



CENTRAL BANK OF CYPRUS

ECONOMIC BULLETIN

DECEMBER 2019

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Introduction

2

Macroeconomic
Developments
and Projections

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ECONOMIC
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ABBREVIATIONS

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

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Introduction

The Cyprus economy continues to record high, albeit decelerating, real GDP growth rates. More specifically, economic activity increased by 4,1% in 2018, compared with 4,4% the year before. Based on the latest preliminary (seasonally adjusted) data, GDP registered an annual increase of 3,1% in the first nine months of 2019, a rate that is above the euro area average.

The GDP growth mainly reflects the rise in domestic demand. More specifically, large private investments, significantly financed by foreign capital, are underway. Private consumption also registers growth, reflecting the increase in household disposable income, mainly due to increased employment and, to a lesser extent, wage growth. At the same time, the historically low interest rates prevailing in the euro area support the rising trend of both investment and private consumption.

Although productivity is still low, most sectors record growth in economic activity. Construction recorded the highest growth, reflecting the developments in the real estate sector. An exception to the positive contribution of sectors is the sector of Financial and Insurance Activities, mainly because of the significant transfer of non-performing Exposures (NPEs) off the banks' balance sheets.

In the short term, GDP growth is expected to exceed potential and, as such, specific sectors of the economy are possibly prone to overheating risks. This is also reflected in the deterioration of the current account deficit. However, the pace for economic growth is expected to converge to potential in the

medium term, due to the gradual completion of certain investment projects and the projected slowdown in private consumption to more sustainable levels.

The positive GDP performance is supporting the labour market as well. According to the Labour Force Survey (LFS), unemployment in the second quarter of 2019 was reduced to 6,5% compared to 7,3% in the same period last year and remains at a lower level compared to the euro area average since the fourth quarter of 2018. At the same time, total wage bill has recorded a gradual rise, mainly due to the increase in employment in most sectors.

Despite the positive developments in economic activity, the improvement in the labour market and the recent wage increases, the harmonized inflation in Cyprus continued to remain subdued during the first ten months of the year. More specifically, domestic inflation reached 0,5% over the reference period as compared to 0,7% a year earlier, amid mixed developments in the main categories of inflation. The decline in domestic inflation is mainly due to the excise tax reductions in Cyprus by 5 cents per litter in the main types of petroleum products, as well as to the lower, on average, price of oil compared to the same period last year. At the same time, the prices of industrial goods excluding energy continued to record annual declines mainly due to increased domestic competition and competition from online purchases. On the other hand, the rises in services and unprocessed food prices had a positive effect on inflation during the first ten months of the year.

Economic growth is expected to slow in

2019 compared to 2018 at around 3% and register slightly lower levels in the years 2020-22. This forecast is revised downwards compared to the June 2019 projections, and reflects a slowing trend in domestic demand. Private consumption is expected to decelerate due to the expected acceleration in loan repayments associated with the ongoing efforts to reduce the level of NPEs, but also because of the contributions imposed for the General Health System (GHS). The projected slowdown in investment is due to the gradual completion of the investment projects (power generation facilities from renewable energy sources, marinas and the casino-resort). Inflation is expected to move to a slightly higher level in 2020 compared to 2019, mainly due to the elimination of the negative impact of the aforementioned reduction of excise duty on main types of petroleum products in 2019 as well as the continued positive performance of economic activity and the further expansion of wages growth.

Despite the positive course of economic activity and the continuation of robust growth, there are still downside risks to the Cypriot economy which potentially might slow growth in the period 2020-2022. Factors such as external geopolitical developments (Brexit, trade war, etc.), and the high level of private debt in relation to the challenges facing the banking sector, continue to constitute potential risks and make the economy vulnerable to shocks.

Regarding developments in the banking sector in 2019, banks continued their efforts to consolidate their balance sheets and reduce NPEs, while still supplying the real

economy with new lending. At the same time, due to the environment of historically low interest rates and growing competition, banks continue restructuring in order to improve profitability and cost effectiveness.

Progress in the issue of reducing NPLs has been significant in recent years. From end 2014 to mid-2019, Cyprus banks' NPL ratio declined from 56% to 32% with the decrease in absolute figures reaching €19bln (from €28 bln to €8,9 bln)¹. However, Cyprus still has the highest NPL rates in Europe, after Greece (over 40%), while the European average is around 3%. In addition, a large part (46%) of NPLs in Cyprus are in arrears for more than 5 years, while the European average stands at 17%. This is an even greater challenge for banks, in view of the fact that the degree of difficulty in solving the problem rises over time.

The reduction of NPLs in the banking system is partly achieved through debt sales. At the same time, the asset quality of financial institutions is improved, thereby helping to strengthen the depositors trust and confidence and reduce the funding costs of banks, which should be reflected in the pricing of loans they grant. Nevertheless, it should be emphasized that these actions do not reduce overall private debt, which remains at very high levels.

The Central Bank of Cyprus (CBC) expects credit institutions to intensify efforts to complete the consolidation of their balance sheets, taking advantage of the continued economic growth and the consequent rise in real estate values.

The existence of a stable legal framework that will, inter alia, govern the new foreclosure

1. Locally Active Institutions, consolidated level, except RCB which has been assessed as outlier (immaterial NPL exposure) including overseas operations

framework, along with an effective insolvency framework that will foster the efforts in achieving the target of NPE resolution are important for the resolution of NPEs. It is essential that those who strategically choose not to fulfil their obligations will be confronted with an effective legal framework. Additionally, the judicial system needs to be streamlined so that decisions can be made efficiently, within a short period of time. It should also be stressed that the Central Bank of Cyprus requires strict adherence by the financial institutions to the Arrears Management Directive and to the Code of Conduct, contained therein.

The overall performance of the economy and the banking system is positive. However, not all macroeconomic imbalances and distortions created in the past have been completely eliminated. There are still significant outstanding issues particularly in relation to essential structural reforms awaiting implementation. The restructuring of the economy and the reformation and strengthening of the banking system has not yet reached levels that guarantee full protection from the existing or future risks. Therefore, the effort for further restructuring or reform should be continued without delay.



Macroeconomic Developments and Projections

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1. International Environment: major developments

- *Slowdown in world economic activity, mainly due to the continuation of trade tensions among the US and China.*
- *Small deceleration in global inflation during 2019Q3 compared with 2019Q2.*
- *Both headline and core euro area inflation remained subdued, with a gradual increase expected over the medium term.*
- *Slight decline and stabilisation of oil prices in the second half of 2019, due to sluggish demand and stable production by OPEC.*
- *Further cut in key interest rates by the Federal Reserve and the ECB.*

1.1 Economic developments

During the second half of 2019, the global economy was adversely affected by the uncertainty mostly caused by geopolitical tensions. In particular, the geopolitical turmoil in the Eastern Mediterranean, Brexit and, most importantly, the continuation of the trade war between the US and China contributed significantly to the escalation of global uncertainty.

The trade war between the two countries led to a significant slowdown in the global economy and the economies of both countries, forcing many central banks around the world to cut interest rates in an effort to mitigate the side effects on their national economies. Trade tensions have particularly affected countries of Asia and Oceania, thus forcing Singapore, South Korea, Australia, and New Zealand to ease monetary policy in order to boost domestic demand.



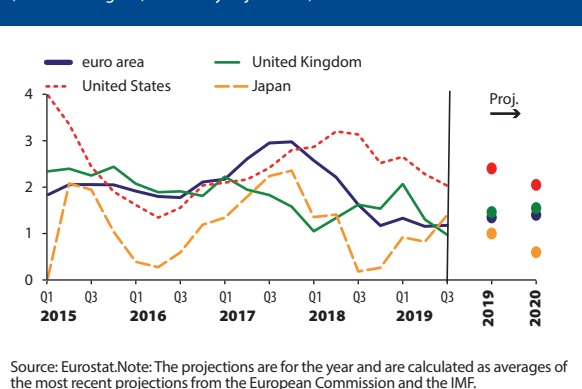
In contrast, countries that are considered economically stable, such as Japan and Switzerland, have seen their currencies benefit from the trade dispute. At the time of writing this *Economic Bulletin*, no final deal between the US and China has been agreed, thus increasing uncertainty in the markets, despite both countries having expressed their willingness to reach an agreement.

In the US, economic activity is still higher relative to other countries, albeit slowing down according to the most recent data releases, amid uncertainty in world trade developments. Specifically, US real GDP growth fell from 2,7% in 2019Q1 to 2,3% and 2,0% in 2019Q2 and 2019Q3, respectively. Growth is broadly in line with forecasts of international organisations and analysts, who expect GDP growth in the country to reach 2,4% in 2019 and to further slow down to 2,1% in 2020, mainly due to the trade war with China.

In the euro area, economic growth stood at 1,2%, in 2019Q2 and 2019Q3, respectively, recording a significant deceleration in comparison with the corresponding quarters of 2018 (**Chart A.1**). The main factors behind the slowdown in growth is, as already mentioned, the uncertainty due to trade tensions, and consequently the decline in exports to China, due to lower demand. The latter has affected mainly countries with a large manufacturing sector, such as Germany. It should be noted, however, that most euro area countries appear to have been adapting to the new environment, as, unlike exports, domestic demand has not been significantly affected.

Uncertainty in macroeconomic conditions has led to an increase in market volatility, with

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



significant changes in investors' risk-aversion. For example, the 10-year German government bonds recorded a considerably lower negative yield since August, albeit with marked fluctuations. Forecasts of international organisations and analysts suggest that the annual GDP growth in the euro area is expected to reach 1,4 % both in 2019 and in 2020, down from a projected growth of 1,8% in 2018².

The uncertainty around Brexit has affected economic growth in the UK more than international trade developments. Despite a 2,1% real GDP growth recorded in the UK economy in 2019Q1, growth decelerated to 1,3% and 1% in 2019Q2 and 2019Q3, respectively. International organisations and analysts estimate that the growth rate reported in 2019Q1 was due to one-off factors, and therefore expect GDP growth in 2019 and in 2020 to linger around 1,4% and 1,6%, respectively.

Inflation³

Global inflation fluctuated at lower levels during 2019Q3 compared with 2019Q2 due to developments in energy prices, reflecting the lower, on average, price of oil on the one hand, and the decelerating economic activity in major advanced economies on the other. According to the projections of international organisations and analysts, inflation in selected major advanced countries such as the US,

2. The GDP forecast is calculated as the average of the latest forecasts by the European Commission (European Economic Forecast, Autumn 2019) and the International Monetary Fund (World Economic Outlook, October 2019).
3. Inflation projections are estimated as the average of the most recent projections from: The European Commission (European Economic Forecast, Spring 2019) and the IMF (World Economic Outlook, April 2019).

UK, Japan and the euro area in 2019, is expected to fluctuate at lower levels compared with 2018 (**Chart A.2**). This development is mainly driven by the expected slowdown in global economic growth and the lower, on average, oil prices. With regard to 2020, inflation in most of the aforementioned countries is anticipated to exhibit moderate increases, reflecting the envisaged wage growth on account of the tightening in the labour market.

Exchange rates

The euro exchange rate against the major international currencies continued its downward trend since the beginning of the year and up to the cut-off date of this Economic Bulletin. The weakening of the euro is mainly due to lower than expected economic growth in the euro area, the US-China trade war impact, as well as the uncertainty surrounding Brexit. Specifically, between the period January and up to 15 November 2019, the euro depreciated by 3,1% against the US Dollar, 4,5% against the pound sterling and 2,8% against the Japanese Yen (**Chart A.3**).

Oil

The price of Brent oil recorded a year-on-year decline of 12,4% in the January-November 2019 period. This decrease reflects, firstly, the significant expansion in oil production in the US, and secondly, the decision of some OPEC members not to abide by the decision to maintain the reduced production throughout 2019. This, combined with the

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

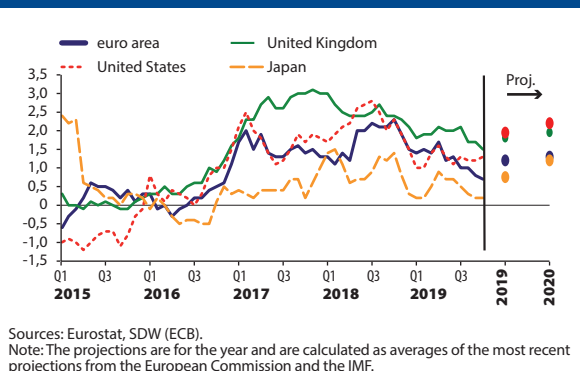
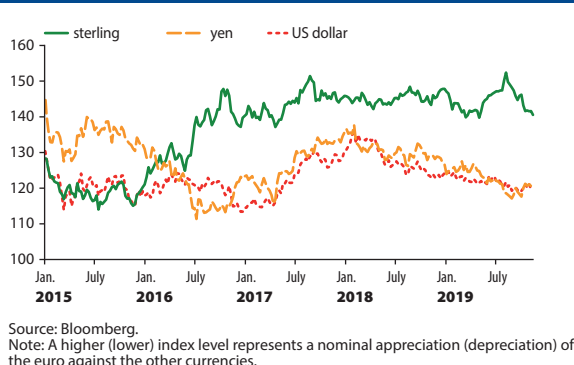


CHART A.3 Euro exchange rate against selected currencies
(weekly data, 2000=100)



fall in global financial markets and the decline in demand led to a gradual decline in prices. In the last three months, prices appear to have stabilised at around 60 dollar per barrel (Chart A.4).

International key interest rates

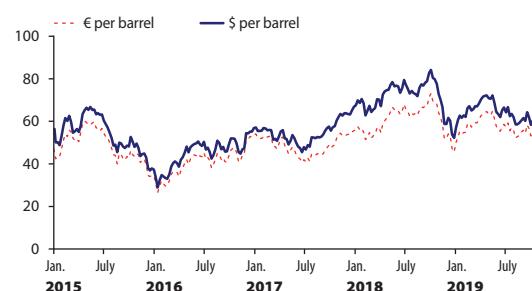
In 2019, the Federal Reserve proceeded with three interest rate cuts, reversing last year's decision to adopt a more restrictive monetary policy stance. Specifically, the upper limit of the US effective federal funds rate was set to 1,75%, down from 2,5% in the beginning of the year (Chart A.5). This was mainly attributed to the external pressures faced by the US economy (see Economic Developments, p. 12), as well as to the Fed's effort to enhance the economy's resilience to risks. Likewise, the ECB reduced its deposit interest rate to -0,50% from -0,40% while keeping the remaining policy rates unchanged. Rate cuts also took place in several other countries, mainly in Asia and Oceania. The Bank of England, on the other hand, kept its interest rate unchanged at 0,75 %.

1.2 Monetary developments in the euro area

Inflation

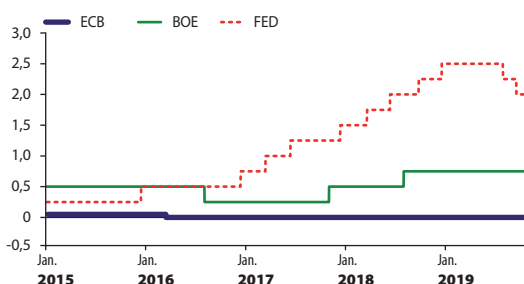
According to the latest available data, euro area inflation decelerated to 0,7% in October 2019 compared with 0,8% in September 2019 (Chart A.6). The marginal drop in inflation was mainly driven by higher decreases in the prices of energy which in recent months have

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



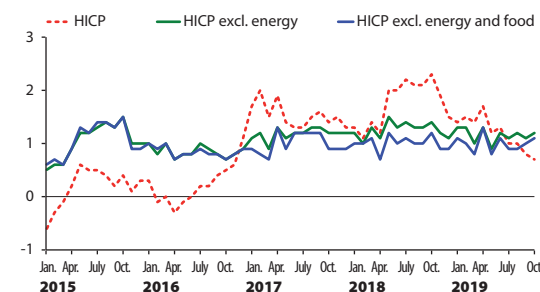
Source: Bloomberg.

