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EUROSYSTEM

ECONOMIC BULLETIN

DECEMBER 2010

NICOSIA - CYPRUS

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ABBREVIATIONS

ATHEX	Athens Stock Exchange
BIS	Bank for International Settlements
BoE	Bank of England
CBC	Central Bank of Cyprus
CDCR	Central Depository and Central Registry
GDP	Gross Domestic Product
CEBS	Committee of European Banking Supervisors
CCIs	Co-operative Credit Institutions
CGFS	Committee on the Global Financial System
CI(s)	Credit Institution(s)
COLA	Cost of Living Allowance
COREP	Guidelines on Common Reporting
CSE	Cyprus Stock Exchange
CPI	Consumer Price Index
Cystat	Statistical Service of Cyprus
EAC	Electricity Authority of Cyprus
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EER	Effective Exchange Rate
EMTN	Euro Medium-Term Note
EMU	European Economic and Monetary Union
EONIA	Euro Overnight Index Average
ERD	Economic Research Department
ESA95	European System of Accounts 1995
ESI	Economic Sentiment Indicator
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro Interbank Offered Rate
EUROSTAT	Statistical Office of the European Union
FED	Federal Reserve
FINREP	Financial Reporting Framework
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IBUs	International Banking Units
ICCS	Insurance Companies Control Service
IMF	International Monetary Fund
IRD	Inland Revenue Department
LFS	Labour Force Survey
LTI	Loan-to-income
LTROs	Longer term refinancing operations
LTV	Loan-to-value
MFI(s)	Monetary Financial Institution(s)
MROs	Main refinancing operations
MSM	Minimum Solvency Margin
NACE Rev.1.1 & Rev.2	Nomenclature statistique des Activités économiques dans la Communauté Européenne (Statistical classification of the economic activities in the European Community)
NEER	Nominal Effective Exchange Rate
NFCs	Non-Financial Corporations
OIS	Overnight Index Swaps
REER	Real Effective Exchange Rate
REU	Real Estate Unit
RICS	Royal Institution of Chartered Surveyors
ROA	Return on Assets
ROE	Return on Equity

ABBREVIATIONS (contd)

RTGS	Real Time Gross Settlement
SDW	Statistical Data Warehouse
UK	United Kingdom
US	United States
VAT	Value Added Tax

Introduction

International developments

The prospects for global economic growth remain positive but have weakened compared to the beginning of the year, as new concerns have arisen in relation to the robustness of the recovery. The prevailing uncertainty about the prospects of economic recovery is fuelled predominantly by the big fiscal challenges faced by a number of countries in the euro area. At the same time, a series of unfavourable data for the US in relation to the labour and property markets, as well as the restrictive monetary policy in China, have amplified concerns that full recovery of the world economy may be delayed.

The debate on the possibility of a double-dip recession became more intense at the beginning of the third quarter, when fiscal developments in Europe led the credit rating agencies to downgrade the creditworthiness of Greece, Ireland, Italy, Portugal and Spain. Although most European governments cut back on expenditure, the risk of further deterioration in their public finances remains. In November, government bond spreads between some euro area countries and Germany rose to historical levels, mainly due to problems with Ireland's banking sector. In fact, Ireland recently had to receive financial support from the European Union (EU) and International Monetary Fund (IMF). Moreover, the upward revision of Greece's 2009 budget deficit and the possibility of the need for new fiscal consolidation measures caused further turmoil in the markets.

In general, uncertainty still surrounds the world economic environment. On one hand, there are positive signs from developments in world trade and, consequently, positive prospects for euro area exports. On the other hand, there are still concerns over the possibility of the reappearance of tensions in the financial markets, and uncertainty in relation to the growth prospects of advanced economies. In addition, downside risks are associated with new price increases in oil and other basic goods, as well as pressures for protectionism in international trade. In particular, many governments have acted in ways that affect the foreign exchange markets, in order to improve the competitiveness of their exports, albeit with negative consequences for inflation.

As from the beginning of the year, global inflation continued to show signs of acceleration, mainly due to the base effect from relatively low oil prices in 2009, and the marginal increase in demand. The likelihood of positive growth has reduced the risk of deflation, while inflation forecasts are positive for most economies.

As a result of the ongoing uncertainty in the economic environment, the major central banks continued their expansionary policy, maintaining interest rates at very low levels. The Eurosystem continued to provide liquidity to the euro area's banking system while it has initiated the process of gradually removing the temporary measures adopted during the period of the financial crisis, which aimed at ensuring the functioning and effectiveness of the monetary policy transmission mechanism. In addition, at the beginning of November, the

US Federal Reserve announced a new plan for the purchase of government bonds worth $600 billion until the end of June 2011, in order to provide further support to the US economy. Moreover, the Bank of England maintained its bond purchasing programme worth ST£200 billion.

Amid discussions about the possibility of a double-dip recession in the current year or early 2011, and the regular revision of GDP forecasts since the beginning of the year, financial markets exhibited increased volatility during 2010. At the same time, the ongoing uncertainty in the economic environment and the strong concerns over the possibility of a revival in inflationary pressures, led to successive increases in the price of gold, reaching historical levels in November. During the same month, crude oil prices reached their highest level in the last two years, following a drop in reserves and rising demand. Oil prices were also driven upwards by the announcement of a new support package for the US economy, thus causing further increase in the demand for oil.

Domestic developments

In 2009 the negative consequences of the global economic crisis were evident in most sectors of the Cyprus economy. Tourism, construction and trade were especially affected. As a result, GDP in 2009 registered a significant contraction of 1,7% compared with an increase of 3,6% in 2008. The negative developments also continued in the first quarter of 2010, while signs of recovery were recorded in the second and third quarters. According to the flash estimate of the Cyprus Statistical Service (Cystat), the annual rate of GDP growth in the first nine months of 2010 reached 0,3%. The confidence indicators for services, industry, retail trade, consumption and construction have stabilised or marginally improved during more recent months.

With respect to prices, the Harmonised Index of Consumer Prices (HICP) increased by 2,7% during the first ten months of 2010, compared with zero growth in the corresponding period last year. The rapid growth in prices in the current year is partly due to the large increase in energy prices, compared with very low oil prices recorded in the first ten months of 2009, the depreciation of the euro against the dollar and the significant number of taxes and charges imposed on electricity prices in the current year. It should also be noted that, despite the slowdown in recorded HICP excluding energy during the first ten months of 2010, increased public expenditure in recent years has maintained overall inflationary pressures.

In spite of the generally subdued economic activity, the annual growth rate of loans accelerated from the beginning of the year and stabilised from mid-2010 until September. The use of special government bonds as collateral by banks for obtaining cheap liquidity from the European Central Bank (ECB) has kept the growth of loans near its long-term average of 10%, since the liquidity obtained was mostly utilised in the provision of housing loans.

Interest rates for some categories of loans increased, while others remained relatively stable with no evident decreasing trend despite the rise in bank liquidity. As a result, the interest rate differential between domestic and the respective European rates persisted.

The current account balance continued to improve in the first six months of 2010, after the significant improvement recorded in 2009. The improvement in the current account balance is mainly the result of the improvement in the income account, which is expected to be of a temporary nature, as it is mostly affected by cyclical and transitory rather than structural factors. To a lesser extent, the improvement in the current account balance is also the result of positive developments in the services account, especially revenues from financial services, which continues to register significant growth. With respect to tourism, revenues in the first nine months of 2010 improved compared with the same period last year, but are significantly lower than in the years preceding the crisis.

As regards the labour market, employment in the first half of the year was still affected by the economic crisis, registering a reduction of 0,7% compared with an increase of 0,2% in the first half of 2009. According to data from the Labour Force Survey (LFS), during the same period there was an increase in unemployment by 1,9 percentage points, reaching 6,8%. Recent data for seasonally adjusted, registered unemployment for the first ten months of 2010 indicate that unemployment shows signs of further deterioration in the second half of the year. It is noted that the number of registered unemployed in the first ten months of 2010 increased by 5.563 over the same period of 2009, reaching 22.728.

With respect to domestic public finance developments, according to preliminary figures published by Cystat, a budget deficit of 2,5% of GDP was recorded during the first nine months of 2010, compared with a deficit of 2,7% for the corresponding period last year. However, this marginal improvement is due to temporary one-off factors, mainly the significant dividend income obtained from the Central Bank of Cyprus (CBC) in 2009 (partly due to the non-conversion of Cyprus pound coins into euro) and revenues from the termination of an interest rate swap deal in early 2010. On the other hand, public expenditure increased during 2010, albeit at a lower rate compared with the corresponding period of the previous year, due mainly to the increase in social transfers and compensation of employees. The deceleration reflected the reduction in operational expenditures and, mainly, the reduction in the expenditure for development projects.

According to data published by the Ministry of Finance, net public debt as a percentage of GDP registered a decrease from 68,7% in the third quarter of 2009 to 60,3% in the third quarter of 2010. The decrease was mainly due to the repayment of short-term debt issued by the Ministry of Finance specifically for the purpose of securing short-term liquidity for banks within the year. It should be noted that, with the possible rise in interest rates over the longer term, the fiscal burden of interest payments will increase due to both higher public debt and primary deficits.

Regarding the CBC projections for the main indicators of the domestic economy and according to the baseline scenario, GDP growth in 2010 is expected to increase by 0,7% while a contained increase of 1,8% is expected in 2011, based mainly on the recovery of our trading partners. The current projections are higher than those of June 2010, mainly due to domestic developments and the recent revision of the national accounts figures. It should be noted that the projections take into consideration only those fiscal measures which are clearly defined and are very likely to be implemented.

Financial stability conditions

Overall, risks to financial stability originating from conditions in the household sector, although contained, remain on the upside. With the exception of a rise in interest rates on new housing loans observed in the third quarter of 2010, there was a further decline in lending rates in Cyprus during the second half of the current year. However, this has not stopped the overall debt-servicing burden of households from rising further. Moreover, a potential further deterioration in the labour market may pose higher risks to household income and have a negative impact on household debt repayments.

The environment in which non financial corporations (NFCs) operate is expected to remain difficult, at least in the short term. The negative domestic macroeconomic conditions that prevailed in the first half of 2010 have adversely affected the earnings and profitability of NFCs. In addition, the higher borrowing costs facing enterprises in Cyprus, compared with other euro area member states, as well as the limited possibility for external financing are expected to contribute to the uncertainty about the short-term profitability prospects of the corporate sector. At the same time, the high level of NFCs' indebtedness renders them less resilient to any potential shocks. Looking forward, weak profits, high leverage as well as firms' dependence on bank finance remain the key vulnerabilities of the corporate sector.

According to the latest available data, the construction sector exhibited a contraction in the first ten months of 2010. In contrast, interest by Cypriots as well as foreigners in the purchase of residential property presents a more positive picture, which can be attributed to an increase in resales or to a reduction in the stock of finished homes. Residential property prices, as indicated by the latest available trends in the CBC residential property price index, registered an average annual decrease of 3,7% in September 2010. Based on real estate valuations collected by the CBC as well as other data relating to the residential property sector up until September 2010, the CBC estimates that residential real estate prices will fall by an annual average of 3% in 2010

In the first half of 2010, for which the latest consolidated data for the Cyprus banking sector are available, banks in Cyprus had to cope with the negative developments in the domestic economy as well as operate in an unfavourable external environment. As a result, banks' total operating profits before provisions remained roughly at the same level compared with the corresponding period of 2009, while net profits declined. At the same time, despite banks' high funding costs, which can be mainly attributed to higher deposit rates compared with other euro area member states, net interest margin exhibited a small increase in the first six months of 2010. A number of indicators showed an increase of liquidity in the banking system during the period under review. In parallel, banks' capital adequacy remained satisfactory, with the overall solvency ratio reaching 12% at the end of June 2010, well above the minimum regulatory requirement of 8% applied to individual banks. The Tier 1 capital ratio of banks also exhibited an increase at end-June 2010. In contrast, banks' asset quality deteriorated, with the ratio of non-performing loans to total loans recording significant growth from 5,9% at the end of December 2009 to 7,2% at end-September 2010.

However, banks face a number of potential risks in the near term. Firstly, despite the muted domestic economic prospects for 2011, the banks' policy of tightening credit standards for loans to households for house purchase, in conjunction with a potential slowdown in demand for new lending by both households and NFCs, may lead to a deceleration in credit expansion, which could adversely affect banks' earnings and profitability.

Credit risk stemming from lending to households and NFCs remains elevated, while any potential reduction in their debt-servicing capacity may lead to future asset quality problems for banks. This could result in an increase in loan loss provisions and thus have a negative impact on banks' bottom-line results.

The counterparty risk facing banks in Cyprus also remains on the upside given their exposure to other credit institutions through the interbank market, and especially considering their significant investment portfolio in fixed-income securities and other debt instruments. It must be noted, however, that the remedial measures taken by governments and central banks in support of the banking sectors in many countries, as well as by the ECB, have, to a great extent, helped to ease market tensions and considerably alleviate concerns associated with counterparty risk.

At the same time, market risk facing banks remains limited.

In contrast, banks' funding liquidity risks continue to be significant as a result of the increased cost of funding emanating, mainly, from the high deposit rates in the domestic market, which can be attributed to strong competition among banks. However, the use of the three-year special government bonds as collateral by banks for raising cheaper funds from the ECB, has helped to alleviate banks' funding needs.

At the same time, the risks originating from the presence of the three largest domestic banking groups in overseas markets have also increased due to the deterioration in macroeconomic conditions in some of the countries, especially Greece, in which these groups operate. The significant contraction in economic activity in Greece has put additional pressure on the financial position of households and NFCs. Credit risk remains the most important type of risk facing Cypriot banking groups as the largest part of their activities in Greece concerns the provision of loans to households and enterprises.

Conclusions

Based on the economic developments and data presented and analysed in the current *Economic Bulletin*, the Cyprus economy shows signs of recovery. Unfortunately, though, this recovery is not adequate to eliminate the increased unemployment created as a result of the economic recession. In addition, there is great concern about the continuing increase in prices, which, in the medium-term, contribute to the increasing misalignment of Cyprus and euro area inflation.

The most significant problem currently confronted by the Cyprus economy is the large rise in the fiscal deficit, which from the end of 2007 until the end of 2009 increased by about ten percentage points. No improvement is evident either in 2010 or in 2011, despite the economy's small recovery. Therefore, it is imperative to adopt fiscal consolidation measures, which will not be of a short-term nature only. The analysis of the long-term path of public spending, shows that these measures should be of a medium as well as long-term nature, so that cost reduction is permanent and sustainable. In particular, the European Commission forecasts that the public debt in Cyprus will increase by about 20 percentage points as a percentage of GDP from 2008 until 2012. This gives an indication of why it is important to reverse this alarming state.

In the preparation of the fiscal consolidation measures, emphasis should be given to reducing public expenditure. The situation is urgent as delays in taking serious remedial measures further increase the cost. And since the continued expansion of public expenditure is mainly responsible for the large budget deficit, fiscal consolidation should focus on the reversal of this trend. Irrespective of how much tax revenues increase (either through measures to combat tax evasion and / or by increasing tax rates), it is impossible to cover the continuing increases in public expenditure. In addition, the apparent gradual economic recovery cannot substantially reduce the large fiscal imbalances alone since the problem is, unfortunately, structural.

Therefore, the reduction in public expenditure should mainly emanate from the reduction in unproductive expenditure and simultaneously through structural changes in order not to undermine, but rather to enhance, the growth prospects of the country. Containment of the state payroll is necessary as well as the better targeting of social benefits, based on income and wealth criteria.

Fiscal consolidation may also need to include moderate increases in tax revenues, which however must not undermine economic growth or weaken the position of Cyprus as a financial centre.

The aforementioned observations should form the guidelines based on which fiscal consolidation can be achieved. In this context, fiscal consolidation measures should immediately be implemented in order to substantially reduce and finally eradicate the fiscal imbalances of recent years.

Banks in Cyprus remain sound, exhibiting satisfactory levels of liquidity and solvency. However, despite the muted domestic economic growth prospects for 2011, potential risks, especially credit risk, facing the banking sector are expected to remain elevated in the near term. The domestic banking groups operating in Greece are confronted with heightened risks and more challenges due to the significant deterioration of the country's macroeconomic conditions.

SECTION A

Macroeconomic Developements and Projections

1. International Environment

1.1 External developments

GDP growth[1]

The recovery of the world economy continued in the second half of the year. However, moderate growth rates were exhibited as a result of the waning impact of the inventory cycle and the fiscal stimuli. In general, the growth path of the world economy is characterised by ongoing uncertainty.

