time, both HICP excluding energy and core inflation are forecast to continue their upward trends. This is driven by the expected increases in prices of services as a result of the continued positive impact of the rise in demand for domestic services (especially for tourism-related categories), as well as strong domestic economic activity, which is expected to have a positive effect on the remaining components of inflation mentioned above. As a result, HICP excluding energy inflation is expected to reach 0,9% in 2019, 1,7% in 2020 and 1,9% in 2021, while core inflation is expected to rise to 0,8% in 2019, 1,6% in 2020 and 1,8% in 2021 (**Table A.13**, p. 65).

Compensation, productivity and the labour market

Strong economic growth is also reflected in employment. Specifically, employment is projected to increase by 4% in 2018 (**Table A.14**). Employment, in particular of Cypriots, is expected to record further increases in the coming years but at decelerating pace, in conjunction with the GDP path, reflecting the expected further improvement in the economic climate and the increase in company turnover. Specifically, employment is projected to register an annual increase of 3%

TABLE A.14 **Labour market projections**
(annual change,%, unless otherwise indicated)

	2017	2018f	2019f	2020f	2021f
Compensation per employee	0,7	1,7	3,3	2,9	3,4
Unit labour costs	0,4	1,8	2,5	2,2	2,6
Productivity	0,4	-0,2	0,7	0,7	0,8
Total employement	3,8	4,0	3,0	2,5	2,5
Unemployment rate (% of labour force)	11,1	8,2	6,8	5,8	5,4

Sources: Cystat, CBC.

in 2019, with a further annual rise of 2,5% per annum expected for the years 2020 and 2021, respectively (**Table A.14**, p. 66).

A significant improvement is also foreseen in unemployment as a percentage of the labour force, converging to the rate associated with full employment conditions. This is also supported by government policies aimed at boosting employment, including programmes targeting the youth and the long-term unemployed. Following a downward trend since 2015Q1, the unemployment rate, as defined by the LFS, is already lower than the euro area average and is foreseen to reach 8,2% in 2018 on average, down from 11,1% in 2017 (**Table A.14**, p. 66). The positive GDP path projected in the coming years, in conjunction with the foreseen employment growth, reinforces the projections for a continued fall in the unemployment rate, in particular of Cypriots, which is expected to drop to 6,8% in 2019, 5,8% in 2020 and 5,4% in 2021 (**Table A.14**, p. 66). Hence, it is expected that unemployment in 2021 will converge to a rate close to the average rate recorded for a long period prior to the crisis.

As regards wages, a moderate annual increase is expected in 2018 compared with the rate of GDP growth, with further rises foreseen in the coming years. Specifically, nominal compensation per employee is forecast to increase by 1,7% in 2018, further to an increase of 0,7% in 2017 due to wage increases in the public sector as well as across various segments of the private sector (**Table A.14**, p. 66). In the public sector, increases are the result of the re-introduction of the policy of wage indexation as well as the gradual restitution of crisis-era reductions in wages and pensions as of 1 July 2018. The projected increase in compensation per employee in the private sector is partly attributable to wage increases that govern the collective agreements of the banking and tourism sectors. In the period 2019-2021 further wage rises of 3,3%, 2,9% and 3,4%, respectively, are foreseen (**Table A.14**, p. 66). The relatively higher annual increase in 2019 compared with 2020 is due to the rise in contributions to the Social Insurance Fund as from January 2019, which affects wages both in the private and public sectors. For 2021, the projected drop in unemployment to below 6% is expected to lead to an upward pressure on wages.

Following the foreseen marginal decline in 2018, productivity is projected to continue to record positive annual increases in the coming years. Specifically, it is expected to decrease by 0,2% in 2018, compared with an increase of 0,4% in the previous year (**Table A.14**, p. 66). From 2019 onwards, productivity is forecast to register an annual increase of around 0,7% per annum due to the implementation of structural reforms (**Table A.14**, p. 66).

The unit labour costs index, mainly driven by developments in compensation per employee but also productivity growth, is expected to register positive rates of change. Specifically, it is projected to increase by 1,8% in 2018 compared with a marginal rise of 0,4% in 2017 (**Table A.14**, p. 66). In the period 2019-2021, it is expected to register further annual increases of the order of 2,5%, 2,2% and 2,6%, respectively, while retaining its comparative advantage compared with the rest of the euro area owing to competitiveness gains in recent years (**Table A.14**, p. 66).