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



Sources: ECB, Fed, BoE.

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



Source: Eurostat.

had a significant downward impact on overall euro area inflation. At the same time, increases in non-energy industrial goods prices continued to remain at very low levels. As a result, both headline and core inflation (inflation excluding energy and food prices) have been persistently subdued, reaching 1,2% and 1,0%, respectively, in the first ten months of 2019.

Given the latest available data as well as the decelerating developments in the global economy, HICP inflation is expected to remain subdued. The most recent euro area inflation projections by international organisations and analysts converge to 1,2% for 2019 and around 1,3% in 2020.

Over the medium term, a gradual increase in headline inflation is expected, supported by the ECB's expansionary monetary policy measures (expected to remain loose for as long as needed), the projected ongoing economic growth and the further gradual rise in wages.

Reference rates and ECB intervention

At its monetary policy meeting on 12 September 2019, the Governing Council of the ECB adopted a new package of standard and non-standard monetary policy measures⁴. These decisions reflected the continuing deviation of inflation from its target of below, but close to, 2% over the medium term, as well as the contained inflationary pressures, in response to the slowdown in the euro area economy and rising downside risks.

More specifically, as regards standard

4. For more details over the decisions of the Governing Council of the ECB, see the ECB website link below:
<https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.el.html>

monetary policy measures, the ECB Governing Council kept interest rates for marginal lending facility operations and main refinancing operations unchanged to 0,25% and 0,00%, respectively. The Governing Council also announced that the above-mentioned key interest rates will remain at their present or lower levels or lower until the inflation outlook robustly converge to its medium-term price stability target.

At its monetary policy meeting on 12 September 2019, however, the ECB proceeded with the further reduction of the interest rate on the deposit facility operations by 10 basis points, from -0,40% to -0,50%. Furthermore, it decided that, as from 1 November 2019, net purchases under the Asset Purchase Programme (APP) will be reactivated at a monthly pace of €20 billion and are expected to run for as long as needed. In addition, the ECB will continue “reinvesting, in full, the principal payments from maturing securities purchased under the APP and will continue to do so for an extended period of time and in any case for as long as it is necessary to maintain favourable liquidity conditions”. The Governing Council also decided to change the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III), so to ensure the smooth transmission of monetary policy and to further support the accommodative stance of monetary policy. Finally, in order to support the transmission of monetary policy via banks, the ECB decided to introduce a two-tier system for reserve remuneration, in which part of banks’ holdings of excess liquidity will be exempt from the negative deposit facility rate.

The main objective of the aforementioned monetary policy measures, both standard and non-standard, was to accommodate the return of euro area inflation back to sustainable levels and in line with the medium-term target of below, but close to, 2%.

As a result, the EONIA rate registered a decrease of 10 basis points, reaching -0,46% on 18 September 2019 (the day that the cut in the deposit facility rate took effect) compared with its average level of -0,36% in August 2019 (Chart A.7). Since then, the EONIA rate had recorded some fluctuations and reached -0,43% on 20 November 2019 (latest available data).

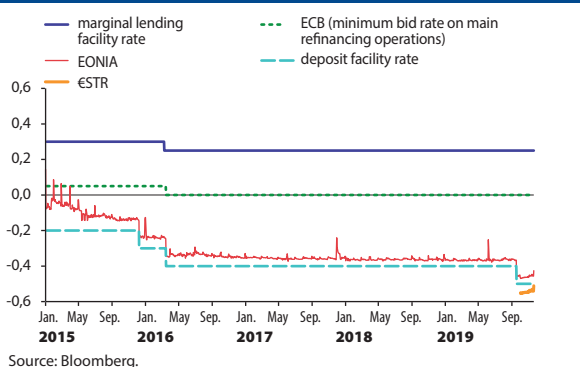
It is important to note that on 2 October 2019, the new short-term rate “€STR” (Euro short-term rate) was launched. €STR reflects the overnight wholesale euro unsecured borrowing costs of euro area banks⁵. On that day, the methodology for computing the current EONIA rate was also changed to allow for its gradual replacement by €STR and it is now calculated as the €STR plus a fixed spread of 8,5 basis points. The EONIA rate will be fully discontinued on 3 January 2022. According to the latest available data, the new short-term rate “€STR” reached -0,51% on 20 November 2019.

Credit expansion: loans

Loans to the euro area private sector have continued to record positive growth rates during 2019Q3, reaching 3,8% as at end September 2019 (Chart A.8). More analytically, the annual growth rate of euro area non-financial corporations’ loans stood at

CHART A.7 ECB reference rates and short term interbank rates

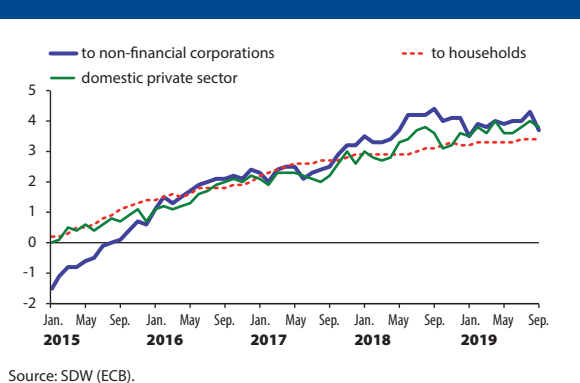
(% per annum, daily data)



Source: Bloomberg.

CHART A.8 Loans to the private sector: euro area

(annual change %, seasonally adjusted data)



Source: SDW (ECB).

5. For more details, see ECB’s Economic Bulletin (7 November 2019): “Box 1: Goodbye EONIA, welcome €STR!”, <https://www.ecb.europa.eu/pub/pdf/ecbu/eb201907.en.pdf>

3,7% in September 2019, whereas the annual growth rate of euro area households loans reached 3,4%. These positive developments mainly reflect banks' excess liquidity, low euro area lending rates as well as the overall favourable supply of bank loans. According to the results of the October 2019 euro area Bank Lending Survey (BLS), an increase in net loan demand by households for all loan categories was recorded in the euro area during 2019Q3, while net loan demand for loans by enterprises remained broadly unchanged during the period under review. At the same time, credit standards for loans to both enterprises and households for housing purchases were further slightly eased, while credit standards for loans to households for consumption and other lending purposes were tightened. According to the BLS, the participating banks expect credit standards for loans to enterprises and households for housing purchases to remain unchanged, whereas those for loans to households for consumption and other lending purposes to remain broadly unchanged. Net loan demand by enterprises is expected to remain broadly unchanged in 2019Q4 compared with 2019Q3, while net loan demand by households for all loan categories is expected to further increase in 2019Q4 compared with 2019Q3.

Despite these positive developments, the high level of NPFs in some member states continues to hinder credit growth dynamics in the euro area as well as overall economic activity.

2. Domestic Environment: main developments

- Slightly lower inflation during the first ten months of 2019, mainly due to decreases in energy prices.
- Inflows of deposits from domestic residents.
- Moderate growth rates of domestic private sector loans.
- Significant decrease in the level of NPFs⁶, mainly in 2018.
- Continuation of the favourable low domestic interest rate regime, with ongoing downward trend in both lending and deposit rates.
- Continued GDP growth, albeit at a slowing pace, reflecting the positive path of domestic demand.
- Further drop in unemployment, registering rates lower than the euro area average.
- Continuation of the real estate sector recovery, with residential property prices recording moderate increases, with the exception of Limassol and recently Larnaca, where apartment prices recorded strong increase.
- Decrease in government debt by more than 4 percentage points compared with the beginning of the year, reflecting sound public finances and early debt repayments.

6. All credit institutions operating in Cyprus (domestic operations only).



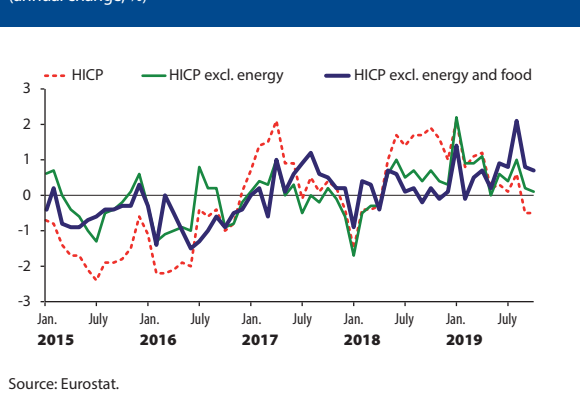
2.1 Domestic Prices, Monetary Aggregates and Labour Costs

Inflation

Despite the positive developments in economic activity, the improvement in labour market as well as the small wage increases, domestic HICP inflation continued to remain at very subdued levels during the first ten months of 2019. More specifically, the Harmonised Index of Consumer Prices (HICP) inflation decreased to 0,5% in October 2019 compared with an increase of 1,9% in the corresponding month of 2018. This development was mainly attributed to decreases in the prices of all HICP main sub-categories, apart from services prices.

The phenomenon of prolonged subdued inflation is even more pronounced in Cyprus than in the euro area in general, mainly due to various idiosyncratic factors. More analytically, with regards to the first ten months of 2019, HICP inflation fell to 0,5% from 0,7% in the corresponding period of 2018 (Chart A.9 and Table A.1) mainly driven by the reduction in energy prices compared with the corresponding period of 2018. The latter reflects the negative impact of the Cyprus Parliament decision to reduce excise duties on the main fuels by 0,05 euro per litre as from 18 December 2018. In addition, it mirrors the lower, on average, price of oil compared with last year's corresponding prices. Decreases in non-energy industrial goods prices continued to contribute to the subdued trend of domestic HICP. These decreases are heavily affected by factors, such as, increased dome-

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



Source: Eurostat.

TABLE A.1 Inflation in Cyprus

	Weights ⁽¹⁾	Annual change, %				
		Jan.-Oct. 2018	Jan.-Oct. 2019	Oct. 2018	Sep. 2019	Oct. 2019
HICP	1.000,00	0,7	0,5	1,9	-0,5	-0,5
Unprocessed food	51,52	1,3	2,9	2,5	-0,3	-1,9
Processed food	180,01	-0,1	-0,1	1,6	-1,6	-1,5
Energy	85,14	7,1	-1,7	16,9	-7,5	-6,7
Services	459,25	1,1	1,7	0,9	1,6	1,5
Non-energy industrial goods	224,08	-1,9	-1,0	-1,2	-0,9	-0,9
HICP excluding energy	914,86	0,1	0,7	0,7	0,2	0,1
HICP excluding energy and food	683,33	0,1	0,8	0,2	0,8	0,7

Source: Eurostat.
(1) Based on the weight for 2019.

stic competition (including off-season or mid-season sales/special offers), competition from e-commerce as well as the shift to cheaper retail importing countries. During the first ten months of 2019, processed food prices recorded, on average, a marginal decrease. In contrast, the average increases in services and unprocessed food prices had a positive contribution to the headline inflation during the period under review.

Core inflation (inflation excluding energy and food prices) registered an increase of 0,8% during the first ten months of 2019 compared with a marginal decrease of 0,1% in the corresponding period of 2018 (**Chart A.9** and **Table A.1**, p. 22) on the back of the significant increase in services prices. Core inflation remains, however, at subdued levels as well. The subdued trend of core inflation mainly reflects the ongoing negative impact of non-energy industrial goods prices which largely offsets the positive impact from services. It should be noted that, core inflation is important as it shows the general price trends excluding the impact of exogenous and volatile factors and components, such as the prices of energy and food.

Monetary Aggregates^{7,8}

Following the restructuring of the domestic banking sector in 2018, relating mainly to the developments regarding the Cyprus Cooperative Bank (CCB), the subsequent business transfer agreement between the CCB and

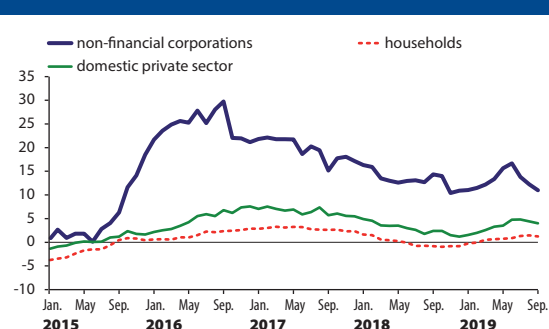
7. For a detailed explanation of the methodology and technical analysis of monetary aggregates, see Technical Notes on p. 74.
8. The analysis on monetary aggregates (deposits and loans) in this section of the *Economic Bulletin* focuses on domestic residents excluding SPEs. SPEs are included in the non-residents category.

Hellenic bank and the revocation of CCB's banking license, monetary developments appear to have normalised and continue to improve. In summary, as consumer confidence in the banking sector, particularly of domestic households, improved, inflows of deposits from domestic residents increased in the first nine months of 2019, while deposits outflows from non-residents in Cyprus were contained. At the same time, efforts to reduce NPFs⁹ continued, while in September 2019 the ESTIA scheme was implemented. Although participation so far has not been as high as anticipated, the scheme is expected to enhance the available tools for the organic reduction of NPFs, which include debt-for-asset swaps and loan write-offs. The continued deleveraging of the private sector is also reflected in the moderate growth rates of loans to non-financial corporations and households, despite the continued gradual increase in new loan contracts. The moderate increase in new loans is compatible with the new stricter regulatory framework and the adoption and maintenance of stricter credit criteria from domestic banks. New sustainable lending is desirable, as it ensures financial stability and shields the domestic economy from future negative shocks.

In particular, domestic private sector deposits recorded an annual increase of 4,0% in September 2019, up from 1,2% in December 2018 and 2,4% in September 2018, mainly reflecting the increase in the annual growth rate of household deposits (Chart A.10). Non-residents deposits, on the other hand, continue to record outflows, albeit to a lesser extent, partly due to stricter anti-money

9. All credit institutions operating in Cyprus (domestic operations only).

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



Source: CBC.

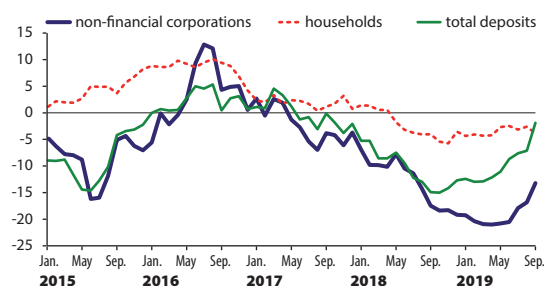
laundering guidelines. In September 2019, the annual growth rate of non-residents deposits stood at -1,9% compared with -12,7% in December 2018 and -14,9% in September 2018 (**Chart A.11**).

Reflecting the positive developments in the economy, new loan contracts, mainly of non-financial corporations, registered a slight increase in the first nine months of 2019 compared with the corresponding period of 2018. However, total repayments and reduced interest capitalisation compared with the previous year, mainly due to the sale of loans and the transfer of CCB loans outside the banking system, contained the annual growth rates of private sector loans to positive but low levels. As a result, total loans to the domestic private sector in September 2019 and December 2018 recorded an annual increase of 1,0% from 0,7% in September 2018 (**Chart A.12**). Specifically, the annual growth rate of loans to the domestic non-financial corporations reached 1,1% in September 2019, while for households it was limited to 0,3%. Turning to the individual categories of household loans, both consumer credit and housing loans showed positive, albeit contained, annual growth rates at the end of September 2019, while loans for other lending registered nil annual growth rate (**Table A2**).

Another positive development for the domestic economy is the significant reduction in the level of NPFs¹⁰, despite the fact that the ratio of NPFs to total loans remains among the highest in the EU. Overall, in the period between their peak in February 2015 and June 2019 (latest available data), NPFs

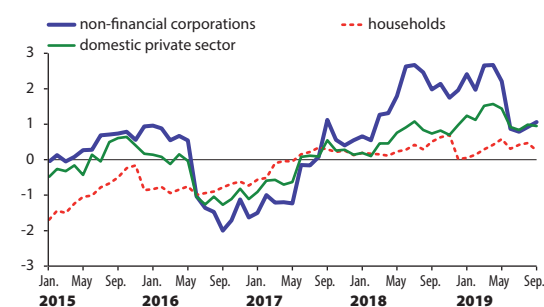
10. All credit institutions operating in Cyprus (domestic operations only).