With continuing concerns about the possible re-emergence of tensions in financial markets and the uncertain prospects for growth in advanced economies, there is a significant risk of the crisis spreading to other debt-laden countries on the "periphery" of Europe. Major fiscal challenges forced Greece and other countries in the euro area to pursue budgetary reforms, while the risk of further deterioration of their economies' finances is still evident. In Ireland, problems in the banking sector had a strong impact on the country's public finances and led the government to seek assistance from the EU and the IMF. As a result, fears were revived about the spreading of the debt crisis to Portugal and possibly Spain. Moreover, downside risks to growth have been associated with moves that might be interpreted as protectionist as well as the possibility of a disorderly correction in global imbalances. Thus, international

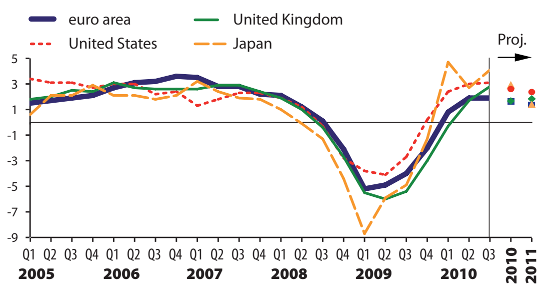
1. GDP projections are estimated as the average of the most recent projections from the Economist Poll (4 November 2010), the IMF (World Economic Outlook, October 2010) and Bloomberg (Contributor Composite, 19 November 2010).

growth prospects have weakened compared to the beginning of the year, while economic activity is expected to vary significantly from country to country.

With respect to economic activity in the major economies, euro area GDP in the third quarter increased by 0,4% and 1,9% on a quarterly and annual basis, respectively, mainly as a result of economic developments in Germany and France (**Chart A.1**). The increase in external demand, combined with loose monetary policy and the measures adopted to restore the functioning of the financial system, continue to support the euro area. However, the recovery in activity is expected to be dampened by the process of balance sheet adjustment in various sectors and by the bleak outlook of the labour market. Unemployment in the euro area stood at 10,1% at the end of the third quarter compared with 10% in the second quarter. According to analysts' macroeconomic forecasts for the euro area, the annual growth rate in real GDP will reach 1,7% in 2010 and 1,4% in 2011.

In the UK, recovery continued in the last two quarters of 2010. The annual growth rate of GDP in the third quarter was 2,8% from 1,7% in the previous quarter, while on a quarterly basis it reached 0,8% from 1,2%, respectively. The increase in GDP growth in the third quarter of 2010 was mainly due to a rebound in private consumption and a continued accumulation of inventories. Analysts believe that inventory adjustments,

CHART A.1 **Gross domestic product**
(annual change %, seasonally adjusted data)



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

loose monetary policy and external demand as a result of the devaluation of sterling will further boost economic activity. However, domestic demand is expected to remain subdued due to stricter lending criteria, the adjustment of households' balance sheets and substantial fiscal tightening. Unemployment stood at 7,7% at the end of the third quarter, virtually unchanged from the previous year. Analysts' latest estimates for GDP growth indicate a rise of 1,7% in 2010 and 1,8% in 2011.

In the USA, the acceleration in economic activity started from the third quarter of 2009 and continued until the third quarter of 2010. Economic growth was mainly boosted by consumer spending and inventories, while it was dampened by the negative contribution from net exports. Specifically, the annual growth rate of GDP in the third quarter of 2010 was 3,1% compared with 3% in the second quarter. The quarterly annualised growth rates were 2% and 1,7%, respectively. Overall, recovery may be restrained due to weak labour market conditions and income growth, the further adjustment of households' balance sheets and the reduction in housing wealth as a result of falling property prices. With respect to unemployment, it stood at 9.6% at the end of the third quarter compared with 9,5% in the second quarter. Analysts' forecasts point to a GDP growth of 2,6% in 2010 and 2,4% in 2011.

In Japan, an acceleration in economic growth was observed in the third quarter, as a consequence of increasing domestic consumption. According to official government data, GDP on an annual basis increased by 4,4% in the third quarter compared with 2,7% in the second quarter. On a quarterly basis, the Japanese GDP increased by 0,9%. This is the fourth consecutive quarter of positive growth in Japan. Consumption increased in the period from July to September mainly due to one-off factors, such as the rise in car purchases following the announcement of a government subsidy for purchases of "green" vehicles. During the fourth quarter, a slowdown in activity is expected, since the aforementioned one-off factors have a limited impact on growth. At the same time, exports are expected to remain subdued due to the appreciation of the yen and limited consumption is anticipated in developed economies. With respect to unemployment, the latest data show a decrease from 5,3% at the end of the second quarter to 5% in the third. Analysts forecast a GDP growth of 2,9% in 2010 and 1,4% in 2011.

Inflation[2]

Since the beginning of the year, global inflation continued to accelerate, mainly due to the base effect from the low oil prices recorded in 2009. Inflation is expected to continue rising in most economies, with analysts' recent projections being revised slightly upwards compared with previous

2. Inflation projections are estimated as the average of the most recent projections from The Economist poll (4 November 2010), the IMF (World Economic Outlook, October 2010 and Bloomberg (Contributor composite, 19 November 2010).

forecasts (**Chart A.2**).

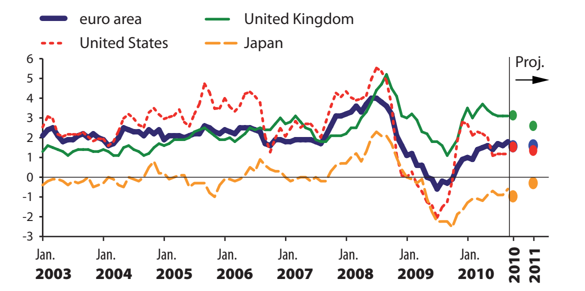
More specifically, HICP in the euro area increased to 1,9% in October 2010 from 1,8% in September 2010, while in October 2009 it stood at -0,1%. The main factor for this increase in inflation is the base effect of crude oil and food prices. In the subsequent quarters, analysts anticipate that inflation will increase further as a result of the anticipated increase in oil prices and commodity prices. However, it is expected to remain below the ECB target of below but close to 2%. The latest inflation projections by international organisations stand at around 1,6% for both 2010 and 2011.

In the UK, inflation rose slightly, reaching 3,2% in October 2010 from 3,1% in the preceding month. In particular, increases were recorded in the prices of fuels and lubricants which were partly offset by reductions in food prices. Analysts forecast that inflation in the UK will be around 3,1% in 2010 and 2,6% in 2011.

In the US inflation reached 1,2% in October 2010 from 1,1% in September, mainly due to the increases in energy prices. According to the latest projections, inflation is expected to reach around 1,5% in 2010 and 1,4% in 2011.

In Japan, the latest data refer to September 2010, when inflation had a smaller reduction of 0,6% compared with -0,9% in August 2010. Analysts' projec - tions stand at around -1% for 2010 and -0,3% for 2011.

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



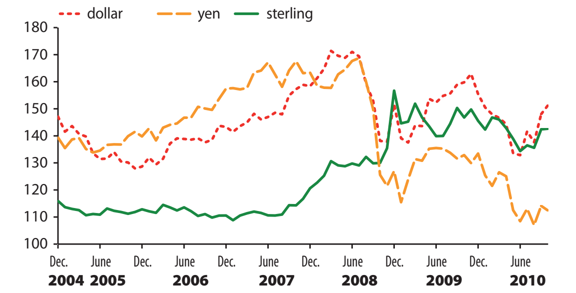
Sources: Eurostat, SDW (ECB).
Note: The projections are for the year and are calculated as averages of the most recent projections from Bloomberg, The Economist poll and the IMF.

Exchange rates

Following its appreciation in 2009, the euro followed a downward path from early 2010 until mid-June. However, this trend has been reversed in recent months, as the euro strengthened against major currencies until 19 November 2010, the cut-off date for data in the current *Bulletin* (**Chart A.3**). The strong appreciation of the euro against the dollar was mainly the result of the Federal Reserve's decision to adopt a new quantitative easing policy. More specifically, the Federal Reserve's decision to proceed with gradual purchases of government bonds worth $600 billion led to lower yields for US securities and the value of the dollar, as investors moved to higher yielding currencies. The euro/sterling exchange rate also progressed on a similar path in recent months, following a series of negative news for the UK economy. As regards the euro/yen exchange rate, it exhibited fluctuations during the period under review, but in general the European currency has depreciated against the Japanese since the beginning of the year.

The sharp fluctuations in exchange rates brought back to the forefront concerns about the revival of protectionism, as some countries pursued actions that analysts have interpreted as interference in the currency markets. Specifically, the US criticised China and other countries for destabilising the world monetary system, since China maintains its currency, the yuan, artificially

CHART A.3 **Selected exchange rates against the euro**
(monthly data, 2000=100)



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

undervalued against the dollar. At the same time, markets interpreted the Federal Reserve's decision for quantitative easing as an indirect devaluation of the dollar.

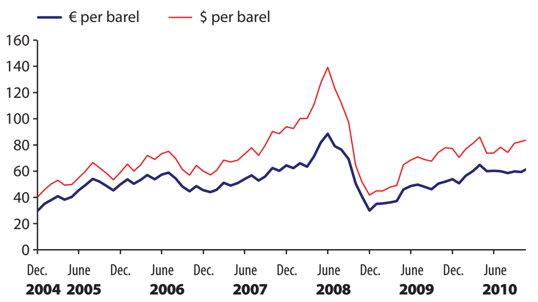
Protectionism concerns have led to the revival of the idea of the Gold Standard in various fora. More specifically, the President of the World Bank has advocated a system which would most probably involve the dollar, the euro, the yen, sterling and the Chinese yuan, that could also use gold as an international reference point for market expectations about inflation, deflation and future exchange rates. In addition, the issue of protectionism was on the agenda of the G20 summit in November 2010. The leaders of the G20 countries agreed to refrain from any competitive devaluation and expressed their support for floating exchange rates.

Overall, from the beginning of the year until 19 November 2010, the euro depreciated by 4,5% against the dollar, 3,5% against sterling and 14,2% against the yen (**Chart A.3,** p. 25 and **Table C.1**, p. 186).

Oil and gold

Oil prices have, on average, stood at around $78 per barrel since the beginning of 2010, exhibiting small fluctuations (**Chart A.4**). Oil prices are mainly driven by demand factors and the general uncertainty that still remains. The International Energy Agency has repeatedly revised upwards its forecast for oil demand in 2010 and 2011, while OPEC decided to keep its production targets

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

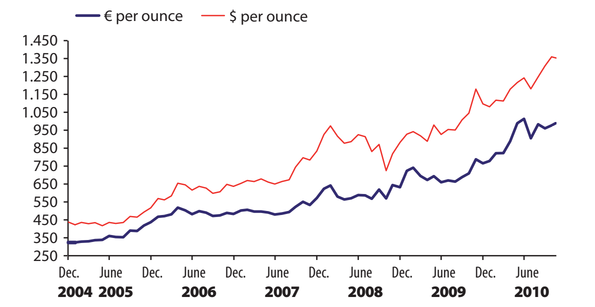


Source: Bloomberg.

to the same levels maintained since December 2008. However, the uncertainty which surrounds the global economic recovery contributed to downward pressures on oil prices. The growth of the world demand for oil, which was strong in the first half of 2010, moderated slightly in the second half of the year, mainly due to the lower growth rate of oil demand from China. The price of Brent crude stood at \$83,6 per barrel on 19 November from \$77,2 earlier this year, thus rising by 8,3%. The trading prices of futures for December 2012 stood at around \$87 per barrel.

The price of gold (**Chart A.5**) exceeded \$1.420 per ounce in November 2010. The rising price of gold was the result of continued uncertainty about the course of the international economy, as investors continued to turn to the precious metal, which is considered a safe haven in times of crisis. Furthermore, the flight of investors away from the dollar, following the Federal Reserve's decision to adopt a new policy of quantitative easing, led to further purchases of gold, in order to hedge against any further weakening in the value of the dollar. On the other hand, the IMF continues its announced programme of gold sales, taking advantage of the high gold prices. Its ultimate target is the sale of 403,3 tonnes of gold by the end of 2010, a figure equivalent to one eighth of the Fund's total reserves. It is noted that since the beginning of the year and up until 19 November 2010, the price of gold in dollars rose by 23,3%.

CHART A.5 **Closing prices of gold**
(monthly data)

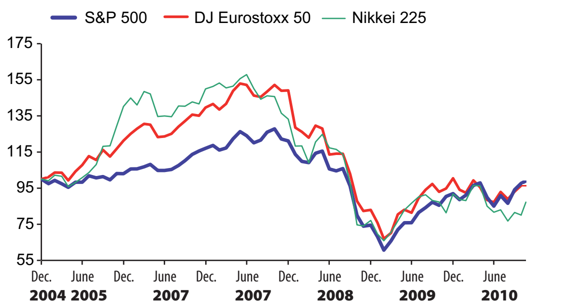


Source: Bloomberg.

Selected international stock market indices

Amid discussions focused on the possibilities of a double dip recession and the regular revisions of GDP estimates worldwide, stock markets also experienced large and frequent fluctuations during the year. A more positive development was the significant strengthening of company balance sheets worldwide, which were aided in part by the policies of governments and central banks. Nevertheless, uncertainty in the markets remains as to the degree of success of the support measures and the impact of the recent fiscal developments in Europe. As a result of these developments, from the beginning of the year the DJ Eurostoxx fell by 4%, the S&P 500 rose by 7,6% and the Nikkei fell by 5% (**Chart A.6**).

CHART A.6 **Selected international stock market indices**
(monthly data, 31/12/2004 = 100)



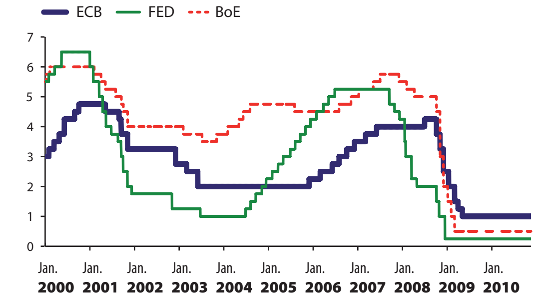
Source: Bloomberg.

International official interest rates

The major central banks continued their expansionary monetary policy until mid-November, maintaining their official interest rates at very low levels while continuing to offer liquidity to markets via non-conventional monetary policy measures. More specifically, the Federal Reserve purchased Treasury bonds worth €600 billion, as a result of its commitment to reinvest the cash received from maturing bonds. With regard to interest rates, up until the cut-off date for data in the current

Bulletin, the Federal Reserve maintained its official interest rate unchanged between 0% and 0,25%, while the Bank of England's official interest rate remained at 0,5%. Furthermore, the ECB's main refinancing operations (fixed rate) stands at 1% as from 13 May 2009 (**Chart A.7**).

CHART A.7 **Official interest rates**
(% per annum)



Sources : ECB, Fed, BoE.

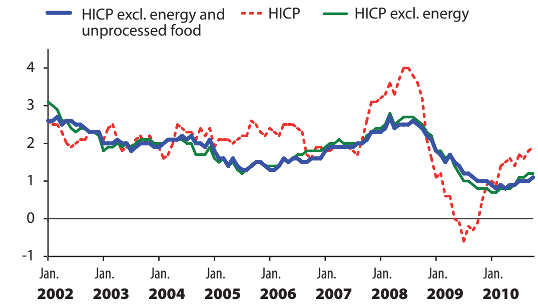
1.2 Monetary developments in the euro area

Inflation

As already mentioned, HICP inflation in the euro area rose to 1,9% in October 2010 compared with 1,8% in September 2010 and -0,1% in October 2009 (**Chart A.8**). The rise in HICP stemmed mainly from the rise in energy prices as well as from the increase in the rate of growth in the prices of unprocessed food.

The HICP excluding energy, recorded an increase of 1,2% in October 2010, unchanged from September 2010. A large part of the rise in October was due to food prices. The HICP excluding energy and unprocessed food increased by 1,1% in October 2010, very close to the levels of 1% recorded in September 2010.

CHART A.8 **Inflation in the euro area**
(annual change, %)



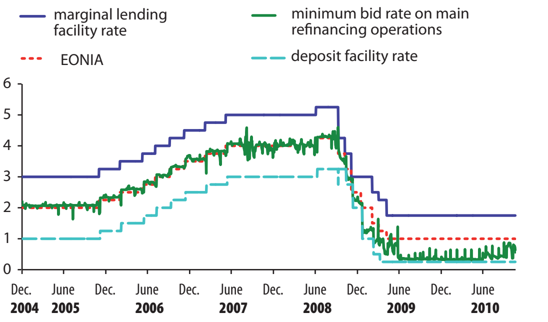
Source : Eurostat.