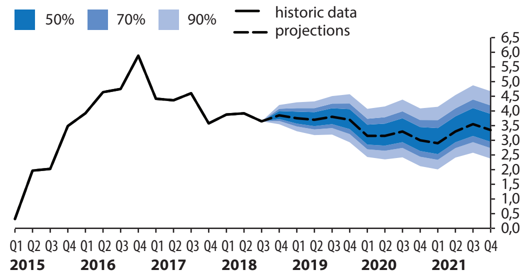
Risk assessment of macroeconomic forecasts[16]

Overall, risks to the baseline GDP scenario are considered to be on the upside, especially for the outer years of the forecast horizon, while risks to the inflation outlook are assessed to be balanced. The projections relating to the GDP path of the Cyprus economy, as presented in **Table A.12** (p. 60), as well as to the HICP and the HICP excluding energy and food (core inflation) (**Table A.13**, p. 65) are considered to form the baseline scenario. The confidence intervals associated with the baseline scenario forecasts for GDP and HICP, which capture the probabilities of deviating from the corresponding baseline scenarios, are outlined in **Charts A.35** and **A.36**, respectively. The confidence intervals associated with the baseline scenario for core inflation are shown in **Chart A.37**. The following paragraphs analyse in more detail the downside and upside risks to the GDP and inflation projections.

Possible downward deviations from the baseline scenario (downside risks) for GDP are mainly related to the ongoing challenges the banking sector faces as well as to various external risks. In more detail, downside risks to GDP are associated with a slower-than-projected decline in the high level of NPEs, as the high level of private debt constrains, to some extent, the granting of new loans. Moreover, downside risks from the baseline GDP scenario relate to a possible deterioration

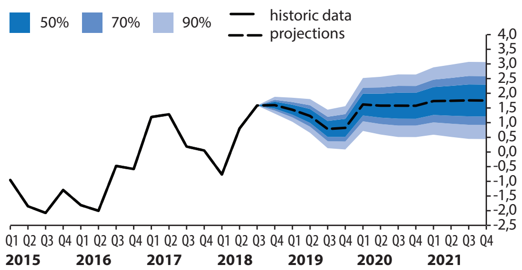
16. For further information regarding the methodology of the risk assessment of macroeconomic projections, see *Economic Bulletin*, June 2015, p. 67.

CHART A.35 **Real GDP fan chart**
(annual change, %)



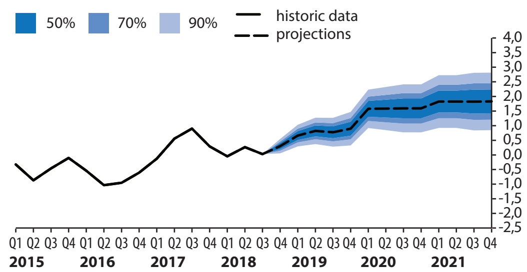
Source: CBC.

CHART A.36 **HICP fan chart**
(annual change, %)



Source: CBC.

CHART A.37 **HICP excluding energy and food fan chart (core inflation)**
(annual change, %)



Source: CBC.

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in external demand for services, because of the unfavourable economic situation that may prevail due to a hard Brexit. In addition, adverse geopolitical developments in the eastern Mediterranean region could negatively affect the prospects of the tourism and professional services sectors. Finally, a possible further appreciation of the euro against the US dollar in light of political developments could make Cypriot exports more expensive, thus leading to a possible slowdown in economic activity via reduced exports and investment.

In contrast, upward deviations from the baseline GDP scenario (upside risks) are associated with a better-than-expected improvement in domestic macroeconomic conditions. Specifically, upside risks relate to a higher-than-expected implementation rate of investment projects by the private sector. The higher value added arising from these projects could have a positive impact on the macroeconomic environment beyond that which is associated with the construction of the projects in question. In this context, both the construction and the operation of the casino as of 2021 stand out, as this is expected to provide a significant boost to employment and to contribute further to the growth of the tourism sector. A conservatively estimated impact due to the operation of the casino as of 2021 has been incorporated in the baseline GDP forecast. In addition, higher-than-foreseen absorption of funds from sources outside of the domestic banking system, including financing from the setup of new investment funds in Cyprus, could contribute to a higher-than-expected rise in investment. Finally, investments related to the exploration of new fields in the Republic of Cyprus' Exclusive Economic Zone for possible natural gas reserves could have a further impact on the macroeconomic outlook. It should be noted that the baseline GDP scenario does not take into account possible commercial exploitation of natural gas, which could lead to higher revenues, both directly and indirectly, via increased economic activity since any such revenues accrue outside the forecast horizon.