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



Source: CBC.

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					
		2018 June	2018 Sep.	2018 Dec.	2019 Mar.	2019 June	2019 Sep.
Domestic households	100,0	0,3	0,5	0,0	0,3	0,3	0,3
1. Consumer credit	13,5	2,3	1,9	1,4	0,9	0,5	0,8
2. Lending for house purchase	66,1	-0,4	-0,1	-0,3	0,1	0,4	0,2
3. Other lending	20,3	0,8	1,1	0,3	0,6	0,2	0,0

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.

decreased by €18,1 billion. The largest decrease, €10,3 billion, was recorded in 2018 mainly due to the transfer of CCB's NPFs out of the banking system and the sale of NPFs by other banking institutions. The above developments, while improving the quality of the banks' balance sheets, are still a concern for the real economy, as these NPFs remain a liability for households and non-financial corporations, limiting the dynamics of economic growth (see Box on p. 27). Addressing the NPFs issue entails many challenges which are likely to deepen in the near future. This is due, on one hand, to the Parliament's decision on various amendments to the insolvency legal framework in August 2019, for which a ruling over their constitutionality is still pending with the Supreme Court. Should these finally come into force, the new amendments could slow down the rapid and effective resolution of the NPFs issue with negative consequences for both the banking sector and the economy in general. On the other hand, the unanticipated limited initial participation in the ESTIA scheme by eligible borrowers, increases the uncertainty over its success in fully addressing the more challenging portfolio of NPFs, i.e. those collateralised by the primary residence.

A stable legal framework which, among other things, will regulate the extrajudicial auctions alongside an effective insolvency framework, also plays a key role in addressing NPFs. It must be ensured that those who strategically choose not to fulfil their obligations are confronted with an effective legal framework. Additionally, the judicial system must be modernised so that justice is

Box: The path of private debt¹ in Cyprus

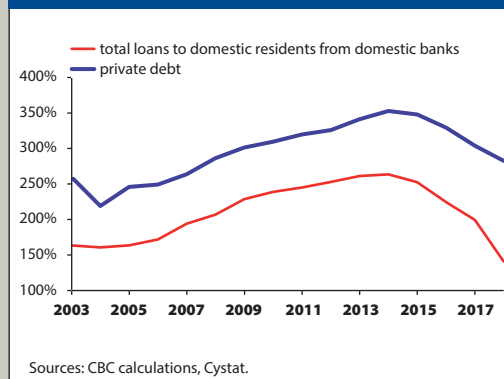
1. Introduction

The 2012-2013 financial crisis in Cyprus and the ensuing unprecedented recession that followed highlighted the importance and consequences of excessive lending and high private debt. The high level of private debt in Cyprus (**Chart 1**) is due to a combination of different factors.

First, and foremost, with the entry of Cyprus into the European Union in 2004 and the subsequent adoption of the euro on 1 January 2008, there was an increase in construction activity due to higher demand for real estate by both foreigners and Cypriots. At the same time, the excessive surplus liquidity of domestic banks created by the adoption of the euro, coupled with the false sense of security brought on by the steady rise in property prices, led to the underestimation of the credit risks of mortgaged loans. As a result, domestic credit expansion² and construction activity surged, causing a widening of the current account deficit as well.

The prolonged period of credit expansion and the respective significant increase in debt, increased the vulnerability of the private sector in effectively dealing with any negative market shocks. Indeed, when the financial crisis hit the country with an

CHART 1 Credit growth and private debt
(% of GDP)



unprecedented rise in unemployment and a significant reduction in wages, a significant share of the non-financial private sector faced difficulties in servicing its debt obligations. At the same time, the continued rise in private debt, due to the accumulation of high interest charges on non-performing loans, raised legitimate concerns about its viability. The need for the private sector to deleverage was imperative.

Since 2015, various structural and legislative measures have been adopted as part of the macroeconomic adjustment program agreed between the Cypriot authorities and the Troika. These measures, such as the insolvency legislation and the creation of centralised arrears management units in banking institutions, have helped significantly in the gradual decline of non-performing facilities and, thus, private debt. At the same time, the high

1. Private debt refers to non-financial private debt and therefore includes non-financial corporations and households (including non-profit institutions serving households).
2. For further analysis of credit expansion during this period, see "Box A.1 The use of the loan-to-value ratio as a macro-prudential policy tool: the case of Cyprus 2007-2008", Economic Bulletin, December 2010.

TABLE 1 Private non-financial sector debt

	2014	2015	2016	2017	2018	2019Q2
<i>euro mln</i>						
Private non financial sector debt	61.421	62.011	62.183	60.918	59.741	57.190
Private non financial sector debt excluding SPEs	48.877	49.458	48.675	46.840	45.313	42.740
SPEs debt	12.543	12.552	13.509	14.078	14.428	14.450
Non-financial corporations debt	38.519	39.325	40.185	39.857	39.230	37.113
SPEs debt	12.543	12.552	13.509	14.078	14.428	14.450
Households debt	22.902	22.685	21.998	21.062	20.512	20.077
<i>% of GDP</i>						
Private non financial sector debt	353%	348%	329%	304%	283%	267%
Private non financial sector debt excluding SPEs	281%	277%	258%	234%	214%	199%
SPEs debt	72%	70%	72%	70%	68%	67%
Non-financial corporations debt	221%	221%	213%	199%	186%	173%
SPEs debt	72%	70%	72%	70%	68%	67%
Households debt	132%	127%	117%	105%	97%	94%

Sources: Cystat (Annual Financial Accounts), CBC (Quarterly Financial Accounts).

growth rate of the Cypriot economy, the continuous decline in unemployment, increased employment and the restoration to a large extent of investors' confidence in the banking sector have intensified the rate of deleveraging, with household debt, as a percentage of GDP, dropping to levels below 100% for the first time after a decade.

Private debt, however, is still very high. It is noted that a significant reduction in the level of non-performing facilities (NPFs) was due to the transfer of a large part of them outside the banking system, and not due to the reduction of private sector lending. Consequently, reducing private debt in Cyprus to more manageable levels remains one of the biggest challenges faced by domestic economy.

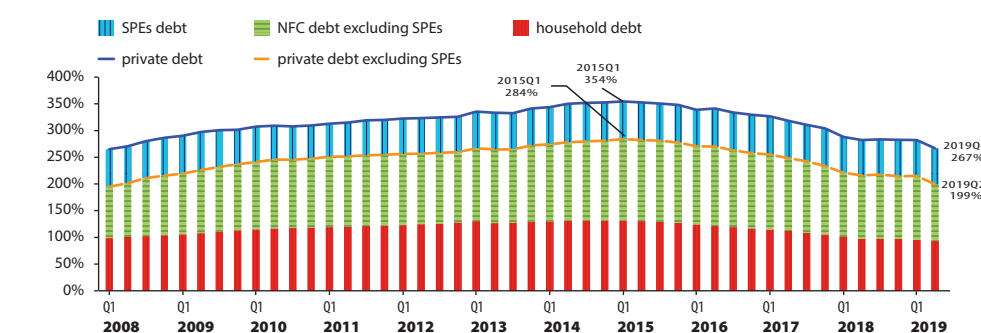
2. Recent developments in the path of private debt in Cyprus

Private debt in Cyprus, despite remaining at high levels, has been declining since the beginning of 2015, as a result of the deleveraging efforts of the private sector and the balance sheet consolidation efforts of domestic banks. Specifically, in 2019Q2 (latest available data), private debt amounted to 267% of GDP³ compared with 354% at its peak in 2015Q1 (Table 1 and Chart 2, p. 29).

With regard to the private sector debt sub-categories, household debt fell to double-digit levels after nearly a decade, reaching 94% of GDP, from 132% at the end of 2014. Non-financial corporations' (NFCs) debt also dropped significantly, to 173% from 221% at the end of 2014 (Table 1). It is

3. Debt figures refer to consolidated data.

CHART 2 Private sector debt as a % of GDP



Sources: CBC (Quarterly Financial Accounts), Cystat.

worth noting, however, that NFCs debt to GDP ratio and, consequently, the private sector debt ratio is significantly affected by the inclusion of special purpose entities' (SPEs)⁴ debt of around 70% of GDP (Table 1, p. 28). Domestic private debt figures are technically inflated by the SPEs debt, as these are mainly owned by companies with no or very limited physical presence in Cyprus, that have real assets (ships) and are financed almost entirely from abroad. As a result, the interconnectedness of the SPEs with the real economy is very limited and their borrowing does not essentially constitute a risk for the Cypriot banking system nor for the domestic economy in general. In 2019Q2, private debt adjusted for SPEs fell to 199% of GDP and is attributed almost equally to NFCs and households (Table 1, p. 28 and Chart 2).

Although the decline in the private

debt ratio over the last five years or so has been significant, further and more intense deleveraging is required. In fact, both households and NFCs remain heavily indebted, containing the future economic outlook of the economy.

As noted in the literature⁵, high levels of private debt can have a significant negative impact on the real economy. The excessive growth of private debt which remains at these levels for a long period of time adversely affects capital accumulation⁶ and leads to lower economic growth. This is because, on the one hand, businesses are forced to spend a large portion of their income on debt repayment and fewer resources remain available for investment, and on the other, households increase their savings to cover up their debt obligations, thereby reducing domestic private consumption. In addi-

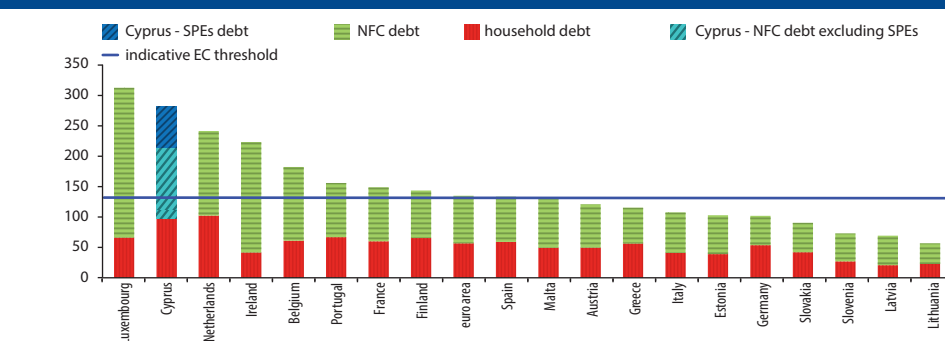
4. In this context, references to special purpose entities refer to non-financial entities.

5. See for example Reinhart and Rogoff (2011), Mian, Sufi, and Verner (2017), International Monetary Fund (2016), Terzi (2016), Lombardi, Mohanty and Shim (2017).

6. Capital accumulation occurs when a share of disposable income is saved and invested in order to increase product and income in the future.

CHART 3 Private sector debt

(as a % of GDP, 2018)



Source: Eurostat (Annual Financial Accounts).

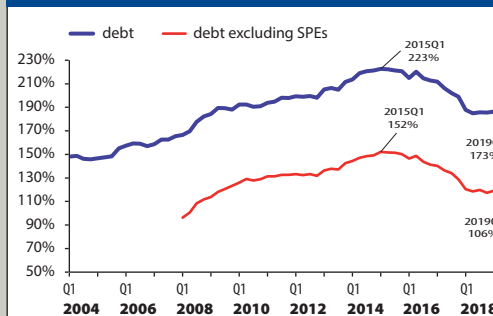
tion, the existence of high private debt is also affecting the banking system, as this is often associated with an increase in NPFs and a decline in banks' capital. There are also indications that delays in dealing with excessive debt can postpone the exit of unprofitable firms from the market, thus affecting the degree of redistribution of capital and labour between businesses and the production sectors of the economy, and reducing the overall productivity of the economy in the medium-term (European Central Bank, 2017).

3. Comparison with other euro area countries

Cyprus' private debt is one of the highest in the euro area countries and well above the 133% of GDP threshold (Chart 3), as reported in the Scoreboard indicators⁷ in the European Commission's Alert Mechanism Report (AMR). This latter report builds

CHART 4 Non-financial corporations debt

(as a % of GDP)

Sources: CBC (Quarterly Financial Accounts), Cystat.
Note: Debt includes loans and debt securities.

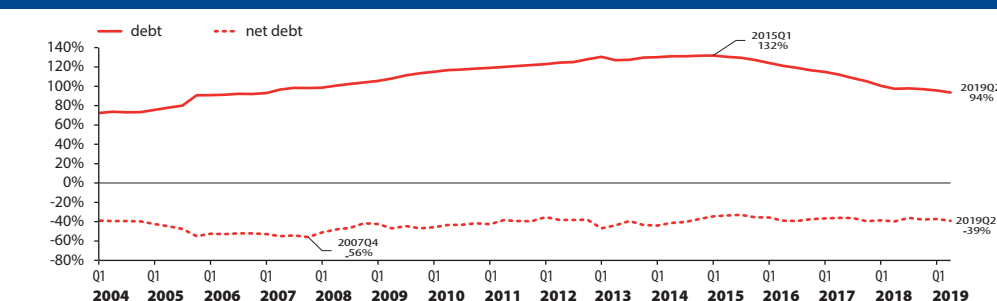
on the EU Macroeconomic Imbalances Procedure (MIP) with the aim of assessing the existence of imbalances or the risks of emerging imbalances in a Member State. However, caution is needed in comparing private debt data between Member States, due to the different features and national characteristics that exist and are presented below.

A significant portion of NFCs debt in Cyprus consists of the debt of SPEs (Chart 4),

7. The Scoreboard includes selected indicators and additional relevant information, as well as a wider set of auxiliary indicators, in order to monitor Member States for potential macroeconomic imbalances that require policy measures.

CHART 5 Household debt

(as a % of GDP)



Sources: CBC (Quarterly Financial Accounts), Cystat.

Note: Debt includes loans and debt securities. The corresponding financial assets used to net out debt include deposits, debt securities and loans.

which, as already mentioned, does not pose a significant financial risk to the domestic economy. In addition, due to the small size of the Cyprus economy, the data may be significantly affected by large transactions of domestic foreign-owned enterprises borrowing from abroad for investment abroad, without jeopardising in essence domestic financial stability. The rest of the NFCs in Cyprus are almost entirely small and medium-sized enterprises (SMEs) with limited access to funding sources other than bank lending due to the virtually non-existent capital market in Cyprus.

Recently, in an effort to address the significant gaps in the financing of SMEs that are the backbone of the Cypriot economy, the National Council on Economy and Competitiveness has put forward a proposal for the creation of an Equity Fund based on international best practices. As stated by the Council, the benefits of setting up the Fund in Cyprus are expected to be manifold and significant, including tackling the extremely high level of leverage and

debt of Cypriot businesses. In view of the above, in August 2019 the Council of Ministers approved its creation.

The high indebtedness of domestic households, on the other hand, is partly related to the historical accumulation of deposits as a safety net due to, inter alia, the lack of an adequate social security system, the until recently absence of a national health system, etc. At the same time, however, it should be emphasised that households' deposits outweigh their debt on average (Chart 5). In this respect, when the respective financial assets (mainly deposits) are deducted, households' net debt-to-GDP ratio turns negative, reaching -39% compared with -15% in the euro area in 2018. In addition, domestic households own real estate and most of their debt relates to the purchase of real estate, e.g. 42% of households in Cyprus have mortgaged loans compared with 23% in the euro area according to data from the second wave of the Households Finance and Consumption Survey (European Central Bank, 2016).