Reference rates and ECB interventions

The key ECB interest rates remain un-changed since 13 May 2009. More specif-ically, the main refinancing operations (fixed) rate stands at 1%, the marginal lending rate at 1,75% and the deposit acceptance facility rate at 0,25% (**Chart A.9**). Furthermore, the implementation of monetary policy by the ECB through the use of unconventional tools continued. Specifically on 2 September 2010, the Governing Council decided that the ECB should continue conducting the main refinancing operations (MROs) and special-term refinancing operations with a maturity of one maintenance period as fixed rate tender procedures with full allotment for as long as necessary. In addition, the ECB continued the gradual phasing out of measures, which had been adopted at the peak of the economic crisis, in order to enhance the liquidity of banks. In particular, the Eurosystem did not renew the 6 and 12 month refinancing operations but continued to provide liquidity through its operations of one week, three months and one maintenance period maturities. Moreover, the programme for the purchase of covered bonds, which was an additional, non-conventional measure of monetary policy, expired on 30 June 2010. The objective for the purchase of covered bonds for a nominal amount of €60 billion was achieved during the 12 months of the programme.

Monetary policy in the euro area remains accommodative. The unconventional measures which remain in force are compatible with the mandate for their temporary usage ordered by the Governing Council.

CHART A.9 **ECB reference rates and EONIA**
(% per annum, daily data)



Sources: ECB, www.euribor.org.

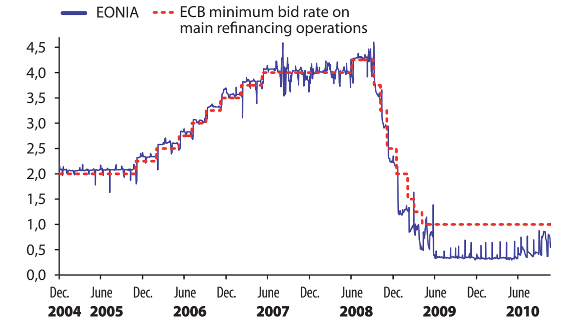
Interbank market and interest rate differentials

Money market rates rose during the period under review. The EONIA rate increased significantly in recent months and was close to 0,55% on 19 November 2010 (**Chart A.10**). This increase was mainly a consequence of the unexpected reduction in excess liquidity at the end of the three longer-term refinancing operations (LTROs) on 30 September. In addition, the EONIA exhibited large fluctuations after the expiration of the first long-term refinancing of one year on 1 July 2010. The 3 month EURIBOR exceeded 1% which is the current level of the ECB's main refinancing operations, mainly due to the gradual phasing out of the temporary liquidity enhancing measures.

On 19 November 2010, the 1, 3 and 12 month EURIBOR rates stood at 0,82%, 1,04% and 1,54%, respectively - an increase of 37, 34 and 29 basis points respectively, from the beginning of the year. Overall, the difference between the 12 and 1 month EURIBOR - which is an indicator of the slope of the money market yield curve - decreased by 8 basis points in the same period and stood at 72 basis points on 19 November (**Chart A.11**).

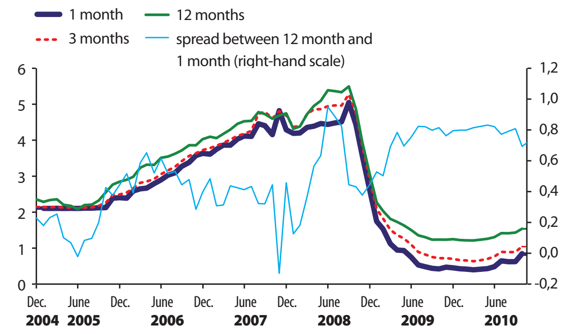
Chart A.12 depicts the spreads between EURIBOR and OIS[3] products, which remained at very low levels. This reflects the smoother conditions in the money markets. Indicatively, the spread between the 3-month EURIBOR and the OIS was around 33

CHART A.10 **EONIA and ECB minimum bid rate on main refinancing operations**
(% per annum, daily data)



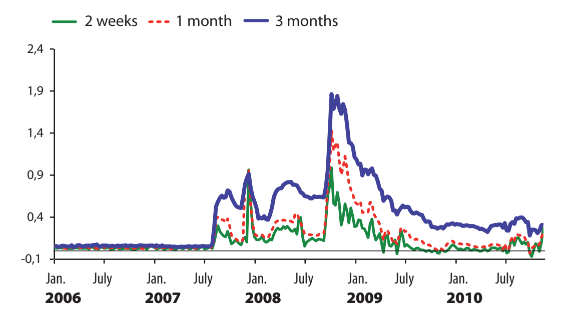
Sources: ECB, www.euribor.org.

CHART A.11 **EURIBOR (selected durations)**
(% per annum, monthly data)



Source: www.euribor.org.

CHART A.12 **EURIBOR and OIS**
(% per annum, weekly data)



Source: www.euribor.org.

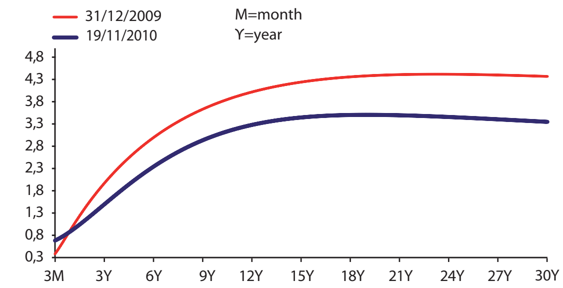
3. OIS (Overnight Index Swaps) are derivative products where EONIA is swapped with a fixed interest rate of selected duration. OIS are used for hedging or speculative moves in the interbank overnight rate or the reference rates of central banks.

basis points at the end of 2009, while up until 19 November 2010 (the cut-off date for data in this *Bulletin*) it reached 32 basis points.

Euro area yield curve

Chart A.13 shows the yield curve for AAA rated euro area government bonds with a 30 year maturity (spot prices). Compared with the end of 2009, the mid-November curve shifted downwards, particularly at the longer end. This is likely due to the downward revision of investor expectations about the future course of euro area long-term interest rates. The shape of the yield curve seems to have also been affected by market expectations for subdued economic growth, the reduction of inflationary pressures and the increased demand for government bonds which are considered safer assets.

CHART A.13 **Euro area spot yield curve**
(%)



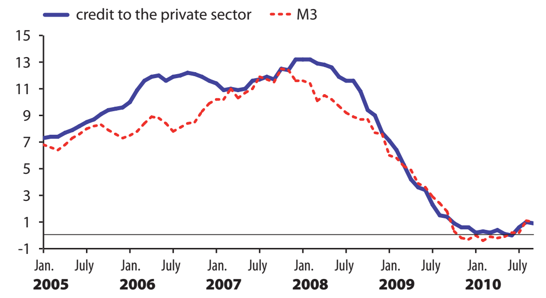
Source: ECB.
Note: Yields on AAA government bonds with maturity up to 30 years, spot prices.

M3 and credit expansion

The annual growth of M3 stood at 1% in September 2010, virtually unchanged from August but registering a rise compared with June and July, when zero growth rates had been recorded. The increase in the growth of M3 reflects the smaller dampening effect of the yield curve, which, due to its steepness in previous months, had encouraged a shift from M3 into longer-term assets.

The increase in the annual rate of growth of M3 was also reflected in the growth of loans to the private sector (**Chart A.14**), which registered an increase, albeit subdued, of 1,2% in August and September. This positive increase was due to the increase in loans to households and to the less negative annual growth of loans to non-financial corporations (NFCs). The annual growth rate of loans to households stood at 2,8% from 2,9% in the previous month, while the annual growth rate of loans to NFCs recorded a negative change of 0,6% in September from -1,1% August. More specifically, housing loans rose by 3,4% in September, unchanged from the previous month, while consumer loans recorded a further negative change of 0,9% compared with -0,4%. Overall, the growth rates of money supply and credit remain moderate, so inflationary pressures are limited in the medium-term.

CHART A.14 **M3 and credit to the private sector: euro area**
(annual change %, seasonally adjusted data)



Source: SDW (ECB).

2. Domestic Prices, Monetary Aggregates and Labour Costs

The Cyprus economy, reflecting the recovery achieved by the economies of its major trading partners, exhibited a marginal positive growth rate during the first nine months of 2010. Similarly, increases were recorded in inflation, which was largely influenced by energy and food prices.

Prices

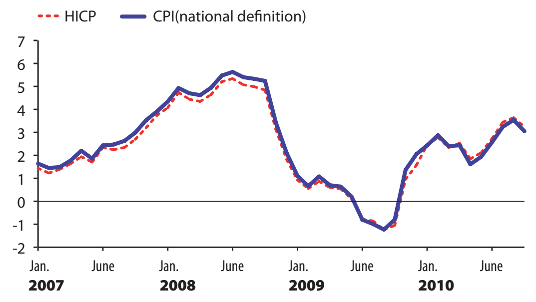
The Consumer Price Index (CPI) for October 2010 increased by 3%, compared with 3,5%

in September 2010 and a decrease of 0,8% in October 2009. During the first ten months of 2010, the CPI averaged 2,7% compared with 0,1% in the same period last year. During the period January-October 2010, the HICP rose by an average of 2,7% compared with 0% during the corresponding period of 2009 (**Chart A.15**).

According to the latest available data, the significant increase in inflation during the first ten months of 2010 was mainly due to a base effect, as a result of low oil prices in the corresponding period of 2009, the depreciation of the euro against the dollar and the imposition of taxes and other charges on the price of electricity during the current year. At the same time, food prices recorded a slowdown during the first ten months of 2010 compared with the corresponding period of 2009, but showed a significant increase in August, September and October 2010. In addition, a marginal increase was recorded during the same period in the prices of industrial goods excluding energy, while in contrast the growth in the prices of services exhibited a substantial slowdown. Inflation excluding energy recorded a significant slowdown in the period January-October 2010, increasing by only 0,7% compared with 2,6% in the corresponding period last year.

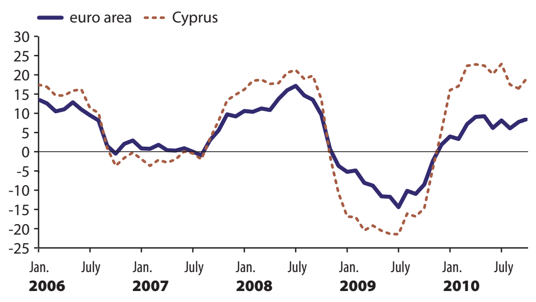
Analytically, in the energy subcategory (**Chart A.16**), there was a significant increase in the price of electricity mainly due to a base effect as well as the additional increases imposed by the Electricity Authority of

CHART A.15 **Consumer price index**
(annual change, %)



Source: Cystat.

CHART A.16 **Harmonised Index of Consumer Prices: energy**
(annual change, %)

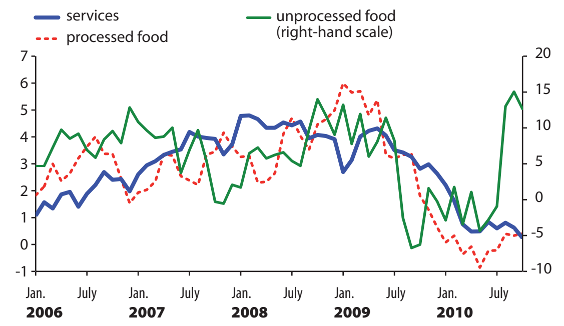


Sources: Eurostat, Cystat.

Cyprus (EAC) in the first ten months of the year. In particular, there was a 2% increase in the basic price of electricity imposed in January 2010. Further increases are also planned for January 2011 and 2012. In addition, the EAC has recently imposed two further increases in the price of electricity. The first increase of 1,9% was a penalty imposed by the European Union for higher emissions of pollution and was implemented in late May 2010. The second increase, imposed in August 2010, was around 2% and was used for public utility purposes as well as the Renewable Sources of Energy Fund. Furthermore, since June 2010 the government imposed an excise tax of 9% on fuel and lubricant prices. Finally, there were significant increases in fuel prices as a result of the increase in euro denominated international oil prices during the first ten months of 2010. As a consequence, in the first ten months of 2010, energy prices rose by an average of 19,7% compared with a decrease of 18,4% in the first ten months of 2009. According to the latest data available for October 2010, the increase in energy prices reached 19,2% compared with a decrease of 14,7% in October 2009.

Regarding food prices, an average deceleration of 1,1% was recorded in the first ten months of 2010 (**Chart A.17**), compared with an increase of 4,6% in the corresponding period of 2009. More specifically, during the first ten months of 2010 there was a slowdown of 2,9% in the prices of unprocessed food compared with

CHART A.17 **Harmonised index of consumer prices: food and services**
(annual change, %)



Source: Cystat.

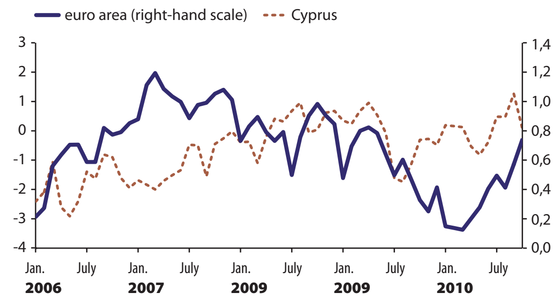
an increase of 5,1% in the corresponding period of 2009. This slowdown was mainly due to falling fruit and vegetable prices in the first seven months of 2010 and the significant slowdown experienced in the price of meat during the first half of the year. However, it should be noted that in August, September and October 2010 there were significant increases in fruit and vegetable prices due to market distortions. On the other hand, in October 2010 the prices of unprocessed food registered a sharp increase of 12,6% compared with a decrease of 6,3% in October 2009. Meanwhile, the prices of processed food remained unchanged during the first ten months of 2010 compared with an increase of 4,3% in the corresponding period of 2009. According to the latest available data, prices in the aforementioned category recorded a slowdown, as they reached 0,4% in October 2010 compared with an increase of 1,8% in October 2009.

Chart A.17 (p. 35) also shows the annual rate of growth in the prices of services, which have followed a downward path since June 2009. In particular, during the first ten months of 2010, the prices of services rose by 0,9% compared with an increase of 3,5% in the same period last year. The main reasons for the small increase in the prices of services are the significant reductions recorded in the prices of accommodation services and air transport because of the economic crisis, and the slowdown in the prices of health, restaurants and cafes. With respect to October 2010, the rate of change in the prices of services recorded a further slowdown as it reached 0,2% compared with an increase of 2,8% in October 2009.

The prices of industrial goods excluding energy (**Chart A.18**) recorded an average increase of 0,1% in the first ten months of 2010 compared with a decrease of 0,2% in the corresponding period of 2009. This is mainly due to the increases in clothing and footwear, which offset the continuing significant price reductions in the prices of motor vehicles. According to the latest available data for October 2010, the rate of change of prices in this category showed a marginal increase of 0,1% compared with a decrease of 0,3% in October 2009.

It is noted that the inflation differential between Cyprus and euro area has been positive since November 2009. In particular, during the first ten months of 2010 domestic inflation reached 2,7% compared with 1,5% in the euro area. Maintaining this differential in the medium-term undermines both the development of the domestic economy and, more generally, domestic competitiveness compared with the euro area. With respect to domestic inflation excluding energy, this is at lower levels compared with the euro area, reaching 0,7% in the first ten months of 2010 compared with 0,9% in the euro area.

CHART A.18 **Harmonised index of consumer prices: non-energy industrial goods**
(annual change, %)



Sources: Eurostat, Cystat.

Monetary aggregates[4, 5]

The annual growth rate of loans to the

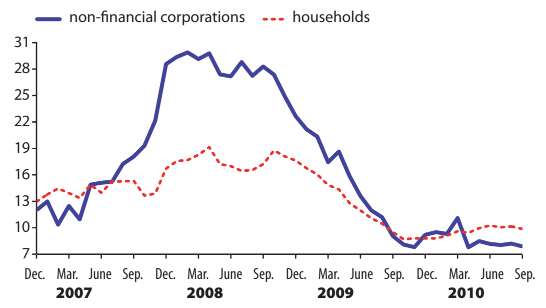
4. For a detailed explanation of the methodology and technical analysis of monetary aggregates, see the technical notes on page 205.
5. Regarding the classification of loans by economic activity, it is noted that as a result of the change in the Directive on the monthly balance sheets of banks and the classification from NACE 1.1 to NACE 2, there is a structural change in the statistical series and therefore annual growth rates cannot be calculated. Further checks are required in order to reconcile the differences between the two classifications. In view of the above, this analysis is not presented in Part A of this *Bulletin*.

domestic private sector has accelerated since the beginning of the year and stabilised in the middle of the year until September. Specifically, at the end of 2009 the annual growth rate stood at 8,4% and continued its upward trend reaching 9,8% in March 2010, despite a general slowdown in the economy. Following March 2010, the annual growth rate of loans registered a slowdown in April and May and, until the end of the third quarter of the year, it accelerated, reaching 9,1% in September. The use of special government bonds as collateral in obtaining liquidity from the ECB supported the growth in loans close to their long-term average of 10%, since most of the liquidity gained was used in providing housing loans.