Regarding inflation, and in line with the GDP analysis above, possible downward deviations from the baseline scenario (downside risks) are mainly linked to a deterioration in domestic credit conditions as well as various external risks. Domestic demand may be negatively affected in case the high level of NPEs is not effectively addressed. In addition, downside risks are associated with a possible decline in external demand for services because of Brexit. Furthermore, a potential appreciation of the euro against the US dollar is expected to have a direct impact on inflation via a fall in import prices.

Possible upward deviations from the baseline inflation scenario (upside risks) stem both from the internal and the external environment. With regard to the internal environment, a better-than-expected improvement in the domestic economic outlook (higher-than-expected implementation of investment plans and strengthening of the tourism outlook as mentioned above for GDP), could be expected to have an upward impact on inflation. Finally, the imposition of restrictive measures on trade may have an upward effect on inflation.

Technical Notes

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(A) Domestic monetary aggregates

All monetary aggregates' data exclude the CBC.

On 1 July 2008, a new definition of residents of Cyprus entered into force (Statistical Purposes Directive, 2008). As a result, MFIs reclassified a large number of organisations or customers' businesses with limited or no physical presence in Cyprus, known as 'special purpose entities (SPEs), from non-residents to residents. The effect of this change is excluded from the monetary and financial statistics series presented in this publication, which reports domestic residents data excluding SPEs. For purposes of normalisation and comparability of monetary time series, data have been further processed by the CBC's Economic Analysis and Research Department.

The calculation of annual percentage changes is based on the methodology used by the ECB. More specifically, the growth of monetary aggregates is calculated based on the monthly differences in outstanding amounts adjusted for amounts that do not arise from transactions, such as reclassifications/other adjustments, revaluation adjustments and exchange rate adjustments, so as to reflect changes due to net transactions.

The above methodology has been adopted since the December 2009 edition of the *Economic Bulletin*. In previous editions of the *Bulletin*, the growth rate of monetary variables was calculated as the annual percentage change of outstanding balances at the end of the period. Details of the methodology can be found in the *Monetary and Financial Statistics*, published by the Statistics Department of the CBC, which is available on the CBC website.

(B) Balance of Payments

The present statistical collection system adopted as of June 2014, is based on the methodology of International Monetary Fund (BPM6), which has also been adopted by the EU, as well as on additional requirements and the level of detail required by both the Statistical Service (Eurostat) and the European Central Bank (ECB).

The adoption of BPM6 by the external statistics of the Cyprus took place in June 2014. In October 2014 was the first publication of the data. The published data for BoP, IIP and external debt cover the period from 2008 to date.

The application of new manuals provided the opportunity to adopt broader changes and revisions to improve the coverage and quality of the statistics of the external sector. Specifically, in addition to the incorporation in all external statistics produced and published of the special purpose entities that are registered / incorporated in Cyprus, the CBC has also upgraded the collection systems and compiling statistics of the external sector, giving greater emphasis to the application of new research and the use of available administrative sources.

(C) National Accounts

In June 2014 Cystat implemented the new statistical standards for the historical data series since 1995. The ESA 2010 replaces ESA 1995 and is based on the System of National Accounts (ESA) 2008 which is in the process of being implemented worldwide. The aim is to adapt the national accounts to the current economic environment, advances in methodology and changing user needs. Regarding the sectoral classification, ESA 2010 provides a clearer separation between non-financial corporations and corporations that are not directly engaged in the non-financial activities. In particular, holding companies of non-financial corporations and other so-called captive financial institutions as well as certain Special Purpose Entities (SPEs) are now classified under a new category. In parallel, the investment funds sector is now separated from the remaining part of other financial intermediaries and insurance companies are shown separately from pension funds. The ESA 2010 has also adopted changes to the financial accounts.

More details on the methodology of compiling the balance of payments and the national accounts are available in Box 1, p. 51, of the December 2014 *Economic Bulletin* and on the website of the CBC.

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