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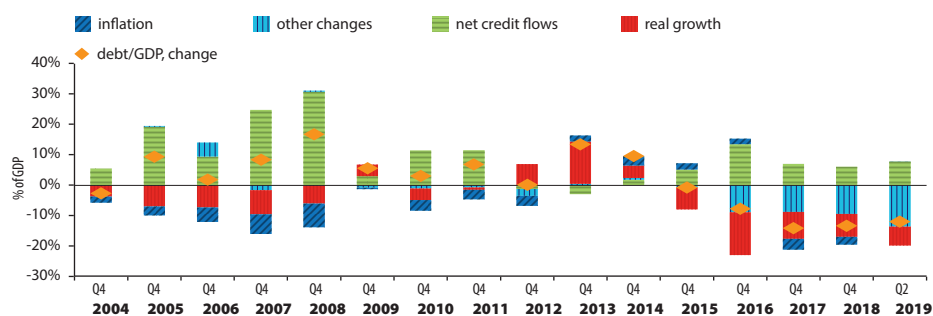
Introduction

2

Macroeconomic
Developments
and Projections

CHART 6 Decomposition of the change in NFC debt

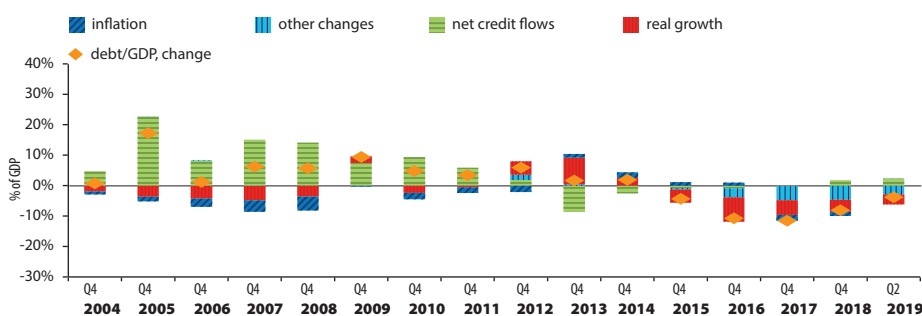
(as a % of GDP) (annual change)



Sources: CBC (Quarterly Financial Accounts), Cystat.

CHART 7 Decomposition of the change in household debt

(as a % of GDP) (annual change)



Sources: CBC (Quarterly Financial Accounts), Cystat.

4. Analysis of the changes in the domestic private sector to GDP ratio

For the assessment of the deleveraging mode, an analysis of the contribution of factors affecting the changes in the households and NFCs debt to GDP ratio is provided below. Specifically, the impact of real growth, inflation, net credit flows (new loans and interest capitalisation minus loan repayments) and other changes, such as loan write-offs, revaluations, reclassifications, etc. are examined (Charts 6 and 7).

As shown in Charts 6 and 7, private sector deleveraging which began in 2015 and continued until 2019Q2 (latest available data), was mainly due to write-offs of non-performing facilities, strong real GDP growth, and loan repayments, which include debt for asset swap agreements. In addition, the decline in private debt, especially for NFCs in 2019Q2, is mainly due to the sale of loans at a discounted value (i.e. at a price lower than their nominal value). The difference between the nominal value and the sale

value was treated as revaluation, thereby reducing the level of total private debt.

Analysing the contribution of various factors to the change in NFCs debt, non-performing facilities write-offs, partly through loan restructuring, have been identified to be the main driver of their debt reduction since 2016. With the peak of the crisis, the pace of loan write-offs also accelerated due to the fact that many indebted companies in Cyprus were forced to either voluntarily liquidate or file for bankruptcy through judicial decrees⁸, resulting in liquidations and loan write-offs. In contrast, the contribution of net credit flows to debt is positive, despite the drop in the overall ratio since the end of 2015. On the one hand, this is due to the fact that net credit flows include the movements of SPEs and Cypriot companies with foreign interests that continue to borrow from abroad. On the other hand, it is due to the granting of new lending by domestic banks to healthy and profitable companies, outweighing existing debt repayments. The increase in new lending, as reflected in the increase in investment in the domestic economy, is considered desirable as it contributes to the growth of the domestic economic activity.

For households, the contribution of write-offs of non-performing facilities, partially achieved through loan restructuring agreements, is also identified to have had the largest impact to the

reduction in households debt, as in the case for NFCs, although at a lower extent. In addition, it is noted that between 2013 and 2017, households' net credit flows either had a negative or a zero contribution to their debt change. It thus goes without saying that a large share of indebted households are repaying their loans either through restructuring agreements or through debt for asset swap agreements. The slight increase in net credit flows observed in 2018, continuing into the first half of 2019, reflects the improved financial position of households, due to lower unemployment and a gradual increase in wages, with more households meeting the stricter lending criteria of banks and becoming eligible to obtain new loans. New lending to households supports domestic consumption, which in turn contributes, albeit to a lesser degree than investment, to the high and robust domestic economic growth.

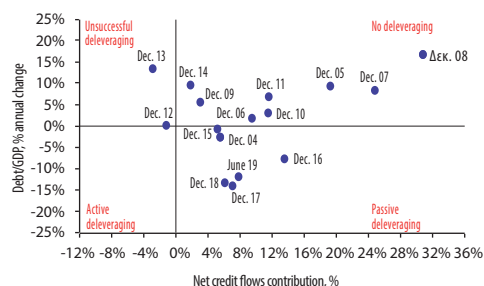
Finally, the increase in investment and in domestic consumption contributes to the further increase in real GDP, which then leads to a further reduction in the NFCs and households debt ratio (denominator effect).

5. Ways to achieve private debt deleveraging

The deleveraging of the balance sheets of both households and NFCs can be achieved

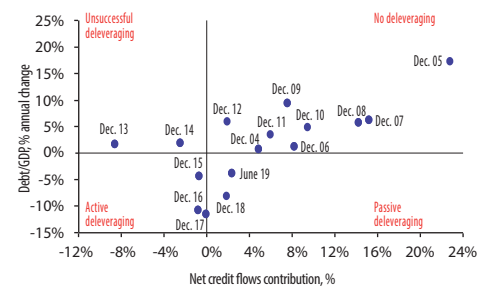
8. Based on data from the Insolvency Service of Cyprus Official Receiver of the Ministry of Energy, Commerce and Industry, total applications increased to 17508 from 2012 to 2018 compared to 10555 in the period 2005-2011.

CHART 8 Non-financial corporations debt



Sources: CBC (Quarterly Financial Accounts), Cystat.

CHART 9 Household debt



Sources: CBC (Quarterly Financial Accounts), Cystat.

ved in several ways. Analytically, the deleveraging modes can be determined based on the degree of deleveraging achieved through the active repayment of debt. In **Chart 8** and **Chart 9** the change in the debt ratio of NFCs and households is compared with the net credit flows to determine the mode of deleveraging:

- **“Active deleveraging”**: the decline in the ratio is essentially driven by negative net credit flows.
- **“Passive deleveraging”**: the debt to GDP ratio is reduced due to the “other changes”, whilst net credit flows are positive (i.e. new loans outweigh repayments, even though loan restructuring agreements continue to take place).
- **“Unsuccessful deleveraging”**: the ratio is growing despite negative net credit flows.
- **“No deleveraging”**: both the change in the debt to GDP ratio and net credit flows are positive.

As discussed in the previous section, NFCs

have passive deleveraging as the reduction in their debt is not driven by negative net credit flows (**Chart 8**). In other words, new loans continue to outperform repayments (positive net flows), while the reduction in the debt ratio is achieved mainly through other changes, such as NPFs write-offs and real GDP growth (**Chart 6**, p. 32).

In contrast, during the period 2015-2017, households registered active deleveraging, with negative net credit flows and a decrease in their debt ratio. After 2018, households also record passive deleveraging as the increase in new lending outweighs loan repayments (**Chart 9**).

The above conclusions highlight the need to intensify efforts for a more balanced reduction in private debt to levels in line with the size of the Cyprus economy. In 2018, following the sale agreement between Cyprus Cooperative Bank and Hellenic Bank, a large part of the NPFs were transferred out of the banking system. Although the above transaction

has significantly reduced the risks to the financial stability of the domestic banking system, the private sector remains heavily indebted, as households and NFCs continue to be burdened with their repayment. As a result, these loans continue to weigh on the real economy, with their majority being considered to be terminated loans.

6. Conclusions

The downward trend in household and NFCs debt should continue unabated, and it is a prerequisite for the further improvement of the financial system stability and the attainment of sustainable growth in the economy. Continuation of private debt deleveraging through consolidation of existing loans, the correction of banks' balance sheets and expectations for a long period of low interest rates, as a result of the ECB's expansionary monetary policy, are expected to boost new lending. Consequently, the new sound and healthy domestic credit expansion, is expected to have a positive impact on both private investment and private consumption, thus supporting the continuation of robust domestic economic growth.

The enhanced insolvency framework and the "Estia" scheme may accelerate the pace of private debt reduction. It should be noted, however, that the "Estia" scheme is faced with the most difficult NPFs portfolio, and its degree of success remains uncertain. At the same time, the various amendments passed by Parliament in the summer of 2019, in relation to the

insolvency law, for which a final ruling by the Supreme Court is still pending, are also a setback to the private debt deleveraging efforts. These amendments, aimed at overruling some of the earlier reform measures, are expected to significantly slow down these processes, making it more difficult for banks to collect their debts and jeopardise the current reduction process of NPFs and thus of private debt. Dealing with NPFs by other means, such as the sale of loans, may help to correct the banks' balance sheets, it does not however aid the reduction in private debt.

As a result, the organic reduction in NPFs remains a major challenge for the Cypriot authorities and the domestic banking sector in general. The use of all available tools to the authorities and the intensification of private sector loan repayments are critical to minimise the risks to the viability of domestic economic and financial growth and ensure that in the event of new shocks, the Cyprus economy will be shielded.

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administered efficiently and swiftly. It should also be noted that the CBC requires banks to ensure fair and proper implementation of the Arrears Management Directive and the code of conduct contained therein.

In line with the above, the October 2019 BLS results indicate that banks continue to maintain strict lending criteria at the levels reached in 2015. In particular, in 2019Q3 the credit standards for granting loans remained unchanged for both households and enterprises. In addition, banks do not expect any change in credit standards in 2019Q4. In 2019Q3, net demand for loans by households remained unchanged for all loan categories. Net demand by households, in all loan categories, is expected to remain unchanged in 2019Q4, that is, it will remain elevated at the high levels reached in 2019Q2. Net demand for loans by enterprises decreased in 2019Q3, reflecting one bank's idiosyncratic factors. Net demand for these loans is expected to increase again in 2019Q4 (Table A.3).

Interest rates

In general, the downward trend in interest rates in Cyprus continued in 2019Q3, as a result of the continued expansionary monetary policy of the ECB and the further expansionary measures adopted in September 2019. Historical low interest rates have contributed to the increased demand for new loans, from non-financial corporations, as also recorded in the Banking Lending Survey, with a consequent positive effect on the domestic economic activity.

TABLE A.3 Summary of BLS results

Summary of BLS results October 2019	Cyprus		euro area	
	2019 Q3	2019 Q4 (expectations)	2019 Q3	2019 Q4 (expectations)
Credit standards for loans				
Enterprises	Unchanged	Unchanged	Easing (slightly)	Unchanged
Households				
- Housing loans	Unchanged	Unchanged	Easing (slightly)	Unchanged
- Consumer credit and other lending	Unchanged	Unchanged	Tightening	Broadly unchanged
Demand for loans				
Enterprises	Decrease	Increase	Broadly unchanged	Broadly unchanged
Households				
- Housing loans	Unchanged	Unchanged	Increase	Increase
- Consumer credit and other lending	Unchanged	Unchanged	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 2019Q3) and the changes that are expected for the next three months (i.e. 2019Q4). The measure used for the statistical analysis of this survey is the diffusion index for the case of Cyprus, while for the euro area is the net percentage methodology.

Analytically, in September 2019 the domestic average interest rate on new loans to households for house purchase¹¹ decreased to 2,13% compared with 2,37% in September 2018 and 2,14% in the first half of 2019 (**Chart A.13**). A similar downward trend in the interest rate for consumption loans was recorded, reaching 2,80% in September 2019. The cost of new lending by domestic MFIs to euro area NFCs for amounts of up to €1 million also declined from 3,52% in September 2018 to 3,28% in 2019Q2 and then to 3,37% in September 2019 (**Chart A.14**).

During the period September 2018 – September 2019, the spread between domestic and euro area lending rates for housing loans declined by 10 basis points, whereas for NFCs it declined to a lesser extent, by 3 basis points. The two spreads currently stand at 67 and 148 basis points, respectively.

With respect to domestic deposit rates, the average interest rate¹² for new household deposits continued to decline and stood at 0,16% in September 2019 from 0,36% in March 2019 (**Chart A.15**). It should be noted that as from July 2019 domestic household deposit rates fell for the first time below the corresponding euro area interest rates, and stood at 0,25% in September 2019. The average interest rate on deposits for NFCs in September 2019 declined to 0,13% compared with 0,34% in 2019Q2 (**Chart A.16**, p. 39). In short, during the period September 2018 – September 2019, the spread between domestic and euro area deposit rates for households and NFCs declined by 41 and 56 basis points, respectively.

11. Euro-denominated loans from Cyprus MFIs with an initial rate fixation of up to one year.

12. 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)



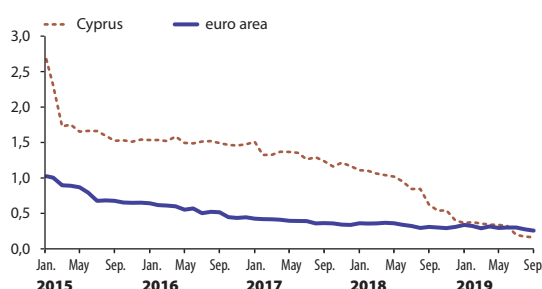
Sources: SDW (ECB), CBC.
(1) With floating rate and up to 1 year initial rate fixation.

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)



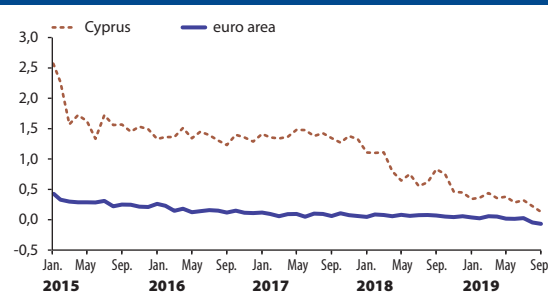
Sources: SDW (ECB), CBC.
(1) With agreed maturity up to 1 year.

To sum up, the historically low interest rates, which are expected to prevail for a long period of time, given the most recent monetary policy decisions of the ECB, are expected to have a positive impact on the real economy. It is noted that the prevailing favourable interest rates contribute to the successful management of existing loan contracts between banks and the private sector, either through restructurings or through further deleveraging by the private sector. As a result, they significantly aid the ongoing efforts of banks to consolidate their balance sheets.

Despite this, however, the prolonged low interest rate environment reduces the net interest rate margin of banks in the euro area, and this is particularly detrimental to Cypriot banks due to the fact that their business models rely heavily on net interest income. More specifically, the net interest rate has been on a downward trend since March 2014, registering an annual decline of 34 basis points over the period June 2018 - June 2019 (latest available data) from 2,3% to 1,9%. In addition, in an environment of ample bank liquidity, and over-indebted domestic private sector, which limits the possibility of sustainable new lending, prolonged low interest rates render an additional risk to banks' profitability, as banks are required to maintain a high amount of deposits at the ECB at a negative interest rate. The ongoing pressures on bank profitability and competition for new sustainable lending, could potentially lead to alternative yield-seeking strategies, easing of lending criteria, increased probability of excessive risk-taking

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.

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1

Introduction

2

Macroeconomic
Developments
and Projections

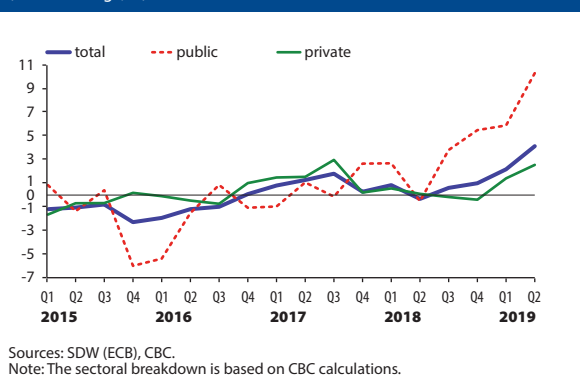
and under-pricing of credit risk, with a subsequent negative impact on the stability of the banking sector in Cyprus and generally in the euro area.