A further analysis of monetary aggregates shows that the annual growth rate of loans to the private sector at the end of the third quarter of 2010 reached 9,1%, compared with 9,5% at the end of the second quarter and 6,9% in the third quarter of 2009. Loans to domestic NFCs grew by 7,9% at the end of September 2010 compared with 8,2% at the end of June and 9,1% at the end of September 2009(**Chart A.19**). Loans to households also recorded a similar trend. In particular, at the end of September 2010 the annual growth rate reached 9,9% compared with 10,3% in June and 9,5% at the end of September in the previous year.

It is noted that the acceleration observed in loans to households for the largest part of the year emanated from housing loans.

CHART A.19 **Loans to domestic households and non-financial corporations: Cyprus**
(annual change, %)



Source: CBC.

Based on figures for outstanding amounts at the end of September 2010 (**Table A.1**), 15,5% was used for consumer loans, 52,5% for housing loans and 32% for other loans. More specifically, housing loans to domestic households increased by of 15,4% in September 2010 compared with an increase of 15,9% at the end of the previous quarter, and an increase of 11,1% in September 2009.

On the supply side, the general policy of MFIs to focus on housing loans which are secured against property and are for a longer term horizon, resulted in the introduction of new products for housing loans. On the demand side, residents seem to have persisted in their borrowing for housing. This may be attributed to social habits in relation to home ownership as well as to the increase in purchases of holiday homes, following the price reductions observed in certain coastal areas.

In relation to the above, according to the results of the Bank Lending Survey conducted in October 2010, the criteria for lending for housing purposes in the fourth quarter of 2010 are expected to become stricter, while no change is expected in the lending criteria of loans to enterprises.

It is noted that monitoring credit developments is mainly carried out for monetary policy purposes. At the same time, this type of analysis is also useful in relation to the implementation of macro-prudential policy. One such example for Cyprus is presented in **Box A.1** (p.42).

With respect to deposits, the annual

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

	Outstanding balance as % of total(3)	Annual percentage change					
		2009 June	2009 Sep.	2009 Dec.	2010 Mar.	2010 June	2010 Sep.
Domestic households	100,0	12,0	9,5	8,8	9,6	10,3	9,9
1. Consumer credit	15,5	12,0	9,9	7,5	5,0	3,9	1,9
2. Lending for house purchase	52,5	14,0	11,1	11,5	13,7	15,9	15,4
3. Other lending	32,0	9,3	7,0	5,7	6,3	5,6	6,0

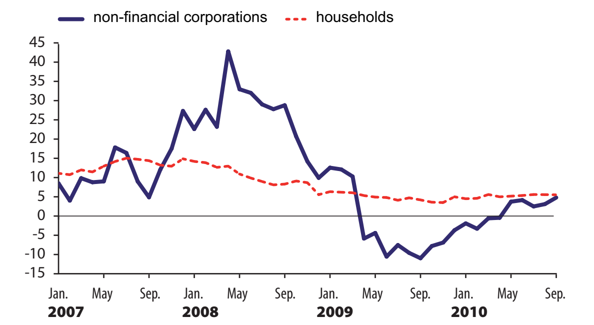
Source: CBC.
(1) Sectoral classification is based on ESA 95.
(2) Including non-profit institutions serving households.
(3) As at the end of the last month available. Figures may not add up due to rounding.

growth rate of deposits from domestic households (**Chart A.20** and **Table A.2**) reached 5,5% in September 2010 compared with 5,3% in June, and 4,2% in September 2009. The acceleration in the growth rate of deposits has continued since May 2010. Deposits with agreed maturity up to one year accounted for 70,9% of total household deposits, while the category of long-term deposits up to 2 years accounted for 71,7% of total deposits at the end of September 2010. This is partly due to the higher interest rates offered by MFIs in an effort to raise and commit funds from their main source, i.e. customer deposits. In addition, the cautious behaviour of depositors - due to the uncertainty regarding the prospects of the economy - is reflected in lower consumption and increased savings in deposits offering a higher return.

It is also noted that the positive growth in overnight deposits continued, although lower than the high level of 8,6% recorded in March. More specifically, the latest data for September showed an increase of 5,4% compared with a decrease 4,9% in September 2009. Deposits redeemable at notice are the only major category which recorded a decrease of 0,5% in the month under review, following five months of positive growth, while a decrease of 16% was recorded in September 2009.

With regard to deposits of domestic NFCs (**Chart A.20**), positive annual growth rates were registered from May 2010. In particular, these deposits increased by

CHART A.20 **Deposits of domestic households and non-financial corporations: Cyprus**
(annual change, %)



Source: CBC.

TABLE A.2 **Deposits of domestic households [(1),(2)]**

	Outstanding balance as % of total[(3)]	Annual percentage change					
		2009 June	2009 Sep.	2009 Dec.	2010 Mar.	2010 June	2010 Sep.
Domestic households	**100,0**	**4,8**	**4,2**	**5,0**	**5,6**	**5,3**	**5,5**
Overnight	**14,9**	**-9,0**	**-4,9**	**2,9**	**8,6**	**5,6**	**5,4**
With agreed maturity	**75,1**	**14,8**	**10,0**	**7,4**	**5,9**	**5,6**	**6,4**
up to 2 years	71,7	16,3	11,4	8,6	6,8	6,9	7,2
over 2 years	3,4	-5,0	-9,8	-9,8	-7,4	-15,9	-8,1
Redeemable at notice	**10,0**	**-24,9**	**-16,0**	**-6,7**	**-1,0**	**3,0**	**-0,5**
up to 3 months	7,6	-29,5	-20,5	-10,5	-3,8	2,4	-0,8
over 3 months	2,5	-9,0	-1,7	4,5	6,8	4,5	0,5

Source: CBC.
(1) Sectoral classification is based on ESA 95.
(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.

4,8% at the end of September 2010 compared with an increase of 4,1% at the end of the previous quarter and a decrease of 11% in September 2009. It is noted that the positive growth in these deposits registered during the past five months is consistent with the fact that, during the period May - September 2010 the interest rates offered on deposits up to one year remained at higher levels, reaching around 3,2% compared with around 2,9% at the beginning of the year. Deposits by NFCs represent approximately 18% of total private sector deposits in the banking system.

Regarding the deposits by non-resident NFCs, including deposits by companies with no physical presence in Cyprus ('brass plates'), these recorded an annual increase of 38,6% in September 2010 compared with a decrease of 6,7% in September 2009. Since March 2010, these deposits have registered significant growth. This increase is partly due to the appreciation of the dollar against the euro and the inflow of deposits.

Household deposits by non-residents of Cyprus increased by 51,9% at the end of September 2010 compared with 4,7% in September 2009. The significant increase in deposits was due to inflows of deposits from Greece, however these have been contained in the last three months.

It is noted that total deposits by non-residents of Cyprus, including "brass plates", recorded an annual increase of 54,6% during the month under review, as a result of the aforementioned factors.

Box A.1: The use of the loan-to-value ratio as a macro-prudential policy tool: the case of Cyprus 2007-2008

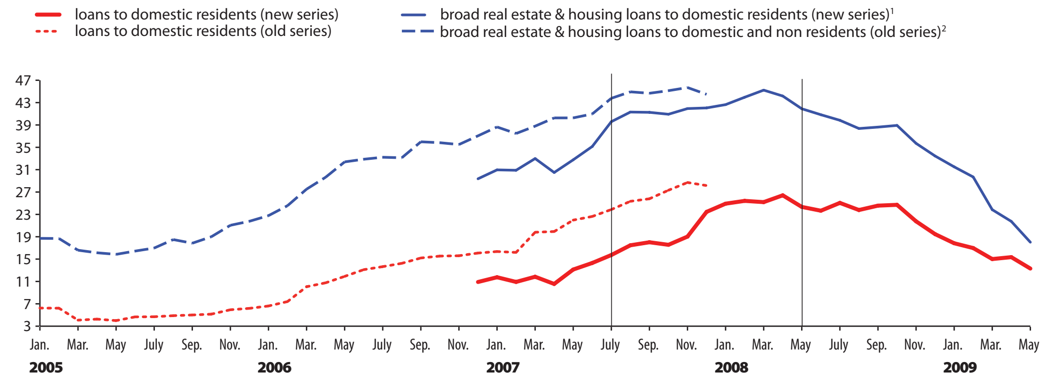
The loan-to-value ratio is among the tools of macro-prudential supervision that can be used in order to contain systemic financial risks, for instance, those associated with excessive credit growth (see **Box B.1**, p.124 for further analysis on the macro-prudential tools and policies). In an environment of a very buoyant real estate sector, it is possible to encounter an excessive increase in property prices as well as in loans for the purchase or construction of property. In such an environment, if developments in the real estate sector are eventually proved unsustainable, the portfolios of the financial institutions could be exposed to increased risks with a potentially systemic impact. One of the measures which the supervisory authority may impose to prevent these risks is to reduce the maximum loan-to-value ratio. That is, the supervisory authority can reduce the amount which a real estate buyer can finance through a loan, with the rest of the financing being self funded. In this way, the supervisor seeks to shield the banking sector from an excessive lending increase in loans and reduce the risks of excessive growth and subsequent sharp fall in property prices.

The CBC successfully used the loan-to-value ratio in the period 2007-2008, in order to prevent risks associated with the rapidly expanding activity in the construction sector. Following Cyprus's entry into the European Union in 2004 and the subsequent adoption of the euro on 1 January 2008, there was an increase in activity in the construction sector fuelled by rising demand for real estate property both by foreigners and Cypriots.

As shown in **Chart 1**, broad real estate and housing loans recorded a rapid growth during the period preceding the adoption of the euro in Cyprus[1]. As a result of these developments, but also in view of the performance of other concurrent real estate indicators, which also pointed to a significant increase in activity in the domestic property market, legitimate concerns emerged regarding the risks of financial institutions' portfolios. The prevailing view at the CBC was that the very rapid growth in activity in the property market had become unsustainable and could not continue growing at the same rate. The risks for Cyprus's financial sector and the economy would have been significant had there been a reversal in market

1. Chart 1 (p. 43) shows the series for total loans and loans to the broad real estate sector. The technical notes at the end of the Box and the explanatory notes to Chart 1 note the differences between the old and new series. Note that the figures for credit growth taken into account when the decision was made in July 2007 were mainly those shown in Chart 1 as the old series.

CHART 1 **Credit developments in Cyprus 2005-2009**
(annual change, %)



Source: CBC.
1) By economic activity of borrower: Consists of construction, real estate and construction related manufacturing (NACE rev 1.1) and housing loans (ESA 95).
2) By purpose of loan: Consists of loans granded for the purchase of land, construction purposes and for the purchase of ready made houses.

conditions. The data available at the time referred mostly to the first half of 2007. More specifically, credit growth and other monetary data were available with a lag of one month, while the time lag for the other monitored monthly indicators ranged from a few days to three months[2]. Other qualitative information such as the expectations of building contractors and real estate agents, was also taken into account.

Against this background, and based on the above data, the CBC decided on 12 July 2007 to impose a reduction in the maximum loan-to-value ratio. In particular, the CBC issued a circular to commercial banks reducing the maximum percentage of financing allowed for the purchase or construction of a second property from 70% to 60% of the property's value. The corresponding maximum percentage of funding allowed for the purchase or construction of a primary residence remained at 80%.

As already mentioned, credit growth, particularly that related to the real estate sector, had grown rapidly in the months leading to July 2007 (**Chart 1**). In addition, other indicators including building permits, property sales contracts and the issuance of title deeds also indicated a rapid increase in economic activity in this sector. As shown in **Table 1** , p. 44 (column 1), the data reinforced the conclusion that the

2. It should be noted that there were no major revisions of the monthly data used for analysis that could affect the overall picture during the aforementioned period.

TABLE 1 **Construction sector indicators**
(annual change, %, period changes)

	June 2006 to May 2007	June 2007 to May 2008	June 2008 to May 2009
Total sales contracts in Cyprus	42,6	7,2	-49,7
Building permits – residential	1,9	-7,2	-0,4
Building permits – total	3,1	-8,0	2,1
Local sales of cement	7,9	12,2	-10,0
Title deeds – Nicosia	8,7	4,4	-39,1
Title deeds – Limassol	36,0	6,5	-48,8
Title deeds – Larnaca	20,4	-1,0	-53,5
Title deeds – Famagusta	30,8	-16,3	-44,0
Title deeds – Paphos	52,0	7,0	-40,4

Sources: Cystat, Department of Lands and Surveys.

real estate sector was indeed experiencing very rapid growth. This growth was considered to be sufficiently high as to raise concerns about the ability of financial institutions to absorb a potentially substantial negative shock to the economy. These concerns were further aggravated by the rapid growth in property prices in Cyprus since 2006, which was among the highest compared with the rest of the euro area.

The CBC's decision to reduce the maximum loan-to-value ratio initially prompted significant opposition. Developers, real estate agents and other affected groups strongly expressed their disagreement while some government officials and members of parliament requested an amendment of the CBC's directive. However, some construction companies took seriously the policy change and altered their expectations and plans. This had a catalytic impact on the effectiveness of the measure.

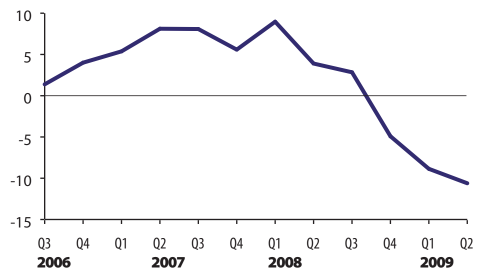
The data on which the CBC decision was based continued to be monitored closely in order to examine the impact of the measure. Meanwhile, as from January 2008 a new and improved data series for credit developments began to be monitored, based on new definitions and on the ECB methodology. The new credit series is shown in **Chart 1** (p. 43), along with the previous one[3].

During 2008 it became evident that the reduction of the maximum loan-to-value ratio, in conjunction with the impact of the global financial and economic crisis, contained the increase in demand. The growth rate of loans to the broad real estate and housing sectors, although still high in the second quarter of 2008, was on a distinctly downward path. The nature of the loan

3. It should be noted that the new series, which starts in December 2005, is currently the only one which is monitored, since the older credit series is no longer compiled.

arrangements in real estate have a built-in lag mechanism, since such loans must first be approved and later disbursed in tranches, according to the progress of the construction work. Despite the observed slowdown in the growth of loans, the existing time lag meant that it would take a few months for the reduction of the maximum loan-to-value ratio to fully materialise. Moreover, as already noted, it was apparent that the announcement of the measure prompted some developers to understand the concerns of the CBC and thus led them to change their plans and reduce their commitments. Furthermore, during the period June 2007 - May 2008, a slowdown in the growth of related indicators – such as title deeds issued, building permits and monthly sales contracts – was recorded (**Table 1**, p. 44). Moreover, the index of production in construction showed clear signs of a slowdown at the end of the first half of 2008, following a period of rapid expansion (**Chart 2**). Based on these developments, the CBC restored the maximum loan-to-value ratio back to 70% on 27 May 2008.

CHART 2 **Index of production in construction**
(annual change, %)



Source: Cystat.

Examining the data related to the real estate sector subsequent to the decision, one may conclude that the measure was effective both in containing the extremely rapid growth of credit in the real estate sector as well as in changing the unsustainable level of construction activity. Therefore, the measure helped to protect the Cyprus economy from the negative consequences of a possible collapse of the real estate sector driven by significantly higher prices and further lending to the sector.

Definitions of data in Box A.1 (continued on p. 46)

1) **Monetary Financial Institutions**
Old series: Consisted of data from "local" banks only and did not include data from the co-operative credit institutions (CCIs) and the former international banking units (IBUs).
New series: Consists of data from all credit institutions operating in Cyprus including CCIs and the former IBUs.