In light of the above risks, in the September 2019 monetary policy decisions, the ECB has taken an additional measure to mitigate the negative effects of further monetary policy easing. Specifically, as mentioned above, the ECB adopted a two-tier system, under which part of the excess liquidity held by banks as reserves would be excluded from the negative deposit facility interest rate, thereby reducing the negative effects on their profit. Both the CBC and the ECB will evaluate these risks at a European level at regular time intervals, in order to ensure that the net impact of the low interest rate environment remains positive and in line with the ECB medium-term objective of maintaining price stability.

Labour costs

Despite robust GDP growth in recent years, labour costs recorded a modest increase owing to the scope for further reduction in unemployment. Nevertheless, a notable rise has been registered in the most recent quarters. In particular, nominal compensation per employee rose by 3,2% in 2019H1, following a slight increase of 0,2% in 2018H1 (**Chart A.17**). The recent introduction of contributions towards the GHS adds to the rise in labour costs as from 2019Q2. Specifically, compensation per public sector employee rose by 8,1%, while a slight increase of 2% was recorded in compensation per

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

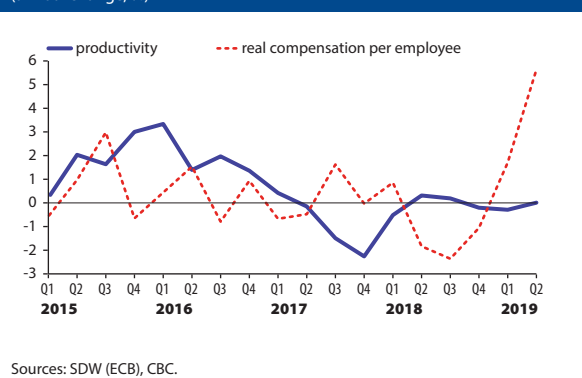


private sector employee. In addition to the impact emanating from the introduction of contributions towards the GHS, developments in compensation per public sector employee are attributed to the gradual restitution of crisis-era cuts in wages and pensions as of 1 July 2018, the recruitment of employees in the healthcare sector and wage increases owing, including among others, to promotions across the civil service. Developments in nominal compensation per employee in the private sector are primarily driven by increases registered in the sectors of trade, transportation, hotels and restaurants. A more pronounced rise in nominal compensation per private sector employee is expected in the coming quarters owing to the finalisation of collective agreements in specific segments of the private sector (banks, construction, hotels), with retroactive application as from the beginning of 2019.

At the same time, price developments during 2019 increased households' purchasing power, with real compensation per employee¹³ recording a year-on-year rise of 3,6% in 2019H1, following a slight decrease of 0,5% in 2018H1 (**Chart A.18**). Productivity, calculated as the change in real GDP per employed person, recorded a marginal annual decline of 0,1% both during the period under review as well as in 2018H1 (**Chart A.18**).

The aforementioned significant increase in labour costs is reflected in developments in the unit labour cost index, an important competitiveness indicator for an economy vis-à-vis competitor economies. Unit labour costs, determined by the difference in nominal compensation per employee growth and

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



13. It should be noted that the deflator used is that of private consumption rather than the CPI.

productivity growth, recorded a year-on-year rise of 3,3%, following a 0,3% increase in 2018H1 (Chart A.19a). Nevertheless, and despite the significant increase recently observed, significant cumulative wage reductions as from 2012 and beyond the crisis years, helped maintain the competitiveness of the Cyprus economy over the medium term. Specifically, the index recorded a cumulative decline of 13,4% over the period 2013-2016, and is lower than the corresponding euro area index as of 2013 (by about 16 percentage points in 2018, Chart A.19b).

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)¹⁴ terms, as calculated by the IMF. Both indices register a weakening trend since October 2018 and up to the first nine months of 2019. 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

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

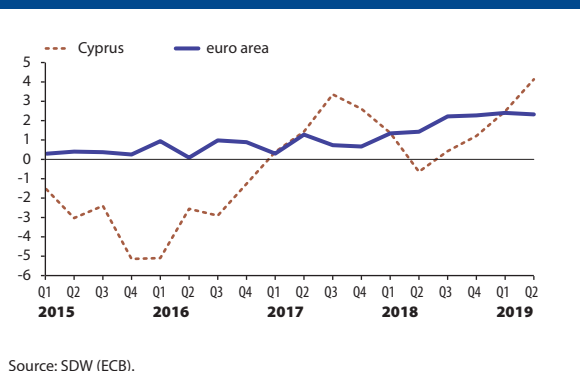


CHART A.19(b) Unit labour costs: Cyprus and the euro area
(index 2010=100)

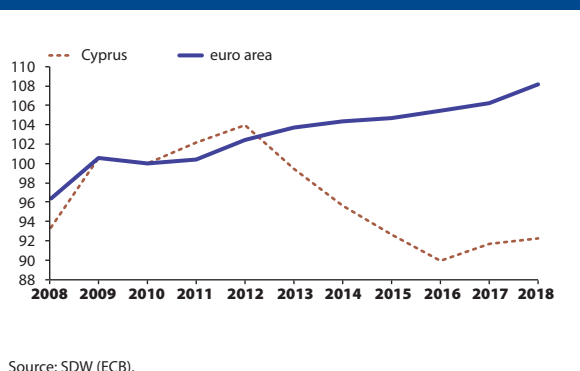
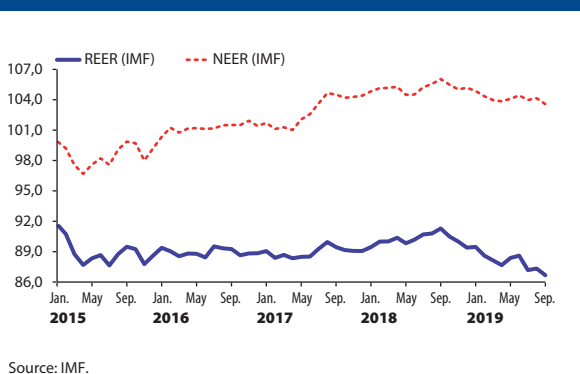


CHART A.20 Real and nominal effective exchange rates (IMF weights)
(base year 2010=100)



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

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 in the recent years has reduced unit labour costs for the whole economy, thus improving competitiveness and supporting the recovery of the Cyprus economy in the medium term.

Balance of payments^{15,16}

In 2019H1, the current account deficit deteriorated, reaching €791,4 million (7,4% of GDP), compared with a deficit of €77 million (0,7% of GDP) in the corresponding period of the previous year (Table A.4 and Chart A.21). This development is mainly attributed to the widening of the goods deficit (in particular SPEs transactions), and the simultaneous decrease in the surplus of the services balance. The current account deficit, adjusted for the impact of SPEs, also worsened and reached €845,5 million (7,9% of GDP), compared with -€513,8 million (-4,9% of GDP) in 2018H1 (Table A.4 and Chart A.21).

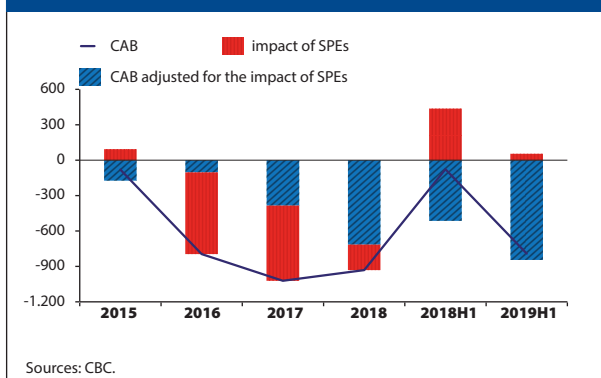
More specifically, the trade deficit of goods increased in 2019H1, reaching €2.230,7 million, compared with a deficit of €1.697,3 million in the corresponding period of the

TABLE A.4 Balance of payments (main categories)

	2018H1 (€ million)	2019H1 (€ million)	Change (€ million)
Current account balance	-77,0	-791,4	-714,4
Current account balance adjusted for the impact of SPEs	-513,8	-845,5	-331,7
Goods and services balance	504,4	-281,1	-785,5
Trade balance	-1.697,3	-2.230,7	-533,4
Exports of goods	2.313,1	1.605,2	-707,9
of which:			
Exports of goods - SPEs	1.267,4	625,9	-641,5
Imports of goods	4.010,4	3.835,9	-174,5
of which:			
Imports of goods - SPEs	1.036,1	700,0	-336,1
Services balance	2.201,7	1.949,6	-252,1
Exports of services	5.307,7	5.638,2	330,5
Imports of services	3.106,0	3.688,6	582,6
Primary income (net)	-379,4	-385,0	-5,6
Secondary income (net)	-202,0	-125,3	76,7
Current account balance (% of GDP)	-0,7	-7,4	
Current account balance adjusted for the impact of SPEs (% of GDP)	-4,9	-7,9	

Sources: Cystat, CBC.

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



Sources: CBC.

15. 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.

16. In October 2019, historic data on external statistics from 2008Q1 were revised, according to the Harmonised European Revision Policy.

previous year, mainly due to the decrease in exports of goods. This was primarily attributed to SPEs transactions and to a lesser extent to the decrease in exports of domestic goods (Table A.4, p. 43). Moreover, imports of goods (excluding SPEs imports) increased, driven by the growth in domestic demand including investments (gross fixed capital formation). More specifically, imports of intermediate inputs, as well as, consumer and capital goods increased.

The surplus of the services balance decreased in 2019H1 and reached €1.949,6 million, compared with €2.201,7 million in the corresponding period of the previous year. This was mainly due to the proportionally larger increase recorded in imports of services compared with the rise recorded in exports of services (Table A.4, p. 43). Exports of services are important for analysis purposes, as Cyprus is a tourist destination and a business centre.

More specifically, in 2019H1 exports of services (Table A.5) recorded an annual increase of 6,2% (€330,5 million), mainly driven by the category of telecommunications, computer and information services (€282,4 million). The aforementioned category recorded an increase, due to the rise in the turnover of the companies operating in the sector. Similarly, increases in the corresponding category of imports can also be attributed to the above factor. Other business services (€31,2 million) and transport (€15,7 million) rose, while financial services decreased by €30 million as a result of the change in the European Securities and Markets Authority (ESMA) legislation regar-

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

	2018H1	2019H1	Change
Services balance	2.201,7	1.949,6	-252,1
Exports of services	5.307,7	5.638,2	330,5
<i>of which:</i>			
Transport	1.481,5	1.497,2	15,7
Travel	1.129,0	1.095,3	-33,7
Financial services	1.428,9	1.398,9	-30,0
Telecommunications, computer and information services	906,7	1.189,1	282,4
Other business services	85,5	116,7	31,2
Imports of services	3.106,0	3.688,6	582,6
<i>of which:</i>			
Transport	826,6	863,3	36,7
Travel	570,4	610,1	39,7
Financial services	672,9	684,1	11,2
Telecommunications, computer and information services	486,6	918,3	431,7
Other business services	245,3	292,9	47,6

Source: CBC.

ding the trading of specific financial products impacting the financial services category up to 2019Q1. The travel category, which includes revenues from tourism, recorded a small decrease of €33,7 million, due to the reduction in daily per capita expenditure together with the decrease in the number of tourist arrivals, in 2019H1. On the basis of available data for the first eight months of 2019, revenues from tourism have decreased, and as a result, only a moderate growth is expected to be registered in the tourism sector in 2019 (see Tourism, p. 46).

In 2019H1, imports of services increased by 18,8% (€582,6 million) compared with the corresponding period of the previous year, mainly in the category of telecommunications, computer and information services (€431,7 million) as explained above. The remaining main categories of imports also recorded increases. More specifically, increases were recorded in other business services (€47,6 million), travel (€39,7 million), transport (€36,7 million), and financial services (€11,2 million) (**Table A.5**, p. 44).

The primary income account (which mainly includes income from employment and investment) recorded a deficit of €385 million, remaining mostly unchanged compared with the deficit of the corresponding period of the previous year. The deficit is mainly attributed to the category of other investments. The deficit in the secondary income account (which mainly includes current transfers) was reduced, both due to the category of other sectors and the increase in the government revenues. (**Table A.4**, p. 43).

The current account deficit in 2019H1, was

mainly covered by transactions of the private sector and to a lesser extent by government borrowing.

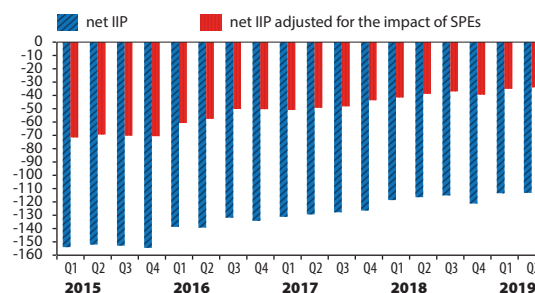
The net international investment position (IIP) in 2019H1 was negative standing at -€24,8 billion (-112,3% of GDP) (Chart A.22). The IIP was negatively affected by the inclusion of the economic transfer of mobile transport equipment (mainly ships) by SPEs registered in Cyprus. These companies have significant 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 2019H1 drops by 78,6 percentage points, standing at -€7,5 billion or -33,7% of GDP, compared with -€8,2 billion or -38,9% of GDP in 2018H1 (Chart A.22). It is noted that, in 2019H1, the net IIP as a percentage of GDP was below the threshold set by the European Commission.

Tourism

Tourism constitutes one of the most important pillars of the Cyprus economy. External factors adversely affected tourism, resulting to a moderate growth of the sector in 2019. The Cyprus tourism industry had to compete with the re-opening of major competitor destinations, such as Turkey and Egypt. Having said that, the quality of the tourism

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



Sources: Cystat, CBC.

product has been upgraded through hotel renovations and new infrastructure, such as the construction of marinas and luxurious hotels. Furthermore, the temporary casinos started operating in the second half of 2018. With the construction of the casino resort by 2021, increased tourist arrivals are expected from existing and new markets.

In the first ten months of 2019, tourist arrivals increased slightly by 0,6% reaching 3,7 million tourists, following four consecutive years of significant increases (Table A.6 and Chart A.23). Tourist arrivals during the summer months (July and August), which have the biggest weights in the year, contributed to the reversal of the negative trend, in the first half of 2019 to positive growth rates. Regarding individual markets, arrivals from Russia decreased by 0,5% reaching 0,7 million tourists in the first ten months of 2019. Arrivals from the United Kingdom decreased marginally by 0,3% reaching 1,2 million tourists, despite the bankruptcy of the British Thomas Cook in September 2019. Arrivals from other important markets, such as Greece and Germany, also decreased with the latter being negatively affected by the closing down of two airlines. Increases were recorded from Israel and Ukraine.

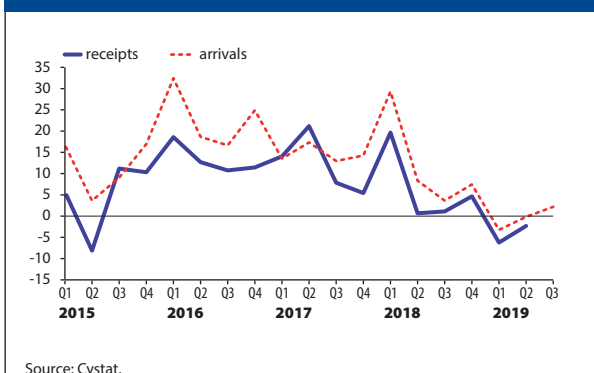
In the first eight months of 2019, revenues from tourism recorded a decrease of the order of 1,7%, as a consequence of the 2,3% decrease in per capita expenditure of tourism. This development is mainly attributed to the decrease in the average length of stay from 9,2 days to 9,0 days, while the daily per capita expenditure remained almost unchanged,

TABLE A.6 Tourism

	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2017	3.652,1	2.639,1	722,6
2018	3.938,6	2.710,1	688,1
annual % change	7,8	2,7	-4,8
2018 Jan. - Aug.	2.719,6	1.889,7	694,8
2019 Jan. - Aug.	2.735,8	1.856,8	678,7
annual % change	0,6	-1,7	-2,3
2018 Jan. - Oct.	3.673,4	n/a	n/a
2019 Jan. - Oct.	3.697,1	n/a	n/a
annual % change	0,6	n/a	n/a

Source: Cystat.

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



Source: Cystat.

recording an annual marginal increase of 0,1% (Table A.6, p. 47).

On the basis of available data and prospects of the tourism sector, a moderate growth of tourist arrivals is expected to be registered in 2019. The challenges of a possible Brexit and the recovery of major competitor destinations remain. The bankruptcy of the British Thomas Cook is expected to affect only the remaining months of 2019, while in 2020, the gap is expected to be covered by other British tourist agents.

2.3 Domestic Demand, Production and the Labour Market

Quarterly national accounts^{17,18}

The Cyprus economy recorded a decelerated rate of growth of 3,1% in 2019H1, compared with 4,4% in 2018H1 (Table A.7). Based on the latest preliminary (seasonally adjusted) data, real GDP recorded a year-on-year growth of 3,1% in the first nine months of 2019.

All GDP expenditure sub-categories, except exports, rose in 2019H1 (Table A.7). The year-on-year increase in private consumption by 3,7% reflects the growth in disposable income of households, mainly due to the increase in employment and, to a lesser extent, the rise in wages. It should be noted that a significant increase in wages

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

	2017	2018	2018H1	2019H1
GDP	4,4	4,1	4,4	3,1
Private consumption	4,5	3,3	3,4	3,7
Public consumption	2,1	3,5	-2,0	11,7
Gross fixed capital formation	24,1	-6,6	-19,4	32,3
Exports of goods and services	8,7	4,6	12,7	-4,2
Imports of goods and services	12,8	2,4	5,0	4,6

Source: Cystat.

17. 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.

18. In October 2019, CYSTAT implemented a major revision of the National Accounts, in accordance with the Harmonised European Revision Policy and the National Revision Policy.

was recorded as of 2019Q2 (see Labour costs). In addition, growth in private consumption was supported by a small increase in consumer loans. Public consumption rose by 11,7% due to increases in compensation of employees (see Labour costs) and intermediate consumption, which were partially offset by a rise in revenue from the sale of goods and services. The increase in intermediate consumption was driven by relevant expenditure incurred by the state-owned asset management company (KEDIPEs) that resulted following the finalisation of the CCB deal¹⁹. The year-on-year increase registered in gross fixed capital formation (32,3%) and imports of goods and services (4,6%) as well as the decline in exports (4,2%) are largely due to the impact of SPEs.

Adjusted for the impact of SPEs, GDP growth in 2019H1 was primarily driven by the aforementioned rise in private consumption, while gross fixed capital formation and public consumption also contributed to growth but to a smaller degree. Specifically, growth in gross fixed capital formation decelerated in the period under review following a significant rise recorded in 2018H1 due to the completion of various projects. Many of these projects are foreign owned and/or are funded by an inflow of foreign capital, thus there is no corresponding increase in domestic borrowing. Exports, adjusted for the impact of SPEs, recorded a year-on-year increase compared with a marginal growth registered in 2018H1, mainly owing to the significant rise in revenue from the telecommunications, computer and information services sectors (see Balance of payments), which was partially offset by a

19. The Cyprus Asset Management Company Ltd (KEDIPEs) has been included in the general government accounts as of September 2018.



decline in exports of goods. The decline in tourism revenue was mainly due to the decrease in per capita expenditure (see Tourism and **Chart A.23**, p. 47). Imports recorded a significant acceleration in 2019H1, following a slight increase in 2018H1, primarily owing to the rise in imports for services (in particular telecommunications, computer and information services) and, to a lesser extent, in imports for goods.

From a sectoral point of view, economic growth remains broad-based (**Table A.8**). The most significant contribution to GDP growth in 2019H1 originated from the construction sector (with the contribution of the aforementioned sector reaching 0,9 percentage points). The sectors of information and communication (0,7 percentage points), trade, transportation, hotels and restaurants (0,6 percentage points) as well as professional, scientific and administrative activities (0,5 percentage points) also contributed to GDP growth. A negative contribution was recorded only by the financial and insurance activities sector (0,6 percentage points), owing to two factors. Firstly, due to the transfer of a significant share of NPFs off banks' balance sheets via the agreement associated with the CCB, as well as the sale of NPF portfolios by other banks to non-financial institutions (in particular the Bank of Cyprus' "Helix" project). Secondly, due to the decline in exports of financial services linked to the European Securities and Markets Authority (ESMA) regulation (see Balance of payments).

Recent economic indicators point to continued positive developments in the economy, albeit at a decelerating trend. GDP

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

	2017	2018	2018H1	2019H1
GDP (%)	4,4	4,1	4,4	3,1
Construction	0,9	1,3	1,1	0,9
Trade, transportation, hotels and restaurants	1,8	1,2	1,4	0,6
Financial and insurance activities	-0,7	-0,6	-0,4	-0,6
Professional, scientific and administrative activities	0,4	0,6	0,6	0,5
Other sectors ⁽¹⁾	2,0	1,6	1,7	1,7

Source: Cystat.

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

growth closely follows developments in the Economic Sentiment Indicator (ESI), which points to the continuation of a markedly positive, albeit slightly slowing, growth rate for 2019. Specifically, the ESI reached 110 in October 2019 compared with 111,5 in October 2018 and 115,3 in December 2018 (Table A.9). In general, the decline in the index recorded in the first ten months of 2019 was mainly driven by changes in confidence in the services sector.

The private consumption path is captured by various economic indicators, which, overall, point to a stabilising trend. Also, according to the National Accounts, growth in private consumption is recording increases. The turnover index of retail trade registered a year-on-year rise of 3,2% in the first eight months of 2019, following a 6,6% increase in the corresponding period of 2018 (Chart A.24). Regarding credit card payments, spending by Cypriot cardholders in Cyprus (adjusted for payments associated with government services and petroleum products) recorded a year-on-year rise of 12,2% over January-October 2019 compared with growth of 13,5% in the corresponding period of 2018 (Chart A.25). The annual decline of 5,5% in motor vehicle registrations over the first ten months of 2019 is associated with expectations of changes in vehicle taxation (ultimately adopted in March 2019) based on emissions (Chart A.26, p. 52). As such, this decrease is not expected to continue in the coming months. In addition, car sales will also be supported by the approval by the Council of Ministers (15 November 2019) of a new scheme associated

TABLE A.9 Business and consumer surveys: confidence indicators

(for sub-indices: difference between percentage of positive answers and percentage of negative answers)

	2018 Dec.	2019 Mar.	2019 June	2019 Sep.	2019 Oct.
ESI	115,3	109,2	110,2	112,3	110,0
Industry	12	3	9	7	9
Services	44	28	24	33	26
Consumer	-6	-8	-8	-4	-9
Retail trade	2	0	2	-3	-4
Construction	-11	-9	-4	-3	-2

Source: European Commission.
Note: Seasonally adjusted data.

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

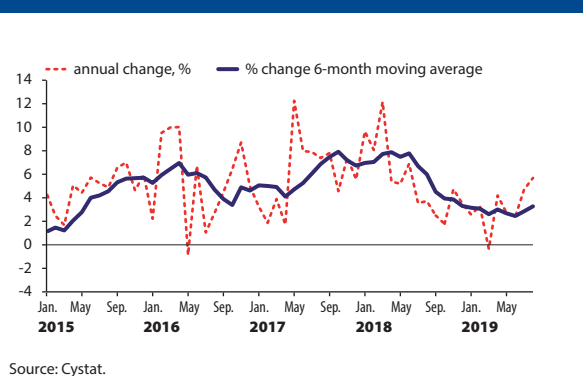
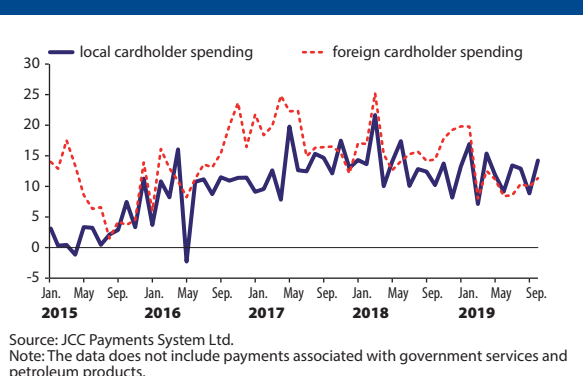


CHART A.25 Credit card spending in Cyprus
(annual change, %)



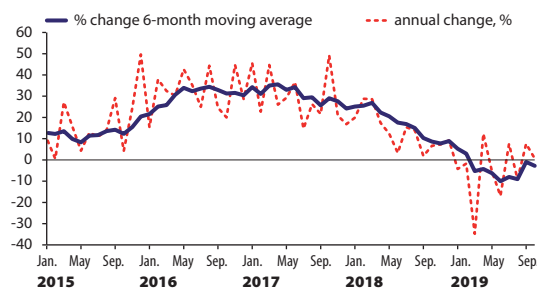
with the withdrawal of old cars and tax incentives for the purchase of an electric one.

As previously mentioned, private sector investment projects have made an important contribution to the improvement of the domestic economic climate. Several indicators in relation to the real estate market point to rising activity in the construction sector and increasing demand for real estate (see Real estate market and **Table A.10**). Important projects are in the process of implementation and include renewable energy generation infrastructure, various residential, commercial and mixed developments, marinas, hotel units and the casino resort, although the construction of the latter has only just begun.

In relation to external demand for services, tourism receipts recorded a year-on-year decline of 1,7% in the first eight months of 2019, due to the aforementioned decrease in per capita expenditure (see Tourism). However, foreign credit cardholders' spending in Cyprus rose by 11% in the first ten months of 2019 (**Chart A.25**, p. 51). In the field of professional services, the number of new company registrations in Cyprus recorded a year-on-year decline of 12,7% over January-October 2019. This development may be related to the more stringent supervisory measures adopted with regard to shell companies. However, it should be noted that the number of new company registrations recorded continuous annual increases over the period 2014-2018.

At the same time, the granting of new loans has contributed to the positive path of the economy. Specifically, new lending is continuing, with new loans to the non-

CHART A.26 Registration of motor vehicles



Source: Cystat.

TABLE A.10 Real estate sector

(annual change, %, unless otherwise stated)

	Jan.-Oct. 2018	Jan.-Oct. 2019	Oct. 2018	Sep. 2019	Oct. 2019
Sales contracts (total)	19,5	13,7	5,6	0,7	0,2
Sales contracts (locals)	na	22,0	na	5,7	19,4
Sales contracts (foreigners)	na	4,7	na	-5,6	-19,1
Building sentiment indicator (average of index)	-14,2	-5,7	-7,7	-2,5	-2,2
Property price expectations for the next 3 months (average of index)	11,0	16,4	13,8	22,7	11,0
Price index of construction materials	1,8	1,0	2,3	0,5	0,2

Sources: Cystat, DLS, European Commission.

financial private sector rising to slightly higher levels in the first nine months of 2019 compared with the corresponding period of the previous year. At the same time, loan repayments have constrained the annual growth in loans to the domestic private sector to low but positive levels (**Chart A.12**, p. 25). The consolidation and restructuring of the banking system (see Monetary aggregates) is expected to support economic growth and to strengthen the capability of the Cyprus economy to address unexpected or external risks.

Real estate and construction sector

The real estate sector in Cyprus continues to recover, registering a positive course in the first ten months of 2019. Foreign investment, new domestic borrowing and the reduction of unemployment have helped the sector to recover further. Demand for real estate, despite a sharp increase in the first months of 2019, subsequently declined, following the adoption of stricter eligibility criteria for the Cyprus Investment Program. Despite the continued significant recovery of the real estate sector, as well as of the Cyprus' GDP, residential property prices are rising moderately, with the exception of areas affected by specific factors, such as the Limassol and Larnaca coastal fronts. The moderate increases at an aggregate level have led the European Systemic Risk Board (ESRB)²⁰ to classify the residential real estate sector in Cyprus at a recovery stage and assess the likelihood of downside risks as

20. <https://www.esrb.europa.eu/pub/pubbydate/2019/html/index.en.html>

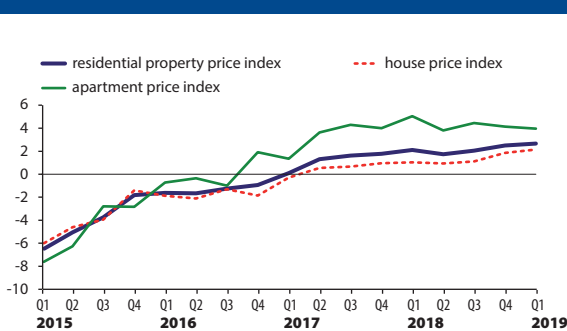


limited. However, areas with high price increases require close monitoring, as well as monitoring for potential spillovers to other areas.

The contribution of the construction sector to Cyprus GDP growth stood at 0,9 percentage points in 2019H1, while the real estate sector (construction and real estate activities) accounted for 1 percentage point of GDP, during the same period. In addition, according to Cystat data, residential investment worth € 760 million (7.1% of GDP) were made in 2019H1, as well as investments in other buildings and constructions worth €473 million (4,4% % of GDP). Based on the above, it should be emphasised that the construction activity observed in Cyprus is not only due to residential projects, but also to productive constructions such as marinas, offices, shopping malls, hotels and renewable energy projects that increase potential GDP.

Residential property prices continued their upward trend in 2019Q1. According to the revised CBC²¹ Residential Property Price Index data, residential property prices recorded a 0,7% increase on a quarterly basis and a 2,7% increase on a yearly basis (**Chart A.27**). The largest increase in sub-indices in the first quarter of 2019 was recorded in the Larnaca apartment price index (9,5%), which for the first time recorded a higher annual increase than the apartment price index in Limassol (7,3%). According to a more thorough analysis of the data, large increases are observed in specific coastal areas of both Limassol and Larnaca, with little diffusion of increases in the remaining segments of each district. In addition, Cystat's house price

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



Source: CBC.

21. Further information on the revision of the indices can be found in the Residential Property Price Index report of 2019Q1, available at: https://www.centralbank.cy/images/media/pdf_el/RPPI-2019Q1-GR0003.pdf

index, which is based on a different methodology and on actual transaction data, recorded an annual growth rate of 4,3% and 8% in 2019Q1 and 2019Q2, respectively. The analysis of the European Central Bank on the valuation of residential real estate prices in the Eurozone is of particular interest, in which Cyprus appears to have undervalued house prices by between 7% and 12% in 2018Q3²².

According to the latest data, the positive trend of the sector is expected to continue. Specifically, according to the sales figures of the Department of Land and Surveys (DLS), sales increased 13,7% year-on-year for the period January - October 2019 (**Table A.10**, p. 52). During the same period, the number of sales to local and foreign buyers saw an annual increase of 22% and 4,7%, respectively, indicating that demand for real estate comes from both local and foreign buyers. However, if we divide this period into before (January - May 2019) and after (June - October 2019) the adoption of stricter criteria for the Cyprus Investment Program, we observe a year-on-year 48,1% increase and a 5,1% decrease in demand for locals, respectively and a year-on-year increase of 20,2% and a decrease of 8,5% for foreigners, respectively.