Definitions of data in Box A.1 (contd)

2) **Residency**
Old series: The statistical definition of residency was based on the *Exchange Control Law*.
New series: The statistical definition of residency is in accordance with the European System of Accounts (ESA95), which considers natural persons to be residents when they reside (or intend to reside) in a country, i.e. Cyprus, for more than a year, while legal entities are considered to be residents when they have a physical presence in a country (e.g. operating through their own office). On 1 July 2008, the CBC harmonised the definition of "resident of Cyprus" with that of the Eurosystem for statistical purposes. This change affects, mainly, the criterion for legal persons. In particular, every organisation or enterprise of any legal form which has been incorporated or registered in Cyprus, irrespective of whether or not it maintains a physical presence on the island, shall be considered as "resident of Cyprus" for statistical purposes. However, the effect of this change has been excluded from the above data.

3) **Annual Growth Rates, %**
Old series: The annual growth rates referred to year-on-year growth based on outstanding amounts.
New series: The annual growth rates are based on the methodology followed by the ECB. For details please refer to the Monetary and Financial Statistics published by the CBC's Statistics Department

Interest rates

In the second and third quarters of 2010, lending rates in Cyprus generally recorded a slight increase compared with the first quarter of 2010, despite the fact that according to the latest available data, a stabilisation or slight decline in some cases was observed at the end of September 2010 compared with the previous month. Nevertheless, competition among banks trying to attract deposits remains strong and prevents further reductions in lending rates. What is more, banks appear to continue maintaining higher spreads between lending and deposit rates for NFCs compared with households.

More analytically, at the end of September 2010 the average interest rate on new euro denominated loans to euro area households from Cyprus MFIs with an initial fixation of up to one year (**Table A.3**), decreased to 6,82% for consumer loans and 6,08% for other loans, from 6,84% and 6,22%, respectively in June 2010, and 7,15% and 6,50%, respectively in September 2009. In contrast, the interest rate on housing loans increased to 4,96% in September 2010, from 4,63% in June, but remains lower compared with September 2009, when it reached 5,48%. The increase in interest rates for housing purposes is also reflected in the latest Bank Lending Survey conducted in October 2010. More specifically, in the third quarter of 2010 banks' credit standards for housing loans were further tightened, partly through an increase in the banks' margin

TABLE A.3 **Cyprus MFI interest rates on euro-denominated loans (new business) to euro area households[1]**
(% per annum, period average)

		Bank overdrafts [2]	Floating rate and up to 1 year initial rate fixation: Consumer credit	House purchase	Other lending
2009	June	7,48	7,65	6,10	7,03
	July	7,44	7,49	6,04	6,56
	Aug.	7,47	7,23	5,88	6,65
	Sep.	7,31	7,15	5,48	6,50
	Oct.	7,30	7,19	5,51	6,49
	Nov.	7,23	7,16	5,19	5,62
	Dec.	7,18	7,00	5,01	6,27
2010	Jan.	7,13	6,87	4,73	5,59
	Feb.	7,12	6,87	4,52	5,94
	Mar.	7,25	6,99	4,43	5,79
	Apr.	7,25	6,70	4,33	5,93
	May	7,21	6,82	4,38	6,05
	June	7,01	6,84	4,63	6,22
	July	6,99	6,81	4,82	6,23
	Aug.	7,02	6,96	4,80	6,33
	Sep.	7,01	6,82	4,96	6,08

Source: CBC.
(1) Including non-profit institutions serving households.
(2) For this instrument category, new business refers to end-of-period.

both for standard and higher risk loans. At the same time, there was an increase in the average interest rate on new loans by MFIs in Cyprus to NFCs in September 2010 compared with June. It should be noted that the average interest rate for other loans of over €1 million to enterprises has followed an upward trend since July 2009 (**Table A.4**).

As regards the corresponding rates for loans from MFIs in the euro area, (**Chart A.21**), these recorded a slight increase in the third quarter of 2010, with the exception of new loans to households for consumption purposes, reflecting the increase recorded in Euribor rates. As for the differential between Cyprus and euro area interest rates is concerned, the biggest difference continues to be recorded in the interest rate on loans to NFCs.

With respect to deposit rates in the third quarter of 2010, these recorded a downward trend for enterprises and a stabilising trend for households (**Table A.5,** p.49). Indicatively, the average rate on new deposits to NFCs with an agreed maturity of up to one year increased in September 2010, reaching 3,08% compared with 2,51% in September 2009, albeit decreasing slightly compared with 3,17% recorded in June 2010. The respective rate for households reached 3,96% in September 2010 compared with 3,87% in June 2010 and 4,11% in September 2009.

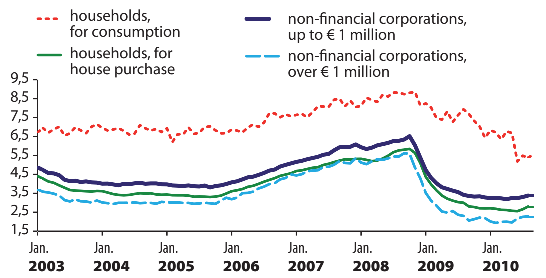
In the euro area, although deposit rates fluctuated at much lower levels than the corresponding Cyprus rates, they increased in September 2010 compared with both the

TABLE A.4 **Cyprus MFI interest rates on euro-denominated loans (new business) to euro area non-financial corporations**
(% per annum, period average)

		Bank Overdrafts [1]	Floating rate and up to 1 year initial rate fixation: Other loans up to €1 million	Other loans over €1 million
2009	June	7,21	7,13	4,68
	July	7,16	6,95	3,97
	Aug.	7,08	6,36	3,99
	Sep.	7,08	6,76	4,19
	Oct.	7,03	6,26	4,69
	Nov.	6,95	6,04	5,72
	Dec.	6,69	6,00	5,47
2010	Jan.	6,69	5,39	4,62
	Feb.	6,67	5,93	4,39
	Mar.	6,61	5,95	4,61
	Apr.	6,55	5,79	4,96
	May	6,53	5,98	5,27
	June	6,52	6,19	4,97
	July	6,54	6,24	6,01
	Aug.	6,57	6,44	6,27
	Sep.	6,57	6,43	5,77

Source: CBC.
(1) For this instrument category, new business refers to end-of-period.

CHART A.21 **Euro area MFI interest rates on euro denominated loans (new business) to euro area residents[(1)]**
(% per annum, period averages)



Source: SDW (ECB).
(1) At floating rate and up to 1 year initial rate fixation.

corresponding month of 2009 and June 2010 (**Chart A.22**). In particular, the average interest rate on euro-denominated deposits by households with an agreed maturity of up to one year reached 2,25% in September 2010 compared with 2,16% in June 2010 and 1,61% in September 2009. The respective rate for deposits by NFCs reached 1,11% in September 2010 compared with 0,89% in June 2010 and 0,69% in September 2009.

The CBC considers the spread between lending and deposit rates to be of importance. During the first nine months of 2010, the spread between lending and deposit rates for households in Cyprus was much lower than the euro area average. In fact, it was the third lowest spread after Finland and Luxembourg. This is attributed to the fact that banks in Cyprus offer the highest average deposit rates to households compared with other euro area countries, whilst the lending rates are the third highest in the euro area.

In contrast, banks in Cyprus seem to maintain their margin between lending and deposit rates for NFCs. During the first nine months of 2010, Cyprus recorded the fourth highest average spread after Slovenia, Portugal and Slovakia. This difference lies in the fact that lending rates for enterprises in Cyprus are much higher than the euro area average.

Labour costs

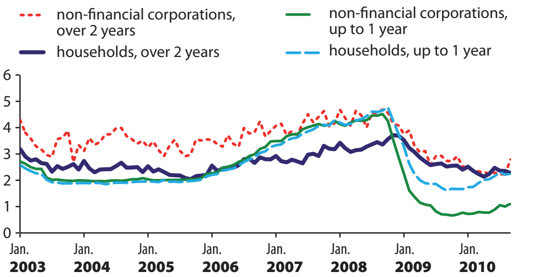
The contraction of the economy during the

TABLE A.5 **Cyprus MFI interest rates on euro-denominated deposits (new business) by euro area residents**
(% per annum, period average)

		Households[1]			Non-financial corporations	
			With agreed maturity			
		Overnight[2]	Up to 1 year	Over 1 and up to 2 years	Overnight[2]	With agreed maturity up to 1 year
2009	June	1,29	4,06	3,88	0,74	2,71
	July	1,25	4,06	3,80	0,69	2,78
	Aug.	1,26	4,05	3,96	0,66	2,91
	Sep.	1,27	4,11	4,26	0,62	2,51
	Oct.	1,24	4,15	3,97	0,60	2,86
	Nov.	1,24	4,11	3,90	0,62	2,93
	Dec.	1,21	4,13	4,56	0,53	2,86
2010	Jan.	1,19	4,15	3,97	0,52	3,11
	Feb.	1,19	4,00	4,06	0,56	3,09
	Mar.	1,16	3,95	3,88	0,49	2,95
	Apr.	1,13	3,87	3,82	0,53	3,22
	May	1,13	3,88	3,96	0,50	3,13
	June	1,12	3,87	4,02	0,51	3,17
	July	1,13	3,92	4,01	0,55	3,33
	Aug.	1,13	3,94	4,16	0,51	3,26
	Sep.	1,14	3,96	4,00	0,52	3,08

Source: CBC.
(1) Including non-profit institutions serving households.
(2) For this instrument category, new business refers to end-of-period.

CHART A.22 **Euro area MFI interest rates on euro-denominated deposits (new business) by euro area residents[1]**
(% per annum, period averages)

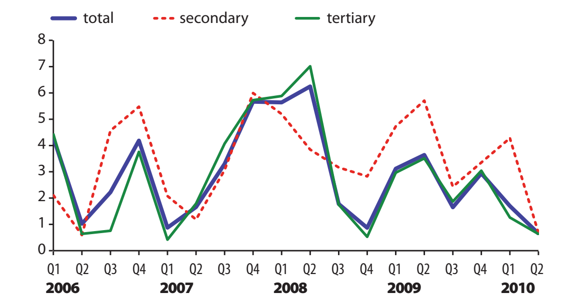


Source: SDW (ECB).
(1) New deposits with agreed maturity.

first half of 2010 continued to affect labour costs, which registered a significant slowdown during the same period. More specifically, according to the latest figures from Cystat, the annual growth rate of nominal compensation per employee, slowed to 1,2% in the first half of 2010 compared with 3,4% in the first half of 2009 (**Chart A.23**). The deceleration was due to the negative economic conditions, the non-granting of general increases in the salaries of civil servants were not granted and the fact that there was no substantial change in the allowance for the cost of living adjustment (COLA) compared with the first half of 2009. The slowdown in labour costs in 2010 was also reflected in the quarterly average monthly earnings for employees, which increased by 2,2% in the first half of 2010 compared with 5,7% in the first half of 2009.

As regards the sectoral breakdown, the increase in compensation per employee in the secondary sector (industry) amounted to 2,5%, exceeding by 1,5 percentage points the respective increase in the tertiary sector (services) in the first half of 2010. The reported increase in compensation per employee in the secondary sector may reflect the fact that a number of low-wage employees left the sector as indicated by a decrease in both employment and total compensation of employees in the sector. However, it should be noted that the level of compensation per employee in the tertiary sector is larger than that in the secondary sector.

CHART A.23 **Nominal compensation per employee by sector**
(annual change, %)



Source: SDW (ECB).

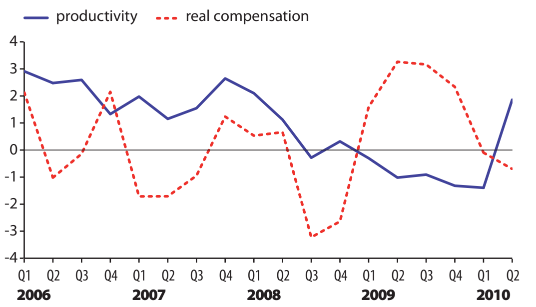
Real compensation per employee decreased slightly in the first half of 2010 compared with the corresponding period of 2009, mainly due to the slowdown registered in the nominal compensation per employee. Specifically, in the first half of 2010, real compensation per employee fell by 0,4% compared with an increase of 2,4% in the first half of 2009. As regards productivity, which is calculated as GDP per employed person, it increased by 0,3% in the first half of 2010 compared with a decrease of 0,7% in first half of 2009 (**Chart A.24**). The growth in productivity in the aforementioned period seems to be the result of increased working hours per employee.

In the first half of 2010, unit labour costs were affected by the increase in productivity and the slowdown in nominal compensation per employee, decelerating to 0,9% in the six months of 2010 compared with an increase of 4,5% in the first half of 2009. In contrast, unit labour costs in the euro area fell by 0,8% during the same period. (**Chart A.25**). Unit labour costs are an important indicator for a country since they are a measure of an economy's competitiveness. Ensuring that unit labour costs are kept low, especially in relation to other countries, is important for improving Cyprus's competitiveness.

3. Domestic Competitiveness and Balance of Payments

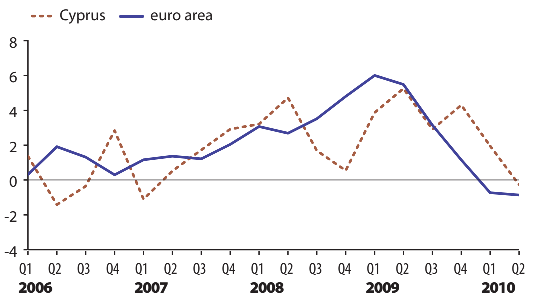
Following a significant improvement in

CHART A.24 **Productivity and real compensation per employee**
(annual change, %)



Source: SDW (ECB).

CHART A.25 **Unit labour costs: Cyprus and the euro area**
(annual change, %)



Source: SDW (ECB).

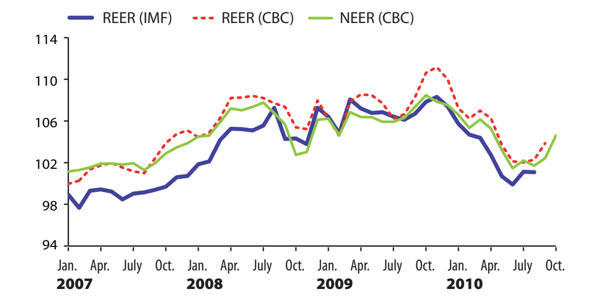
2009, the current account deficit decreased further in the first half of 2010. This improvement was primarily the result of the improvement in the income account which cannot be attributed to structural factors. For Cyprus, it is important that the improvement in the current account results from structural rather than cyclical factors, thus enabling the current account deficit to be maintained at low and sustainable levels. Even though the deficit of the past two years does not appear to have caused any direct financing problems, it is of crucial importance since it indicates a further loss in competitiveness.

Effective exchange rate

Chart A.26 shows the effective exchange rate (EER) of the Cyprus currency (the Cyprus pound until the end of 2007 and the euro from 2008 onwards), the real EER (REER) as calculated by the IMF, and the real and nominal EER index, as calculated by the CBC[6]. The Chart shows a weakening (depreciation) in the real EER from December 2009 until July 2010, while from August 2010 onwards the situation was reversed, largely owing to the path followed by the euro.

The REER, inflation and unit labour costs are important indicators of the competitiveness of the Cypriot economy, especially in comparison with the respective indicators of competing countries. Specifically, the rise in unit labour costs and an appreciating REER indicate that

CHART A.26 **Real and nominal effective exchange rates of the Cyprus currency (IMF weights)**
(Base year 2005=100)



Source: CBC, IMF.

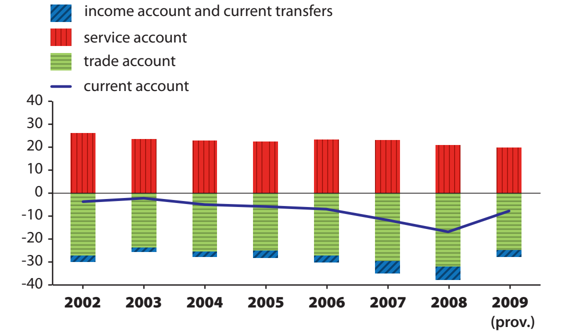
6. The effective exchange rate in real terms "REER IMF" is calculated by the IMF and takes into account third country competition with 19 other countries. The deflator used is the CPI. Because of the time lag in publishing this index, the CBC calculates a simplified index using eight countries instead of 19 ("REER CBC"). The same index is also calculated by the CBC in nominal terms ("NEER CBC").

domestic exports are more likely to be less competitive and imports to be cheaper. Higher inflation encompasses, among other factors, the two aforementioned indicators and therefore reflects the potential competitiveness problems faced by the Cyprus economy.

Balance of payments[7]

Since its significant improvement in 2009, the current account deficit, continued to improve in the first half of 2010, reaching 2,4% of GDP compared with 14,1% in first half of 2009 (**Chart A.27**). The large improvement in the current account deficit is due to the improvement registered in the income account. More specifically, the income account showed an improvement of about 10,8 percentage points due to lower payments in the category of income from direct investments and higher receipts in the same category. This change cannot be described as structural due to the nature of the transactions, while a reversal of the situation is expected in the second half of the year. The trade deficit reached 27% of GDP in the first half of 2010, a deterioration of about 1,8 percentage points over the first half of 2009. This is likely due to the increased prices of petroleum products in the aforementioned period, while domestic demand for imported goods remains low. The services account recorded a surplus of 19,4% of GDP compared with 17,5% in first half of 2009, mainly due to improved revenue from financial services and revenue

CHART A.27 **Current account**
(% GDP)



Source: CBC.

7. It should be noted that the current account data described are not yet included in the national accounts published by Cystat.

from other business services. Finally, there was an improvement in the current transfers account, which recorded a deficit of 0,5% of GDP, reaching 0,7 percentage points lower than the first half of 2009.

Additional data on foreign trade for the third quarter of 2010 shows a similar picture to the first half of the year (**Table A.6**). More specifically, the trade account deficit registered an annual increase of 6,7% in the third quarter of 2010, while the annual increase for the first nine months of the year reached 9,7%. It should be noted that, excluding the renewal of the Cyprus Airways fleet in the first half of 2010, which Cystat classifies as imports of goods, the annual increase in the first nine months of the year was 6,9%. It should also be noted that the exports of goods recorded higher growth rates than the imports of goods, but since the value of imports is much larger, the trade balance is affected to a lesser extent by increased exports.

The financing of the current account deficit has been mostly met through foreign direct investment. The exceptions were the years 2007 and 2008, when the very large current account deficits were primarily financed through "other investments" (**Chart A.28**). The proportion of current account funding from direct investments in 2009 stood at 76%, while as a percentage of GDP it reached 5,9%.

Tourism

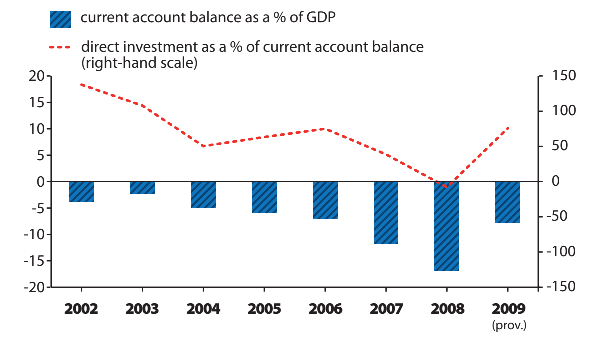
Revenues from tourism in the first nine months of 2010 increased by 3,1%

TABLE A.6 **Trade account**
(€ million)

	Imports	Exports	Trade deficit
2008	7.366,7	1.190,4	6.176,3
2009	5.691,8	970,4	4.691,2
annual % change	-22,7	-18,5	-24,0
2009 Jan. - Sep.	4.232,7	725,8	3.507,0
2010 Jan. - Sep.*	4.670,6	823,9	3.846,7
annual % change	10,3	13,5	9,7

Source: Cystat.
* provisional data.

CHART A.28 **Current account financing by foreign direct investment**



Source: CBC.

compared with the corresponding period of 2009 (**Table A.7**). This small improvement is mainly due to the fact that revenues in 2009 were significantly lower (base effect) compared with previous years. It is worth mentioning that despite the increase in revenues recorded in 2010, these remain at comparatively low levels. Arrivals have also shown a slight improvement in the first nine months of 2010, increasing by 1,3%, again due to base effects.

As shown in **Chart A.29**, the rate of increase in revenue growth was on average higher in the first eight months of 2010 than the growth rate of arrivals, indicating that per capita spending increased during this period.

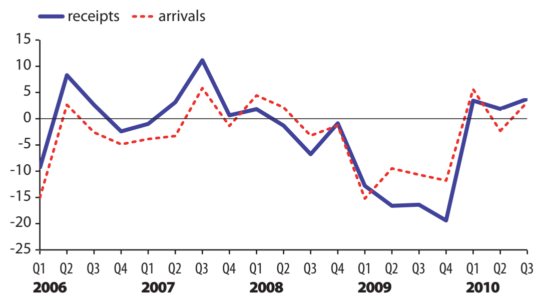
Regarding the overall picture of tourism, the sector seems to have been affected by the global economic crisis, particularly in the UK economy which represents around 50% of tourist arrivals. On the other hand, tourism from Russia has clearly improved, although not sufficiently to overturn the general picture. In addition, the tourist product in Cyprus is losing competitiveness relative to similar destinations.

TABLE A.7 **Tourism**

	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2008	2.403,8	1.792,8	745,8
2009	2.141,2	1.493,2	697,4
annual % change	-10,9	-16,7	-6,5
2009 Jan. - Sep.	1.754,9	1.233,3	702,8
2010 Jan. - Sep.	1.777,5	1.271,0	715,0
annual % change	1,3	3,1	1,7

Source: Cystat.

CHART A.29 **Tourist arrivals and receipts**
(annual change, %)



Source: Cystat.

4. Domestic Demand, Production and the Labour Market

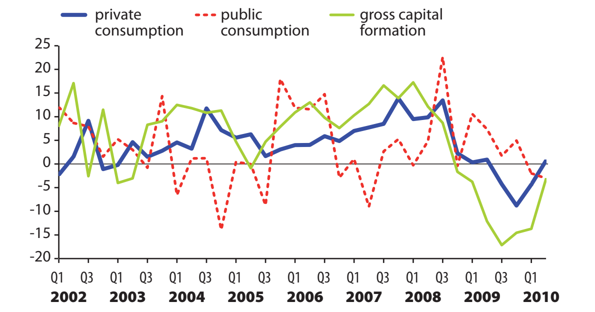
Quarterly national accounts

Based on data published by Cystat, the annual growth rate of the economy contracted by 0,4% in the first half of 2010 compared with a contraction of 0,6% in the corresponding period of 2009. It should be noted, however, that in the second quarter of 2010 the economy recorded positive growth of 0,5%. According to Cystat's flash estimate, GDP in the third quarter of 2010 grew by 1,7% on an annual basis. Thus the economy's contraction is not expected to continue in the second half of the year (**Charts A.30 (a)** and **A.30 (b)**).

The contraction in real GDP recorded in the first half of 2010 was mainly due to sluggish domestic demand and reduced exports. More specifically, during the period under review, exports of goods and services recorded a decrease of 2,2% compared with a decrease of 9,6% over the corresponding period of 2009. At the same time, imports of goods and services recorded a decrease of 1,4% compared with a decrease of 19,2% over the same period in the previous year. A reduction of 1,9% was also recorded for private consumption compared with a marginal increase of 0.6% over the corresponding period of 2009. Moreover, public consumption registered a decrease of 2,5% in the first half of 2010 compared with an increase of 8,9% over the same period of the previous year. In addition, gross fixed capital formation during the same period decreased by 8,3% compared with a reduction of 8,2% in the corresponding period of 2009.

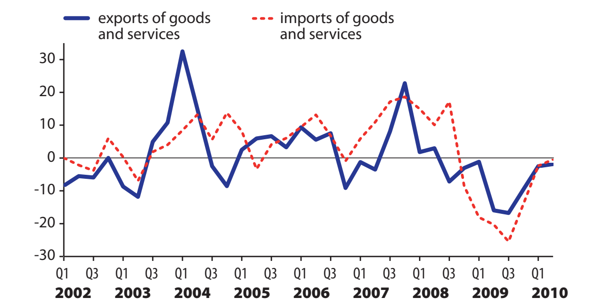
Developments in GDP expenditure in 2010 have varied from quarter to quarter. Specifically, the first quarter recorded a decline of 1,3% compared with a marginal increase of 0,5% in the second quarter. A

CHART A.30(a) **Quarterly GDP growth (expenditure categories)**
(annual change, %)



Source: Cystat.

CHART A.30(b) **Quarterly GDP growth (expenditure categories)**
(annual change, %)



Source: Cystat.

significant improvement of 0,7% in private consumption was recorded in the second quarter, compared with a decrease of 4,3% in the first quarter of 2010. Gross fixed capital formation declined by 3,1% in the second quarter compared with a decrease of 13,7% in the first quarter. Moreover, a significant increase was recorded in inventories, which contributed significantly to the recovery of GDP in the second quarter. In contrast, public consumption deteriorated by 3% in the second quarter of 2010 compared with 2% in the first quarter.

Recent indicators of domestic demand also point to a mixed picture. According to the confidence indicators for October (**Table A.8**), the marginal recovery in GDP is expected to continue for the remainder of 2010. More specifically, the indicators for consumption, services and construction show signs of stabilisation albeit at low negative levels. Furthermore, the indicators for retail trade and industry show similar signs of marginal improvement. Specifically, retail sales in July and August recorded a marginal recovery.

Other economic indicators such as car registrations and indirect tax revenue present a worse picture since they continue to fluctuate in negative territory, despite their improvement relative to the corresponding period of 2009.

TABLE A.8 **Business and consumer surveys: confidence indicators**
(for sub-indices: difference between percentage of positive answers and percentage of negative answers)

	2010 June	2010 July	2010 Aug.	2010 Sep.	2010 Oct.
ESI	81,9	85,1	87,3	93,1	88,4
Industry	-6	-9	-7	-4	-7
Services	-19	-10	-7	5	-2
Consumer	-36	-31	-30	-32	-32
Retail trade	-22	-22	-22	-15	-12
Construction	-49	-45	-47	-47	-49

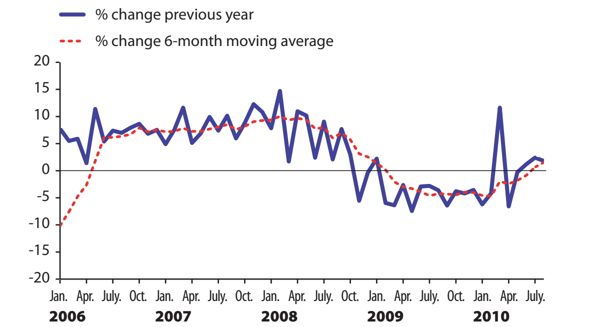
Source: European Commission.
Note: Seasonally adjusted data.

Private consumption

Based on the national accounts data for the first half of 2010, private consumption recorded negative growth, although the trend is expected to slightly reverse in the remainder of the year. More specifically, private consumption recorded a decrease of 1,9% in the first half of 2010 compared with a marginal increase of 0,6% in the corresponding period of 2009. Data for the turnover index of retail trade, excluding the sales of motor vehicles, show signs of stabilisation, registering a marginal decrease of 0,2% in the first eight months of 2010 compared with a decline of around 3,3% in the corresponding period of 2009 (**Chart A.31**). In addition, VAT receipts registered a decrease of 1,1% in first nine months of 2010 compared with a decrease of 11,1% in the corresponding period of 2009. Motor vehicle registrations declined by around 13,9% in the first ten months of 2010 compared with a 26,7% reduction in the corresponding period of 2009 (**Chart A.32**).

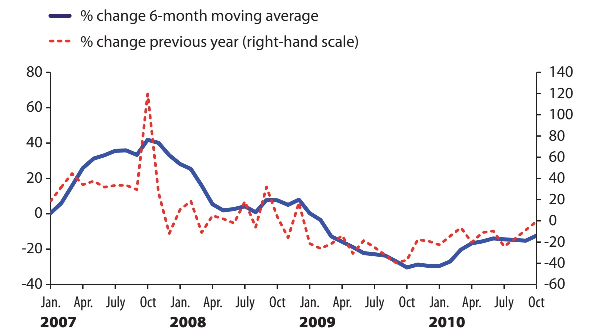
On the other hand, credit card spending by domestic card holders in Cyprus recorded an increase of 3% in the first ten months of 2010 compared with a reduction of 3% in the corresponding months of 2009(**Chart A.33**). More specifically, the biggest increase in card holder spending was recorded in: petrol stations (possibly due to increased fuel prices); various payments to the government (probably because of consumer preference for credit cards instead of cash); and supermarkets. Card spending in Cyprus by non-residents also grew, recording an increase of 4,8% in the first ten months of

CHART A.31 **Retail sales (excluding motor vehicles)**



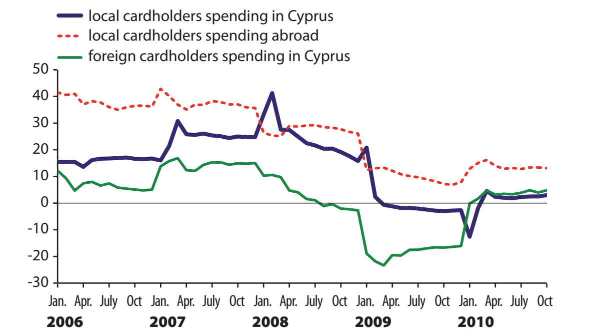
Source: Cystat.

CHART A.32 **Registration of motor vehicles**



Source: Cystat.

CHART A.33 **Credit card spending**
(cumulative annual % change from January)



Source: JCC Payments System Ltd.

2010 compared with a decrease of 16,7% in the same period last year.

Additionally, total imports in the first half of 2010 recorded a decrease of 1,4% in real terms, which is consistent with private consumption and fixed investment. Based on the aforementioned figures, private consumption in 2010 is expected to continue to be sluggish, with only a marginal recovery in the second half of the year compared with the 1,9% contraction in the first half of the year.

Secondary sector: construction

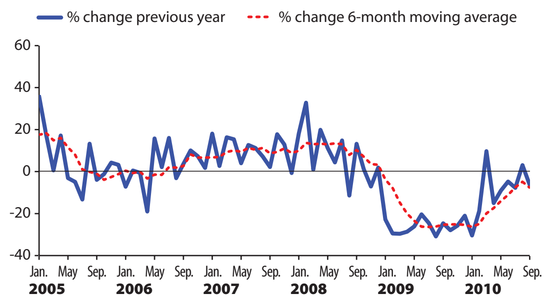
The construction sector in Cyprus recorded a significant decline in the first quarter of 2010, a trend that continued in the second and third quarters of 2010.

More specifically, the sales of cement in the period January-September 2010 registered an annual decrease of 9,5% compared with a reduction of 26% in the corresponding period of 2009(**Chart A.34**). Moreover, according to market signals, a further decline is expected in local sales of cement in the coming months.

In addition the Index of Production in Construction recorded an annual decrease of 5,9% and 3,2% for the first and second quarters of 2010, respectively (**Chart A.35**). The production index reveals that growth in construction activity is stabilising at negative levels.

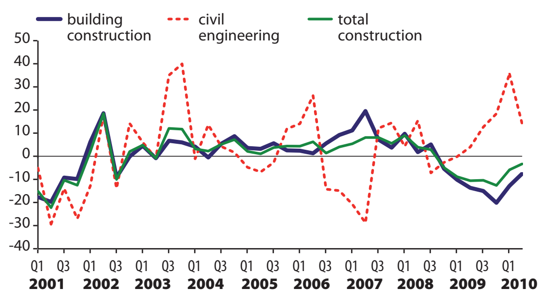
The negative picture recorded by the construction sector is also reflected in the

CHART A.34 **Sales of cement**



Source: Cystat.

CHART A.35 **Quarterly index of production in construction**
(annual change, %)



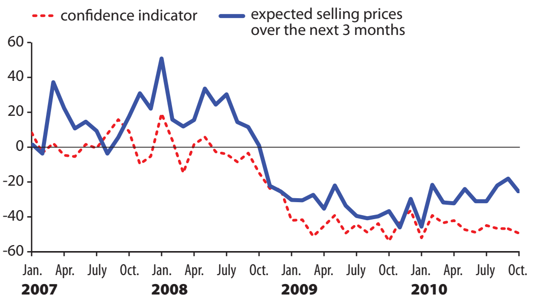
Source: Cystat.

continued rise in unemployment in the sector. The average number of unemployed in the second and third quarters of 2010 was 3.588 and 3.241, respectively, compared with 2.553 and 2.698 in the corresponding periods of 2009. This represents a decrease in the annual growth of unemployment from 40,5% in the second quarter of 2010 to 20,1% in the third quarter of 2010.

As regards the expectations of Cypriot residents for property prices in Cyprus in the next three months, as revealed in the relevant questionnaire of the European Commission, these continue to be negative, although there is a slight improvement compared with 2009(**Chart A.36**). More specifically, the average value of this index during the first nine months of 2010 stood at -28,6 compared with -33,2 in the corresponding period of 2009. In parallel, the construction component of the business and consumer surveys confidence indicators (**Table A.8**, p. 57), remained at the negative levels of 2009, indicating a further decline in construction activity.