The recovery of the real estate sector is also supported by new lending to households for the purpose of house purchase. According to the CBC Bank Lending Survey (**Table A.3**, p. 37), there is still significant demand for home mortgages, although in 2019Q2 it remained unchanged compared to the previous quarter. In addition, according to the CBC's Monetary and Financial Statistics, new

22. Available at: <https://sdw.ecb.europa.eu/browse.do?node=9689359>

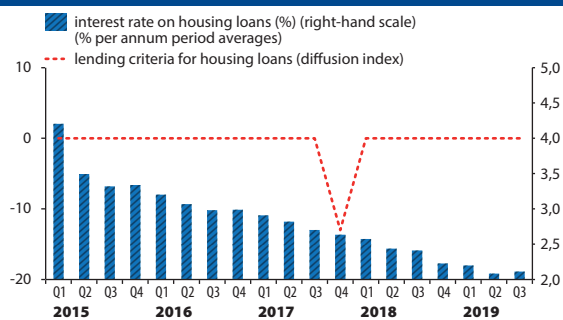


housing loans in the period January-September 2019 amounted to €675 million, which stands at a similar level compared with the same period last year. Demand for borrowing is expected to continue to recover while unemployment declines, wages in the labour market increase and the environment of low interest rates continues (**Chart A.28**). The lending criteria remain at the strict levels adopted before 2015 (**Chart A.28**), thus ensuring to a large extent that new loans will be viable.

Construction continued its upward trend, with the index of production in construction of buildings, published by Cystat, recording an annual increase of 24,8% in 2019Q2. Increased construction activity is expected to continue in the future, as the number of authorised building permits recorded an annual increase of 11,3% for the period January - August 2019, especially for residential projects, as the annual increase in building permits for dwellings increased by 46,6% for the same period.

According to the European Commission's Business and Consumer Surveys, the market is expecting a further rebound in property prices, as the index of property price expectations averaged at 16,4 in the period January-October 2019, compared with 11 in the respective period of 2018 and 3,8 in 2017 (**Table A.10**, p. 52). Other indicators relevant to the real estate sector included in these surveys are also improving, a more detailed analysis of which is contained in the CBC's quarterly publications of the Residential Property Price Index.

CHART A.28 Lending criteria and interest rate on housing loans



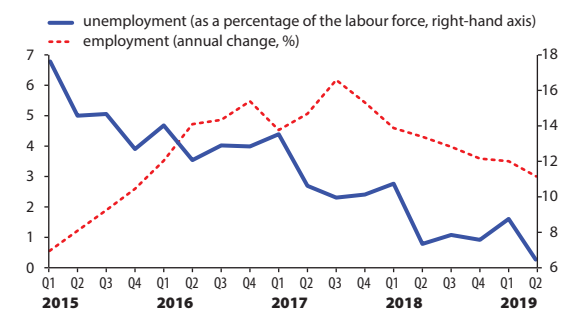
Source: CBC.
Note: The higher the positive number in the lending criteria series the tighter the criteria.

Labour market

In line with the GDP path, employment decelerated reaching a year-on-year growth of 3,2% in 2019H1, following a rise of 4,4% in the previous year (**Chart A.29**). The increase 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 LFS, this improvement was largely owing to the rise in employment of Cypriots and, to a lesser extent, of non-Cypriots. The significant increase in non-Cypriot employment in 2019Q2, due to the influx of EU workers in the hotel and construction sectors, was mainly the result of staff shortages in the specific sectors. Total hours worked rose by 3,7%, following a year-on-year increase of 3% in 2018H1. As a result, hours worked per employed person dropped by 0,7% in 2019H1, following a 0,3% decrease in the corresponding half of the previous year.

As a consequence of the aforementioned developments, a significant improvement in unemployment was also recorded. According to the LFS, the unemployment rate reached 6,5% of the labour force in 2019Q2, compared with 7,3% in the corresponding quarter of the previous year (**Chart A.29**). This is almost entirely attributed to the decline in the number of unemployed Cypriots, which partly explains the rise in employment of Cypriots. According to seasonally adjusted data, the unemployment rate in Cyprus fell below the euro area average. At the same time, the youth unemployment rate fell to 14,9% in 2019Q2, down from 17,9% in the corre-

CHART A.29 Unemployment and employment



Source: Cystat (LFS).

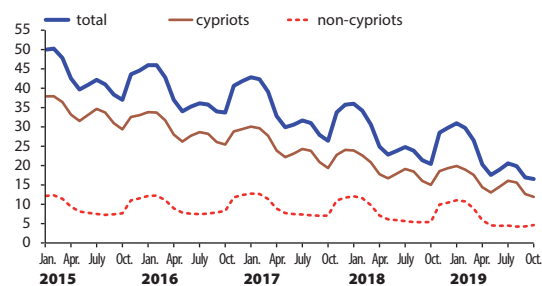
sponding quarter of the previous year. Youth unemployment constitutes only about 1,2 percentage points of the total unemployment rate for the quarter in question. According to EUROSTAT data concerning the harmonised unemployment rate (seasonally adjusted data), the percentage of unemployed fell to 6,6% in September 2019 down from 8% in the corresponding month of 2018. The downward trend in unemployment is also confirmed by the number of registered unemployed (**Chart A.30**), which in October 2019 recorded a year-on-year decline of 19,1% (from 20.447 to 16.544 persons).

An important development is associated with the decline in the number of long-term unemployed given that, in periods with persistent high unemployment, the long-term unemployed find it harder to re-integrate into the labour market. According to the LFS, the unemployment rate with a duration of six months and over fell to 3,2% in 2019Q2, down from 4,1% in the corresponding quarter of the previous year (**Chart A.31**). The most recent CYSTAT data, shows that the relevant number of registered unemployed recorded a decline of 2.686 individuals in October 2019, compared with the corresponding month of 2018. Overall, all relevant economic data suggest that the labour market, in line with the positive GDP growth path, continues to recover at a steady pace and has reached conditions that are closely associated with full-time employment.

2.4 Domestic Fiscal Developments

According to preliminary data published by

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



Source: Cystat.

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



Source: Cystat (LFS).

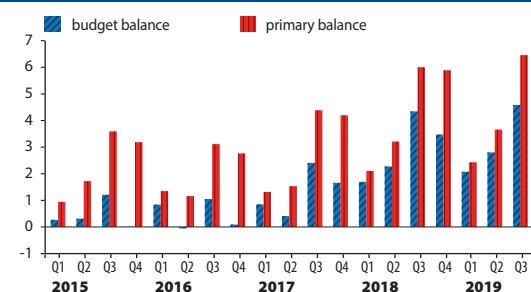
Cystat for the first nine months of 2019, the strong fiscal performance continued, with the budget balance recording a surplus of 4,6% of GDP. In contrast, the respective period of 2018 recorded a deficit of 3,5% of GDP, which, however, was affected by the cost of facilitating the deal between the CCB and Hellenic Bank²³. Respectively, the primary surplus recorded a surplus 6,5% of GDP for the first nine months of 2019 compared with a deficit of 1,8% of GDP for the same period of 2018²⁴ (Chart A.32).

In 2017-2018, the annual growth in revenue was significantly higher than the expenditure growth (Chart A.33), allowing for the realisation of significant surpluses in the aforementioned period. In the third quarter of 2019, the cumulative revenue growth continues to be higher than the growth in cumulative expenditure²⁵. It should be noted that the strong growth in revenue as well as in expenditure in 2019, are mainly due to the GHS-related contributions and expenses.

In particular, the increased surplus in the first nine months of 2019 is due to the significant increase in total revenue (12%) and the base effect of the cost of facilitating the deal between the CCB and Hellenic Bank (-7,3% of GDP) (Table A.11, p. 60). Total revenue increased mainly due to the increase in social contributions as a result of the implementation of the General Healthcare System (GHS). Contributions to the system started in March 2019, while the GHS started supplying services in June 2019, which

CHART A.32 Budget and primary balances of the general government

(cumulative for the period as from Q1 as a percentage of GDP)

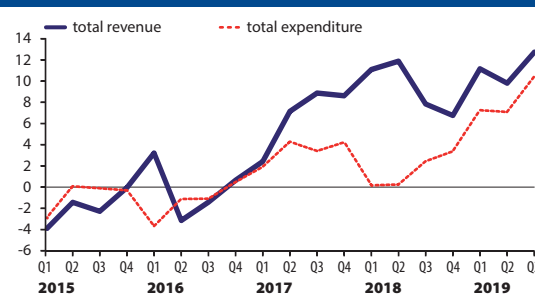


Sources: Cystat, CBC.

Note: The budget and primary balance for 2015Q4 (€175 million) and for 2018Q3 (€1,7 billion) do not include the fiscal impacts associated with the Cyprus Cooperative Bank (CCB).

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 for 2015Q4 (€175 million) and for 2018Q3 (€1,8 billion) do not include the fiscal impacts associated with the Cyprus Cooperative Bank (CCB). Total revenue for 2018Q3 (€0,1 billion) also do not include the associated impact.

23. Adjusting for the aforementioned impact, the budget balance for the first nine months of 2018 recorded a surplus of 3,8% of GDP.

24. Adjusting for the fiscal impact of the deal between the CCB and Hellenic Bank, primary surplus for the first nine months of 2018 recorded a surplus of 5,4% of GDP.

25. The expenditure for the third quarter of 2018 excludes the fiscal impact of the deal between the CCB and Hellenic Bank (base effect).

affected positively the budget balance by 0,5% of GDP. During the aforementioned period, direct taxes also recorded significant increases reflecting the improved conditions in the labour market and the economy in general.

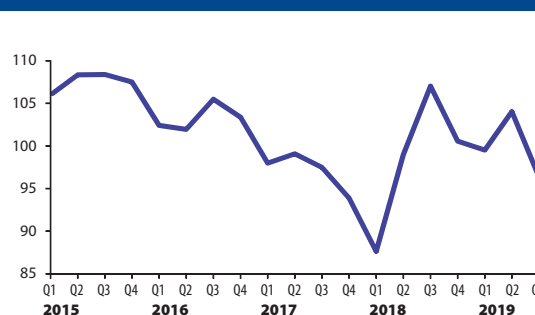
Adjusting for the impact of the support measures for the deal between the CCB and Hellenic Bank, total expenditure for the first nine months of 2019 recorded an increase of 10,4% compared with the respective period of 2018. This increase is mainly due to the increase in social transfers (12,1%), compensation of employees (9,3%) and intermediate consumption (26,8%) (Table A.11). The magnitude of the increase in social transfers reflects mainly the implementation of GHS and to a lesser degree the increase in the contribution rates of the Social Security Fund. The increase in employees' compensation mainly reflects the gradual restitution of public wages after the wage cuts implemented during the economic crisis, the reinstatement of the increments and the cost-of-living allowance, the introduction of GHS contributions that affected the contributions of the State as an employer, and the filling of promotion positions that were frozen in the previous years. The increase in intermediate consumption mainly reflects the inclusion of KEDIPEs in the accounts of the general government.

Regarding public debt (Chart A.34), it stood at 96,3% of GDP in September 2019, recording a decrease of more than 4 pps compared with December 2018. This is mainly due to the strong budget surpluses that allowed the early repayment of the Russian

TABLE A.11 Accounts of general government

	Jan.-Sep. 2018 (€ million)	Jan.-Sep. 2019 (€ million)	Change %
EXPENDITURE			
Intermediate consumption	471,2	597,5	26,8
Compensation of employees	1.697,7	1855,9	9,3
Social transfers	1.919,2	2151,2	12,1
Interest	350,5	414,0	18,1
Subsidies	30,3	31,8	5,0
Other current expenditure	321,2	389,1	21,1
Gross fixed capital formation	1.003,7	167,2	-83,3
Other capital expenditure	897,0	45,6	-94,9
Total expenditure	6.690,8	5.652,3	-15,5
Total expenditure as a % of GDP	31,7	25,6	
REVENUE			
Taxes on production and imports	2.520,8	2.559,5	1,5
Current taxes on income, wealth, etc	1.359,5	1.498,2	10,2
Social contributions	1.340,9	1.762,5	31,4
Other current resources	135,7	139,7	2,9
Sales	422,8	452,1	6,9
Capital transfers received	95,1	156,1	64,1
Property income	74,8	97,7	30,6
Total revenue	5.949,6	6.665,8	12,0
Total revenue as a % of GDP	28,1	30,2	
Primary balance	-390,7	1.427,5	
Primary Balance as a % of GDP	-1,8	6,5	
Surplus (+) / Deficit (-)	-741,2	1.013,5	
Surplus (+) / Deficit (-) % of GDP	-3,5	4,6	

Sources: Cystat, CBC.

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


Sources: Cystat, CBC.

loan in September 2019. At the same time, the Cyprus bonds' yields remain at very low levels (0,61% for the ten-year bond, 20/11/2019) and so do the spreads of the Cyprus ten-year bond compared with the respective German bund (0,96 basis points, 20/11/2019).

Public Debt is expected to further decline in the coming years, reflecting the projected strong fiscal surpluses and strong, though decelerating, economic growth. 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. Finally, a significant development is the issuance of a €750 million 30-year bond in April 2019, the longest-dated bond the Republic of Cyprus has ever issued, at a coupon rate of 2,75%.

3. Macroeconomic forecasts for the Cyprus economy

- *Relatively strong, though slightly decelerating, GDP growth rates for the Cyprus economy expected for the period 2019-2022.*
- *Positive trends in domestic demand, with a deceleration in both private consumption and investment (adjusted for the impact of SPEs) compared with 2018.*
- *Gradual, albeit modest, increases in inflation partly reflecting the expected positive GDP developments and the gradual increases in wages.*
- *Slight upward risks in relation to the baseline GDP scenario for 2019, with risks assessed to be on the downside over 2020-2022. Balanced risks for inflation over the period 2019-2022.*



The CBC's updated macroeconomic GDP forecasts have been revised downwards compared with those published in the June 2019 issue of the *Economic Bulletin*. This mainly reflects the downward revision in private consumption and investment. It is also attributable to the decline in external demand from the euro area, with a significant downward revision in the latter compared with the previous set of forecasts, exerting a negative indirect effect on exports and on economic activity in general. The decline in external demand is linked to the prolonged uncertainty prevailing in the external environment owing to the continued imposition of restrictive measures on international trade²⁶, as well as the timing and final provisions that will govern the agreement associated with UK's exit from the EU. Regarding domestic factors, the downward revision in private consumption is motivated by the release of revised historical National Accounts data²⁷. Furthermore, the baseline macro scenario since the June 2019 *Economic Bulletin* incorporates the impact of the introduction of social contributions towards the GHS as of 1 March 2019 (rates to be adjusted as from 1 March 2020) and the projected acceleration of loan repayments. Regarding investments, a downward revision has also been implemented compared with the previous set of forecasts due to two main reasons. Firstly, the decline in public investment

26. Despite the preliminary agreement reached between the US and China on 11 October 2019, the possibility of further escalation in the trade dispute between the two countries remains owing to the recent (20 November 2019) approval by the US Senate of a bill supporting demonstrators in Hong Kong, which is an autonomous Special Administrative Region of China.

27. The revised data incorporate results from the Household Budget Survey (2015) for the estimation of the Household Final Consumption Expenditure. The Household Budget Survey is conducted approximately on a five-year basis.

due to the methodological treatment of transactions related to the sale of real estate assets by KEDIPE²⁸. Secondly, the downward revision in private investment owing to the frontloading of investment projects.

The CBC's updated HICP inflation forecasts have also been revised downwards compared with those published in June 2019. The HICP excluding energy and food projections (core inflation) have been slightly revised downwards compared with the previous forecasts for the years 2020 and 2021. As such, the downward revision in HICP projections is driven by the significant downward revisions in both energy and food prices, in line with the most recent assumptions.

National accounts²⁹

Based on the latest preliminary (seasonally adjusted) data, GDP grew by 3,1% on a year-on-year basis over the first nine months of 2019, reflecting a positive contribution from almost all sectors of production apart from the banking sector (see Quarterly national accounts). For the entire current year, the Cyprus economy is projected to expand at 3% (Table A.12).