In contrast to the reported contraction in construction activity, indicators such as the number of sale contracts and loans for house purchase noted a more positive picture, which may be due to increases in resales or a reduction in the stock of finished houses. In particular, data from the Department of Lands and Surveys show that the total number of sales contracts by residents and non-residents registered an annual growth of 8,2% in the first ten months of 2010 compared with a decrease of 50,1% in the

CHART A.36 **Construction confidence indicator**



Source: European Commission.
Note: Seasonally adjusted data.

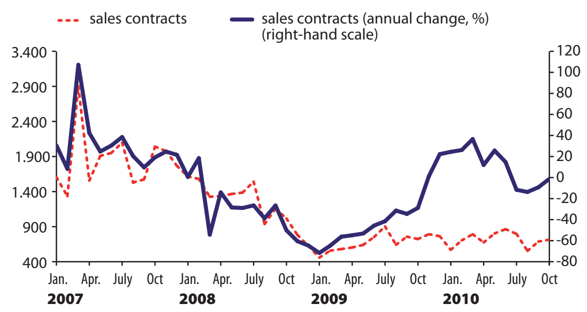
same period of last year (**Chart A.37**). In addition, the number of issued title deeds increased by 23,2% on an annual basis in the first ten months of 2010, while in the same period last year it decreased by 45,7%. A small recovery also occurred in the number of sales contracts and title deeds issued to foreigners, which increased in the first ten months of 2010 by 7,6% and 28,4%, respectively, on an annual basis.

It should be noted, however, that the issuance of title deeds and sales contracts stabilised at very low levels in 2009 and continued to fluctuate at low levels in 2010. Thus the positive growth observed in 2010 is mainly a base effect. With regard to the increase in the issuance of title deeds, this is possibly the result of the acceleration in the process of issuing title deeds for the purposes of tax collection by the government. At the same time, it could also indicate an increase in property resales.

In connection with the above, the receipts of the Inland Revenue Department from immovable property tax and stamp duties during the first nine months of 2010, increased by 18,3% and 28%, respectively, compared with a decrease of 8% and 40,9%, respectively, in the first nine months of 2009. Furthermore, capital gains tax increased by 18,9% in the above period compared with a decrease of 79,4% in the same period of 2009.

Regarding housing loans to residents, an annual increase of 15,4% was recorded in September 2010 compared with an increase

CHART A.37 **Sales contracts (total of locals and foreigners)**



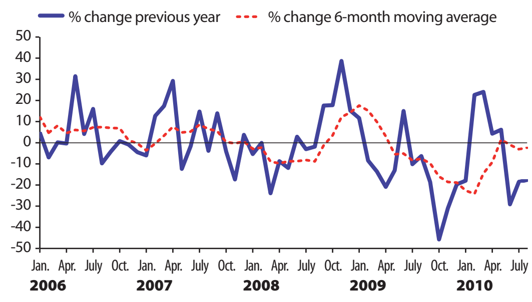
Source: Department of Lands and Surveys.

of 11,1% in September 2009 . Housing loans to non-residents increased by 12,6% on an annual basis in September 2010 compared with an increase of 15% in September 2009[8].

The number of building permits, which constitutes a leading indicator of future activity in the construction sector, recorded a slight annual increase of 0,1% during the first eight months of 2010 compared with an annual increase of 5,1% during the first eight months of 2009. This increase can be partly attributed to residential permits which increased by 2,5% on an annual basis in the first eight months of 2010. On the other hand, the approved permits for non-residential buildings declined by 19,8% on an annual basis in the first eight months of 2010. In contrast to the increase in the total number of permits, the total value and area for the first eight months of 2010 decreased by 6,8% and 4,3%, respectively, on an annual basis (**Chart A.38**). With respect to building permits by district, during the first eight months of 2010 Larnaca recorded the biggest percentage increase in the number of building permits, followed by the district of Limassol (with an increase in rural areas and a decrease in urban areas). In contrast, Nicosia, Paphos and Famagusta experienced a decline in the number of permits, with the greatest reduction registered in the Famagusta district.

As far as construction costs are concerned, these recorded a small increase in the first ten months of 2010. Specifically, the price index of construction materials

CHART A.38 **Building permits authorised**



Source: Cystat.

8. Based on the ECB methodology for the calculation of annual percentage changes.

recorded an annual increase of 2,5% in the aforementioned period, mainly due to the increase in oil prices.

Based on the methodology presented in **Box 2** (p. 64), the residential property price index constructed by the CBC recorded an average annual decrease of 4% in 2009. On the basis of real estate valuations collected by the CBC and other data relating to the real estate sector in general until September 2010, it is estimated that the aforementioned index will record an average annual decrease of 3% in 2010.

In conclusion, the construction indicators point to a decline in construction activity. Given that cement sales have recorded negative growth rates, confidence in the construction sector is at strong negative levels and the index of production in construction is also at low levels, a further reduction in the stock of houses is very likely.

Labour market

As a result of the downturn experienced in the Cyprus economy, which was carried over to the first half of 2010, employment recorded negative growth during the period under review. In particular, employment decreased by 0,7% compared with an increase of 0,2% in the first half of 2009. Total hours worked also recorded a decrease of 0,4% in the first half of 2010 compared with a decrease of 1% in the same period last year. The reduction in total hours worked

Box A.2: Residential Property Price Index

Project description

The need for closer monitoring and analysis of the property market, particularly in relation to prices, led the members of the Association of Cyprus Banks, the Co-operative Central Bank and Eurobank to cooperate with the CBC for the establishment of a specialised research unit for this purpose. The Real Estate Unit (REU) was set up in 2010 in the Economic Research Department (ERD) of the CBC. The REU's main purpose is the overall monitoring and analysis of the real estate sector, which includes the creation of an index and sub-indices of residential property prices as well as price indices for other types of property based on valuations collected by banks. The preparation of indices was agreed to be under the auspices of the CBC due to its independence, which guarantees the confidentiality of the data used and objectivity of the results that are necessary for such a sensitive subject.

The indices are an essential tool for the effective monitoring of the property market, which is one of the most important sectors of the Cyprus economy. Furthermore, these indices may be used by the participating banks for the effective implementation of the CBC Directive for the calculation of capital requirements. In addition, the publication of these indices is expected to enhance the reliability of information about price movements in the property market, with benefits for many stakeholders, such as households, private investors, real estate agents and land developers.

As previously mentioned, the preparation of these indices is based on real estate valuations collected by the participating banks, which are received from valuation and property consultancy offices for the purposes of granting loans. These valuations are highly correlated with real estate transaction prices and therefore are an alternative source of data for the creation of real estate price indices. The creation of price indices is a challenging task both from a statistical and practical perspective since no index alone encompasses all the potential benefits or excludes all the possible disadvantages that characterise such an index . Hence, other price indices available for the Cyprus property market are not expected to record the same results, since the methodologies and/or the data used vary. Nevertheless, they are expected to exhibit similar trends[1].

1. See for instance the real estate price indices of Halifax (Fleming and Nellis, 1984) and Nationwide (2010) in the UK, the BuySell real estate index for Cyprus by Platis and Nerouppos (2005), the asking price real estate index for Cyprus by Pashardes and Savva (2009) and the RICS real estate index for Cyprus by McAllister and Fuerst (2010).

Data collection

The collection of data from the CBC for the preparation of the index was carried out in two phases. The first phase involved the collection of all available historical data of real estate valuations held by banks until the end of 2009. In the second phase which began in January 2010, valuations were sent to the CBC in a standardised form on a monthly basis by all the participating banks. They were then stored in a CBC database, ensuring their integrity and confidentiality. The foregoing procedure will continue in 2011. In particular, for residential properties, apartments and houses for the period 2006-2009, valuations collected from banks amounted to 34.420, while the corresponding figures for the first three quarters of 2010 was 12.742.

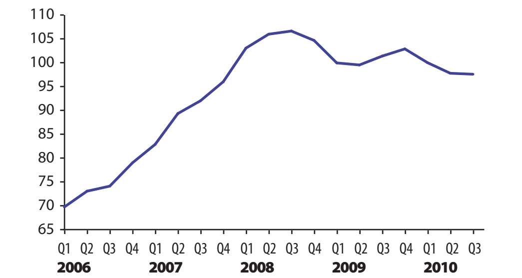
The data are representative of the overall Cyprus property market, covering the entire area where the Cyprus government exercises effective control and refer to all property types. Additionally, the real estate valuations used in the analysis are accompanied by a wide range of geographical characteristics (such as region, planning zone, etc) and structural parameters (such as property size, number of rooms, property type, etc), which are recorded in either a quantitative or qualitative form. Before being analysed, all data are subject to further processing by a system developed by the CBC to remove any incomplete or incorrect entries.

Hedonic methodology

In constructing real estate price indices, the REU uses the hedonic methodology which has been extensively used in the academic literature. This methodology examines how and to what extent various factors affect property prices. These factors consist of several important characteristics of each property, such as location, size, number of rooms, type of property and the planning zone. This methodology assesses econometrically and quantifies the contribution of each of these characteristics to the price of the property, at all times. Subsequently, the indices are constructed based on the results from the aforementioned econometric analysis.

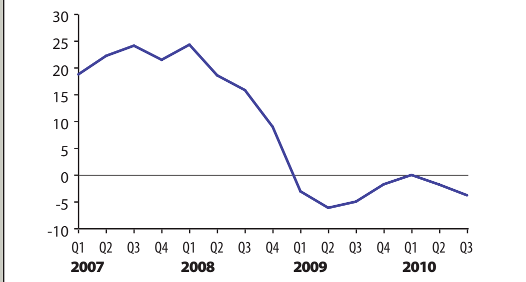
The literature has extensively documented that the hedonic methodology has significant advantages over other methods of analysis, such as the simple average of the price per square meter. The main advantage of the hedonic methodology stems from the fact that

CHART 1 **Residential property price index**
(base 2010:1=100)



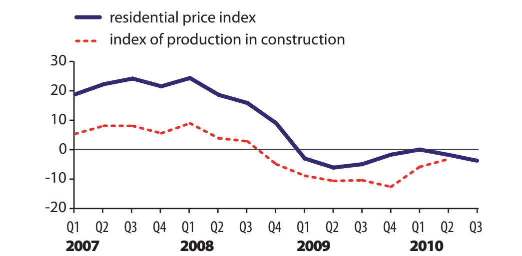
Source: CBC.

CHART 2 **Residential property price index**
(annual change, %)



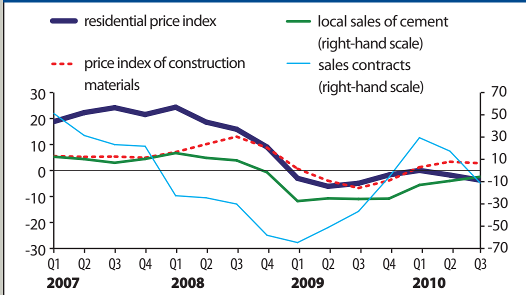
Source: CBC.

CHART 3 **Residential property price index and index of production in construction**
(annual change, %)



Sources: CBC, Cystat.

CHART 4 **Residential property price index and other real estate indicators**
(annual change, %)



Sources: CBC, Cystat, Department of Lands and Surveys.

it takes into account the heterogeneous nature of the various important characteristics of the property over and above its area, thus allowing a separate assessment of the influence of these characteristics on property prices. The usefulness of this analysis is that it allows a comparison of real estate prices valued at two successive periods, when the sample of properties valuated in each period is not homogeneous and the property characteristics in each period are not the same. In other words, if real estate prices change at a certain point in time, the hedonic methodology can isolate the change in prices from a change in the equilibrium conditions of supply and demand in the market, while at the same time it can standardise the effect of a change in the proportion of property characteristics assessed in different periods, e.g. having more valuations for coastal houses in the second period than in the first one.

Residential Property Price Index

Chart 1 (p. 66) shows the residential property price index (apartments and houses), which covers the period from the first quarter of 2006 up to the third quarter of 2010. The index is rebased so that the first quarter of 2010 corresponds to 100. The index has recorded an upward trend since the first quarter of 2006, reaching its highest historical level in the third quarter of 2008. Subsequently, prices have been declining with some stabilisation observed from the second half of 2009 onwards. As shown in **Chart 2** (p. 66), the index recorded an annual decrease of 4,1% in 2009, while for the first three quarters of 2010 the annual decline reached 1,8%[2].

By comparison, the residential property price index exhibits a positive correlation with other housing market indicators. Specifically, **Chart 3** (p. 66) shows that the trend of the annual rate of change in residential property prices follows the trend of the annual rate of change of the index of production in construction. Furthermore, **Chart 4** (p. 66) shows a positive correlation between the annual rate of change of the index and other real estate indicators, such as the price index of construction materials, the local sales of cement and the sale contracts.

Future work

Apart from the construction of a residential property price index, which will start being published henceforth on a quarterly basis, the REU is working towards the creation of sub-indices, by district and/or by type of property, aiming to contribute to a more comprehensive analysis of the real estate sector in Cyprus. Furthermore, a more detailed description of the methodology, possible revisions and further analysis of the property market will follow in later CBC publications or announcements.

2. It should be noted that comparisons of previous years with 2010 should be made with caution, since data collection in a detailed and standardised form by all banks only began in 2010. Furthermore, the series will become more comparable and reliable as more data are collected and accumulated through time. It is also noted that the index varies across districts.

References

Platis, S. and M. Nerouppos (2005) “Asking price and transaction-based indices for the Cyprus housing market (rebased)”, BuySell Cyprus Real Estate, monograph, November.

Pashardes, P. and C. S. Savva (2009) "House prices in Cyprus", Economic Policy Paper No. 01-09, Economics Research Centre, University of Cyprus.

Fleming, M. and J. Nellis (1984) “The Halifax house price index: technical details”, Halifax: Halifax Building Society.

Nationwide (2010) “The Nationwide house price index”, http://www.nationwide.co.uk/hpi/Nationwide_HPI_Methodology.pdf

McAllister, P. and F. Fuerst (2010) “Constructing real estate indices for Cyprus: an evaluation of the options”, http://www.joinricsineurope.eu/uploads/files/IndexConstructionReportFinal_2.pdf

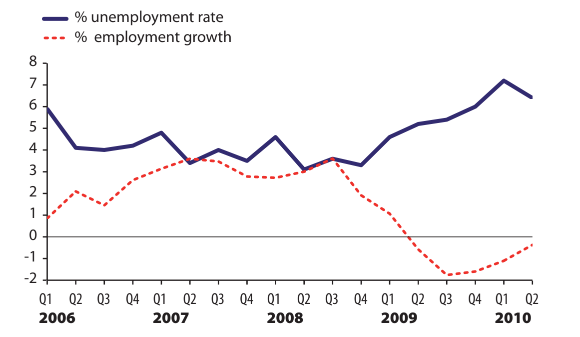
resulted from the fall in employment, which was compensated for by the increase in the hours worked per unit of employment. This may possibly indicate that those persons no longer working were working fewer hours than those currently in employment.

According to the Labour Force Survey (LFS), unemployment increased by 1,9 percentage points in the first half of 2010, thus reaching 6,8% (**Chart A.39**). On a quarterly basis, unemployment decreased in the second quarter of 2010, reaching 6,4% compared with 7,2% in the previous quarter. This was mainly due to the seasonality unemployment exhibits vis-a-vis the tourism industry.

As regards the sectoral breakdown of employment, the reduction in employment in the first half of 2010 was mainly brought about by the sectors most severely hit by the crisis, i.e. trade, repairs, hotels, restaurants, transport and construction(**Chart A.40**). The contribution to the negative growth of employment by the manufacturing sector, including energy, was marginally negative, while financial intermediation, real estate, renting and business activities had a zero contribution. Finally, other services had a positive contribution, but were not able to reverse the overall effect of the aforementioned sectors.

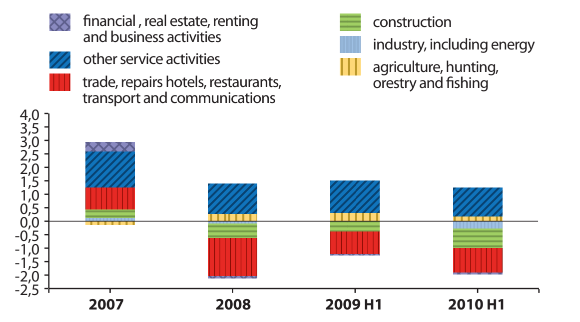
The most recent available data for unemployment (**Chart A.41**) refer to the registered unemployed, which in recent years have followed the general trend recorded by the LFS, albeit at lower levels.