The foreseen GDP growth rate for 2019 is driven by domestic demand developments. Private consumption is expected to record a

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

	2018	2019f	2020f	2021f	2022f
GDP	4,1	3,0	2,9	2,8	2,7
Private consumption	3,3	3,1	1,9	2,0	1,9
Public consumption	3,5	12,8	7,7	2,8	0,8
Gross fixed capital formation	-6,6	18,1	4,9	4,9	4,8
Exports of goods and services	4,6	-3,0	1,9	2,5	2,6
Imports of goods and services	2,4	3,1	2,6	2,5	2,1

Sources: Cystat, CBC.

28. Receipts related to the sale of real estate assets are recorded as negative capital expenditure, following discussions between CYSTAT and EUROSTAT.

29. Due to the volatility in imports and exports of mobile transport equipment (ships and aircraft), it is extremely difficult to forecast the aforementioned series. Therefore, it is assumed that the level of transactions associated with these series for the period 2020-2022 remains broadly fixed at the 2019 level. Consequently, the rate of change in imports and exports as well as in gross fixed capital formation adjusted for the impact of these transactions does not differ relative to the unadjusted series.

slowdown to 3,1%, despite an increase in total earnings (wages and social contributions) (**Table A.12**, p. 63). This is primarily due to the increase in contribution rates towards the Social Insurance Fund (SIF) and the introduction of contributions towards the GHS. A significant acceleration is projected in public consumption by 12,8%, mainly owing to the incorporation of healthcare expenditures by the GHS³⁰. In addition, it is attributable to the projected increases in expenditure related to compensation of employees and intermediate consumption (see Quarterly national accounts and **Table A.12**). Gross fixed capital formation is expected to register an annual growth of 18,1% in 2019 following a 6,6% decrease in the previous year, mainly driven by the transactions of SPEs and non-recurring factors³¹ (**Table A.12**, p. 63). Adjusted for the impact of SPEs, gross fixed capital formation is projected to record a mild slowdown in 2019 relative to the growth rate observed in 2018, owing to frontloading of investment plans in previous years.

Net exports are forecasted to contribute negatively to economic growth in 2019. Exports of goods and services are projected to register a 3% decline in 2019, following a 4,6% rise in 2018, partly affected by transactions of SPEs and non-recurring factors (see footnote 30) (**Table A.12**, p. 63). Adjusted for the impact of SPEs, exports are expected

30. Following discussions with EUROSTAT, relevant expenditures (foreseen to be higher in 2019H2 due to the ongoing implementation of the GHS) have been incorporated into the sub-category "Social transfers in kind", which is a component of public consumption. By contrast, and in the previous set of forecasts, these expenditures were incorporated as "Social benefits other than social transfers in kind", which are not part of public consumption.

31. These non-recurring factors are related to a base effect owing to the termination of the leasing of aircraft by Cobalt airlines, as a result of the company's closure in October 2018.

to record an increase in 2019 compared with a marginal decrease in the previous year. This is due to the rise in revenues from the telecommunications, computer and information services sector (see Balance of payments), which is expected to offset the sluggish developments envisaged in other types of services also owing to the negative external environment. The decline in tourism receipts, due to the decrease in per capita expenditure (see Balance of payments), curbs to a small extent the aforementioned increase in total exports. Imports of goods and services are projected to grow by 3,1% in 2019, following an increase of 2,4% in 2018 (**Table A.12**, p. 63). Adjusted for the impact of SPEs, imports of goods and services are forecasted to register a significant increase in 2019 compared with the growth rate observed in 2018. As in the case of exports, the notable rise in imports of services is attributable to the telecommunications, computer and information services sector. In addition, it is driven by the path of imports of goods related to investment and private consumption.

Recent monetary indicators are in line with the positive path of the economy. The rise in new loan contracts in the first nine months of 2019 to slightly higher levels compared with the corresponding period of 2018 is a positive development. This is supported by historically low interest rates, positive trends in economic activity and, by consequence, the increased demand for new loans. At the same time, the increase in total earnings is expected to have a positive impact on household savings, thereby further reducing the level of NPFs and increasing the prospects for the Cyprus



economy. Further declines in NPFs are projected to exert a downward impact on private debt, which accumulated mainly in the years preceding the peak of the crisis, with a subsequent positive impact on the real economy.

In the period 2020-2022, real GDP growth is envisaged to be driven by continued growth in domestic demand. A continuation of GDP growth is projected in the coming years, albeit at a decelerating pace, reaching 2,7% in 2022 (**Table A.12**, p. 63). Specifically, private consumption growth is foreseen to record a stabilisation at around 2% over this period, owing to the rise in disposable income that is offset by the expected acceleration in loan repayments and the increase in contribution rates towards the GHS (**Table A.12**, p. 63). Gross fixed capital formation is expected to grow slightly below 5% per annum in the period 2020-2022 (**Table A.12**, p. 63). This is due to the gradual completion of investment projects spanning the energy, tourism and transport sectors as well as residential investments. The residential investment path observed to date is partly linked to foreign demand and the Cyprus Investment Programme. Looking ahead, foreign demand is expected to slow down due to the recently introduced stricter eligibility criteria. Regarding infrastructure projects, significant private investments have already commenced and are projected to be completed by 2022 (see Quarterly national accounts). The casino resort is a major project that will enrich the tourist product, further lengthen the tourism season and create new jobs. Decelerating



annual increases are expected to be recorded in public consumption over the period 2020-2022, reflecting the rises in healthcare expenditure related to the GHS (completion of gradual implementation in 2020) and, to a lesser extent, in wages (**Table A.12**, p. 63).

Net exports are expected to contribute negatively to economic growth in 2020 and 2021, due to the import content of domestic demand, with a small positive contribution foreseen in 2022. Exports are projected to grow by 1,9% in 2020 and around 2,5% in the period 2021-2022 (**Table A.12**, p. 63). The sector of telecommunications, computer and information services (see Balance of payments), as well as tourism and transport contribute positively to the export outlook. Tourism is projected to recover in 2021 and 2022, due to the expected operation of the casino resort³². Efforts are being made to expand the maritime sector through improvements to the setup of services and infrastructure. The establishment of Deputy Ministries for Shipping (as of 1 March 2018) and for Tourism (as of 1 January 2019) should in principle provide a further impetus to the sectors in question. At the same time, total imports, which are significantly affected by imports for intermediate, consumer and capital goods, are expected to increase at a decelerating pace in the period 2020-2022, in line with domestic demand (**Table A.12**, p. 63).

32. The baseline scenario includes only a partial impact from the operation of the casino resort over the period 2021-2022.



Compensation, productivity and the labour market

The relatively high, albeit slowing, pace of economic growth is also reflected in the employment growth path. Employment is projected to slow to 3% in 2019 down from 4,1% in 2018 (Table A.13). In the period 2020-2022, it is foreseen to register further decelerated growth rates, reaching 2,2% in 2022 (Table A.13).

Unemployment is expected to improve further, reaching levels even closer to full-time employment conditions. This is supported by government policies aimed at stimulating employment, for example programmes to support youth and the long-term unemployed. The unemployment rate is already below the euro area average and is projected to drop to 7% in 2019, down from 8,4% in 2018 (Table A.13). The projected positive GDP growth path, in line with the growth in employment, albeit slowing, reinforces the forecasts for a continued decline in the unemployment rate, which is envisaged to reach 5,2% in 2022 (Table A.13).

The significant increase in nominal compensation per employee in 2019 (5,6%) is largely due to the impact of changes in contribution rates, including the introduction of contributions towards the GHS, which was incorporated as from the June 2019 forecasts³³. Adjusted for the impact of social contributions, a slightly more modest growth

TABLE A.13 Labour market projections
(annual change,%, unless otherwise indicated)

	2018	2019f	2020f	2021f	2022f
Compensation per employee	0,5	5,6	3,6	2,7	2,7
Unit labour costs	0,6	5,7	3,4	2,4	2,1
Productivity	0,0	0,0	0,3	0,3	0,6
Total employment	4,1	3,0	2,7	2,4	2,2
Unemployment rate (% of labour force)	8,4	7,0	6,0	5,5	5,2

Sources: Cystat, CBC.

33. An upward revision of the relevant projection for 2019 has been implemented compared with the June 2019 set of forecasts owing to the incorporation of the impact of the following factors: hirings in the public healthcare sector, promotions across the civil service and the finalisation of collective agreements across various segments of the private sector (see Labour Costs) with retroactive application as of beginning of 2019.

in wages in 2019 relative to the rate of economic growth is foreseen, at least for the case of the private sector (**Table A.13**, p. 68). More significant rises are expected in the public sector, mainly because of the gradual restitution of the crisis-era wage and pension cuts, wage increases owing, including among others, to promotions as well as hirings in the healthcare sector. Looking ahead, further increases in nominal compensation per employee are envisaged of the order of 3,6% in 2020 and 2,7% per annum in 2021 and 2022 (includes the impact of the rise in contribution rates towards the GHS) (**Table A.13**, p. 68). By 2021, the envisaged fall in unemployment to 5,2% that is near levels associated with full-time employment conditions, could lead to higher pressures for wage increases.

Productivity (per employee) is expected to remain constant in 2019, as was the case in the previous year. This development is partly due to the fact that the share of part-timers is still high compared with the pre-crisis situation, despite the gradual decline observed. After taking into account the working hours, hourly productivity growth rates are positive, albeit modest. In the coming years, productivity (per employee) is projected to register positive growth rates of 0,3% per annum in 2020 and 2021 and an increase of 0,6% in 2022 reflecting, in part, the gradual implementation of structural reforms (**Table A.13**, p. 68).

The unit labour costs index is expected to record positive rates of change, influenced by projected developments in nominal compensation per employee as previously analysed and with stagnant productivity. In

particular, it is expected to grow by 5,7% in 2019 with further, albeit slowing, growth rates foreseen in the coming years (Table A.13, p. 68). However, it retains its comparative advantage compared with the rest of the euro area owing to the reductions observed in the past and, by consequence, the improvement in competitiveness recorded in previous years (see Labour costs and Table A.13, p. 68).

Inflation

Prices are expected to remain subdued in 2019. Specifically, HICP inflation in 2019 is expected to drop to 0,5% compared with 0,8% in 2018 (Table A.14), amid mixed developments in the main HICP categories. It is mainly influenced by the foreseen increases in food and services prices and, additionally, it is impacted by the projected reductions in energy prices and industrial products excluding energy in 2020. The envisaged evolution of energy prices is due to lower oil prices compared with the corresponding period of the previous year and is in line with the decline in excise duties as of December 2018. Core inflation, i.e. HICP excluding energy and food, is forecasted to increase, reaching 0,8% in 2019 compared with 0,1% in 2018.

Further gradual increases in prices are expected over the period 2020-2022, albeit at subdued levels. HICP inflation is expected to increase to 0,9% in 2020, gradually rising to 1,2% in 2022, mainly driven by the projected increases in service prices. Furthermore, HICP inflation is expected to be increasingly impacted by the gradual further rise in wages

TABLE A.14 HICP projections
(annual change, %)

	2018	2019f	2020f	2021f	2022f
HICP	0,8	0,5	0,9	1,0	1,2
HICP excluding energy and food	0,1	0,8	1,2	1,4	1,5

Sources: Cystat, CBC.

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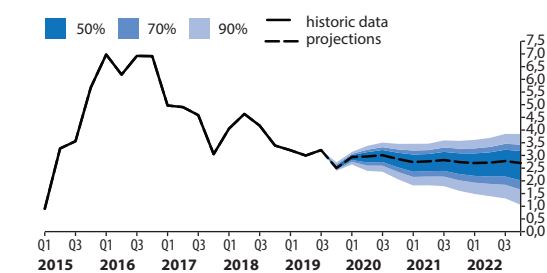
as well as the continuation of the positive, albeit stabilised, path foreseen in private consumption. At the same time, core inflation is envisaged to continue rising, reaching 1,2% in 2020 and 1,5% in 2022.

Risk assessment of macroeconomic forecasts³⁴

The expected GDP path, as presented in **Table A.12** (p. 63), as well as the HICP and core inflation forecasts (**Table A.14**, p. 70) underpin the baseline economic scenario. The confidence intervals associated with the baseline economic forecasts, which capture the probabilities of deviating from the corresponding baseline scenarios for GDP and HICP are outlined in **Charts A.35** and **A.36**, respectively. Possible deviations with respect to the baseline forecast for core inflation are presented in **Chart A.37**. The following paragraphs analyse both the downward and upward risks to GDP and inflation, with a risk assessment summary presented in **Table A.15** (p. 72).

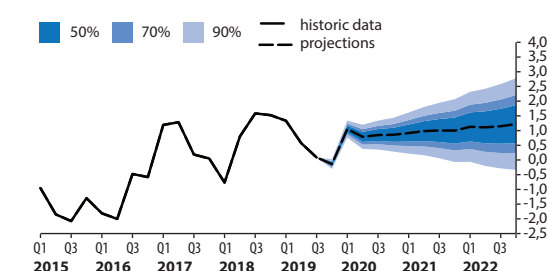
The risks of deviating from the baseline GDP forecast for 2019 are on the upside, in view of the recent publication of revised quarterly figures for the first nine months of the year. During the period 2020-2022, risks are assessed to be on the downside and are associated with a slower than projected decline in the high level of NPFs as the high level of private debt constrains, to some extent, the granting of new loans, consumption and investment. Specifically, the adoption of provisions recently put forward by Parliament concerning the relaxation of

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



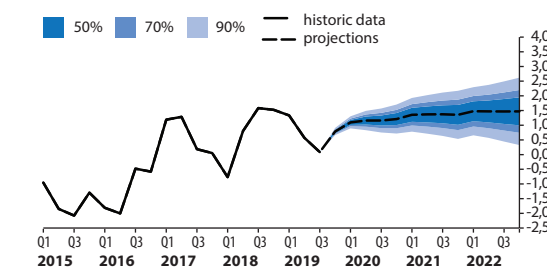
Source: CBC.

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.

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

the foreclosure and insolvency framework could potentially undermine the path associated with the reduction in NPFs. Downside risks are also linked to a possible deterioration in external demand for services. This is a consequence of the continued imposition of restrictive measures on international trade, due to the deadlock in the US-China trade discussions, and the prolonged uncertainty related to the timing and provisions that will govern the agreement associated with UK's exit from the EU. Unstable geopolitical developments in the eastern Mediterranean region, including the escalation of tensions with Turkey due to illegal drilling in the Cypriot EEZ, may adversely affect the prospects of tourism and professional services sectors. Possible upward deviations from the baseline GDP scenario (upside risks) are associated with a higher than expected implementation rate of private sector investment projects, including those related to the energy sector (signing of agreement related to the commercial exploitation of the Aphrodite gas field as of 2025 on 7 November 2019). Finally, upside risks are linked to a stronger than expected tourism performance owing to the casino resort's operation as of 2021.

Risks in relation to inflation are balanced over the 2019-2022 period. Possible downward deviations from the baseline scenario (downside risks) are mainly associated with a deterioration in domestic credit conditions. In addition, they are linked to a further escalation of restrictive measures in relation to international trade and the ongoing uncertainty associated with the UK's

TABLE A.15 Summary of risk assessment

Risk	GDP (2020-2022)	Inflation (2020-2022)
NPFs and credit conditions	-	-
Geopolitical developments, incl. possibility of higher oil prices	-	+
Hard Brexit	-	-
Global trade war	-	-
Higher-than-envisaged investments	++	+
Better than expected performance of tourism-related services, incl. the casino	+	+
Overall assessment	-	=

Source: CBC.

Note: the following symbols cover the spectrum of risks: ++, +, =, -, --.

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exit from the EU, particularly for the period 2020-2022. Specifically, the negative impact on inflation due to reduced demand that may result from the continued imposition of restrictive measures and tariffs on trade is expected to outweigh the direct impact on inflation from the imposition of the aforementioned measures. Upward deviations from the baseline scenario (upside risks) for inflation emanate from the domestic environment. Higher than expected implementation of investment projects and performance of the services sectors could have a positive impact on inflation. Finally, higher oil prices than originally envisaged constitutes an upside risk. By contrast, and reflecting the balance of risks for GDP, the risks for core inflation are also on the downside.

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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.