CHART A.39 **Employment growth and unemployment rate**



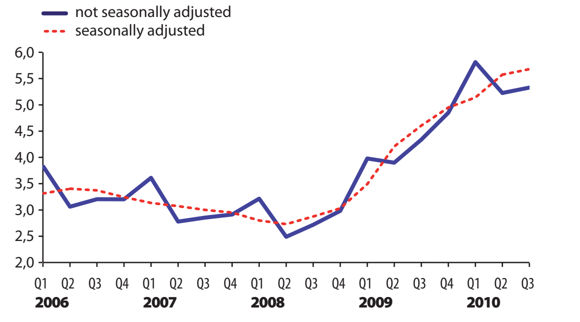
Source: Cystat.

CHART A.40 **Contribution to employment by sector**
(%)



Source: Cystat.

CHART A.41 **Registered unemployment rate**
(%)



Source: Cystat.

The data record a downward trend up to the first half of 2008 and an increase afterwards, reflecting the effect of the economic crisis and the consequent slowdown of the Cyprus economy. The rate of registered unemployment in the first ten months of 2010 increased by 1,2 percentage points compared with the corresponding period of 2009, reaching 5,1%. Moreover, during the period under review, the number of registered unemployed increased by 5.575 compared with the corresponding period of the previous year, reaching 22.339. The upward trend of the registered unemployed is confirmed by the seasonally adjusted data, which also reveal a decelerated rate of increase in unemployment in 2010.

It should be noted that the number of registered unemployed and the respective rate of unemployment are lower than those shown in the LFS because of differences in the methodologies used. As shown in a recent paper[9], in periods of slowdown or recession, the difference between the registered unemployed and the number of unemployed based on the LFS is larger. This is because in such periods there is an increase in the number of unemployed new entrants and in the number of people who are unemployed for a period of over six months. These two factors are reflected in the LFS but not fully in the figures for registered unemployed. This is because: 1) unemployed newcomers do not receive unemployment benefits; and 2) those unemployed for more than six months do

9. Kyriacou, G., M. Louca and M. Ktoris (2009) "Unemployment in Cyprus: comparison between two alternative measurement methods", *Cyprus Economic Policy Review*, 3(2): 23-29.

not receive unemployment benefits beyond this period. In both cases there are no financial incentives to register as unemployed.

5. Domestic Public Finance Developments

According to preliminary general government figures published by Cystat, a budget deficit of 2,5% of GDP was recorded during the first nine months of 2010, compared with a deficit of 2,7% of GDP for the corresponding period of 2009 (**Table A.9**). In nominal terms, the budget deficit amounted to €437,1 million compared with €454,6 million in 2009. More specifically, during the first nine months of 2010, total general government revenue recorded an annual increase of 3,3% while total general government expenditure increased by 2,7% over the same period. It should be noted that the annual growth of public expenditure in the first nine months of 2010 was lower than the 9,4% recorded in the corresponding period of the previous year. The slowdown in total general government expenditure is partly due to lower expenditure on intermediate consumption of €33,8 million (this category includes operational expenditures) and expenditure of €99,8 million for capital formation (this category includes development expenditures). As a percentage of GDP, government revenue and expenditure during the period under consideration

TABLE A.9 **Accounts of general government**

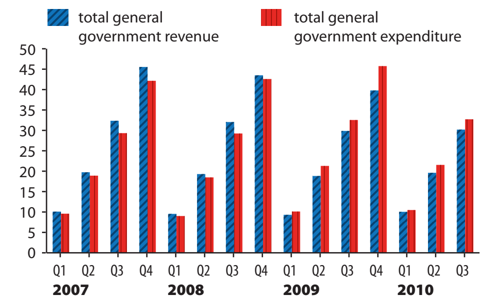
	Jan.-Sep. 2009 (€ million)	Jan.-Sep. 2010 (€ million)	Change (%)
EXPENDITURE			
Intermediate consumption	648,3	614,5	-5,2
Capital formation	460,4	360,6	-21,7
Compensation of employees	1.836,2	1.872,6	2,0
Other taxes on production	0,1	0,3	200,0
Subsidies	1,2	11,5	858,3
Interest paid	321,8	362,3	12,6
Social transfers	1.645,9	1.840,8	11,8
Other current transfers	544,7	552,0	1,3
Capital transfers	56,4	51,2	-9,2
Total expenditure	**5.515,0**	**5.665,8**	**2,7**
Total expenditure (% of GDP)	**32,5**	**32,7**	**-**
REVENUE			
Market output and output for own final use	303,8	300,7	-1,0
Taxes on production and imports	2.007,7	2.013,5	0,3
of which VAT	1.256,2	1.243,9	-1,0
Property income	143,7	261,8	82,2
Current taxes on income, wealth, etc	1.359,3	1.335,6	-1,7
Social contributions	1.144,6	1.221,0	6,7
Other current transfers	95,0	89,8	-5,5
Capital transfers	6,3	6,3	0,0
Total revenue	**5.060,4**	**5.228,7**	**3,3**
Total revenue (% of GDP)	**29,9**	**30,2**	**-**
Surplus (+) / Deficit (-)	**-454,6**	**-437,1**	**-**
Surplus (+) / Deficit (-) % of GDP	**-2,7**	**-2,5**	**-**

Source: Cystat.

amounted to 30,2% and 32,7%, respectively, compared with 29,9% and 32,5% of GDP in 2009 (**Chart A.42**). The aforementioned fiscal developments are reflected in the general government primary balance[10], which recorded a deficit of €74,8 million (0,4% of GDP) during the first nine months of 2010 compared with a deficit of €132,8 million (0,8 % of GDP) during the corresponding period of the previous year (**Chart A.43**). However, it should be noted that the reduction in the primary deficit in the period under consideration is associated with increased spending for interest payments to service the public debt. More specifically, the aforementioned general government expenditure, as recorded in the category "interest paid", amounted to €362,3 million during the first nine months of 2010 compared with €321,8 million in the corresponding period of the previous year.

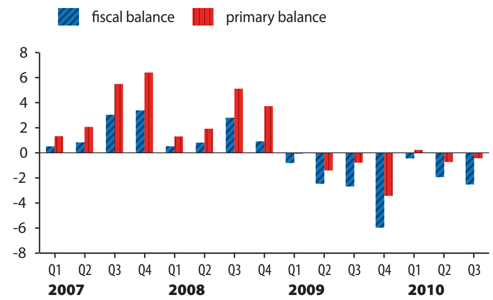
With regard to government revenue accounted for by the category "property income receivable", a large increase was observed during the first nine months of 2010, which includes non-tax revenues. This improvement is due to the increased CBC dividend income in 2009 (partly because of the non-conversion of Cyprus pound coins into euro) and revenues from an interest rate swap deal that was terminated at the beginning of the year. Thus, given the temporary and one-off nature of recent fiscal developments, there is no room for complacency. Overall, revenues in the category "current taxes on income, wealth

CHART A.42 **Total general government revenue and expenditure**
(cumulative for the period as from the first quarter as a percentage of GDP)



Source: Cystat.

CHART A.43 **Fiscal and primary balances of the general government**
(cumulative for the period as from the first quarter as a percentage of GDP)



Source: Cystat.

10. The primary balance is defined as the budget deficit excluding interest payments.

etc." recorded an annual decrease of about 1,7% in the first nine months of 2010. Moreover, during the same period, revenues in the category "taxes on production and imports", which include revenues from VAT, recorded a marginal annual increase of about 0,3%. VAT receipts recorded an annual decrease of the order of 1% during the first nine months of 2010, despite marginally positive GDP growth during this period. The decrease in VAT receipts mainly reflects the reduction in private consumption.

More recent data from the Inland Revenue Department (IRD) and the Department of Customs and Excise for the period January-October 2010, confirm the temporary nature of the aforementioned marginal improvement in the budget deficit. Specifically, the IRD figures indicate that receipts from corporation tax declined by 14,9% in the first ten months of 2010 compared with a decrease of 9,1% during the corresponding period of 2009. More analytically, the shortfall in the IRD's corporation tax receipts recorded during the first ten months of 2010 compared with the corresponding period of 2009 amounted to €83,1 million, of which €30,8 million are attributed to the shortfall in receipts for October alone. Therefore, the Ministry of Finance's projection that "the budget deficit in 2010 will be around 6% of GDP, provided that receipts from corporation tax in the last four months of 2010 will not be lower compared with the receipts of the corresponding period of the previous year"[11], may turn out to be optimistic.

On the other hand, revenues from capital gains tax and stamp duty increased by 18,8% and 24,4%, respectively, over the period January - October 2010. However, it should be noted that these revenues represent only a small share of the total IRD revenue and therefore are not expected to make a significant contribution to government revenues for 2010.

As regards data from the Department of Customs and Excise, receipts from import duties over the first ten months of 2010 fell by 12,1% compared with the corresponding period of 2009.

As previously noted, total general government expenditure continued to rise over the first nine months of 2010, albeit at a lower annual rate than in the corresponding period of the previous year. As was the case in 2009, this rise was primarily due to the increase in expenditure for social transfers and compensation of employees. More specifically, government expenditure for social transfers and compensation of employees increased by 11,8% and 2%, respectively, during the first nine months of 2010 compared with the corresponding period of 2009. As previously noted, expenditure for intermediate consumption and capital formation during the period under consideration recorded an annual decrease of the order of 5,2% and 21,7%, respectively, thus contributing to a significant extent to the slowdown in total general government expenditure.

11. *Fiscal Developments in 2010* and *Outlook for 2011.*

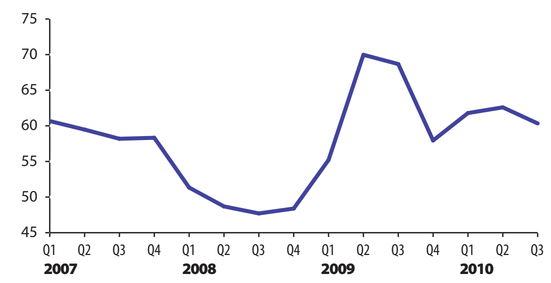
Without the adoption of effective measures to contain and reduce government expenditure, the deterioration in public finances will continue. In light of the aforementioned fiscal developments, the government's projection of a 5,9% budget deficit for 2010 may, as already mentioned, prove to be optimistic. This projection was presented in the Excessive Deficit Procedure (EDP) notification submitted to the European Commission on 29 September 2010 (which is in line with Cyprus’s obligation to the European Commission for a deficit of less than 6% of GDP in 2010). Failure to achieve the deficit target for 2010 would affect the deficit target for 2011. It should be noted that the 2010 budget was produced on the assumption that the deficit for 2009 would reach 2,9% of GDP (according to the EDP notification submitted to the European Commission on 30 September 2009), which then led to an over-optimistic forecast for the 2010 budget deficit. The deficit for 2009 eventually exceeded the aforementioned government projection by three percentage points.

Thus, it is important that the government adopts measures which will reduce expenditures on a long-term basis, such as those related to the introduction of income criteria for various social payments and the reduction of the total public sector wage bill. Such measures would allow the government to support the poorer members of society with no overall increase in government expenditure.

According to data published by the Ministry of Finance, net public debt[12] as a percentage of GDP decreased from 68,7% in the third quarter of 2009 to 60,3% in third quarter of 2010 (**Chart A.44**). This decrease was mainly due to the repayment of short-term debt (**Table C.20**, p. 199). More specifically, on 23 December 2009 €1,4 billion worth of 82-day treasury bills expired and on 30 December 2009 €1 billion worth of 35-week treasury bills expired. The aforementioned short-term debt instruments formed part of the government effort to boost liquidity in the banking system via the reduction of lending rates. Given the short-term nature of the aforementioned debt issuances (of less than one year duration), the government proceeded in December 2009 with the issuance of three-year special government bonds to commercial banks worth almost €3 billion. This was in order to assist the banks in raising cheap liquidity from the ECB in the medium-term. Additionally, it should be noted that there was an increase in the medium-term foreign debt in early 2010. More specifically, on 27 January 2010 the government issued a ten-year Euro Medium-Term Note (EMTN) worth €1 billion.

It should be noted that with a possible rise in long-term interest rates (due to the expected economic recovery in the euro area and the recent downgrading of Cyprus's sovereign rating by Standard & Poor's), the fiscal burden of interest payments will

CHART A.44 **Net total debt as a percentage of GDP**



Source : Ministry of Finance .

12. Net public debt is total debt excluding intragovernmental borrowing and short-term obligations of the CBC to the IMF.

increase due to higher public debt and higher primary deficits. As is evident from **Table A.9**, p. 70, expenditures in the category "interest paid" in the first nine months of 2010 increased by 12,6% compared with the corresponding period of the previous year.

6. Macroeconomic Projections for Cyprus

The Eurosystem prepares and publishes its projections for the euro area on a biannual basis. These projections are used by the ECB's Governing Council for the evaluation of economic developments and inherent risks to price stability. The preparation of euro area projections is undertaken in cooperation with national central bank and ECB staff, based on common working assumptions. It is within this framework that the CBC prepares its projections for the Cyprus economy.

Working assumptions

The projections for the Cyprus economy are based on the Eurosystem's assumptions about the world economy, e.g. commodity prices and financial sector developments. These projections are used to analyse and evaluate the international developments and risks to price stability by the ECB's Governing Council, which is responsible for setting monetary policy in the euro area. These assumptions are the same as those used by the Eurosystem for their own macroeconomic projections of the euro area and mainly cover variables such as interest rates, exchange rates, the price of oil and international trade. The projections are based on the assumptions and data available as at 11 November 2010.

The working assumptions of the Eurosystem are as follows: the euro is expected to fluctuate at around $1,34 in 2010 and $1,39 in 2011 and 2012. The price of oil is expected to be around $79,5 per barrel in 2010, while in 2011 and 2012 it is expected to reach $88,6 and $90,7 per barrel, respectively. The projections concerning the Cyprus economy were prepared by taking into consideration only those fiscal measures which are clearly defined and are very likely to be implemented. Thus, very few measures were taken into consideration and, as a result, public consumption, public investment and private consumption do not reflect the potential impact of any additional fiscal consolidation measures that the government may possibly adopt. This approach contains downside risks, that is risks from adverse developments in relation to the prevailing scenario of the projections presented below.

Eurosystem projections for the euro area

Based on the above working assumptions, euro area inflation is expected to increase and fluctuate between 1,5% and 1,7% in

2010 compared with 0,3% in 2009 (**Table A.10**). In 2011 the average increase in HICP inflation is expected to fluctuate between 1,3% and 2,3%, while HICP inflation excluding energy and food is anticipated to increase gradually. GDP growth is expected to increase in 2010, rising between 1,6% and 1,8%, while in 2011 euro area GDP is expected to increase between 0,7% and 2,1%. In 2012 GDP is expected to increase between 0,6% and 2,8%. The anticipated recovery in GDP reflects the expected gradual increase in domestic demand.

TABLE A.10 **Eurosystem projections for the euro area**
(annual change, %)

	2009	2010f	2011f	2012f
GDP				
December Projections 2010	-4,1	1,6 - 1,8	0,7 - 2,1	0,6 - 2,8
June Projections 2010	-4,1	0,7 - 1,3	0,2 - 2,2	-
Inflation				
December Projections 2010	0,3	1,5 - 1,7	1,3 - 2,3	0,7 - 2,3
June Projections 2010	0,3	1,4 - 1,6	1,0 - 2,2	-

Source: ECB.

Projections for the Cyprus economy

Prices: harmonised index of consumer prices

Based on the Eurosystem's working assumptions, Cyprus HICP inflation in 2010 is expected to reach 2,7% compared with 0,2% in 2009 (**Table A.11**). The significant increase in HICP inflation is partly due to the increase in oil prices, the depreciation of the euro against the dollar and the significant increases in electricity prices as a result of the various additional fees imposed by the Cyprus Electricity Authority. On the other hand, services and food prices are expected to slow down as a result of the unpredictable weather conditions which affect fruit and vegetable prices. As a consequence, HICP inflation excluding energy is expected to reach 0,7% in 2010 compared with 2,3% in 2009.

TABLE A.11 **HICP projections**
(annual change, %)

	2009	2010f	2011f	2012f
HICP				
December Projections 2010	0,2	2,7	3,4	2,4
June Projections 2010	0,2	2,9	3,2	-
HICP excluding energy				
December Projections 2010	2,3	0,7	2,5	2,0
June Projections 2010	2,3	1,1	2,5	-

Sources: Cystat, CBC.

In 2011 HICP inflation is expected to increase by 3,4%, mainly due to the imposition of 5% VAT on food and pharmaceutical products, and various taxes and fees in the energy sector. More specifically, the working assumptions for oil prices and the euro/dollar exchange rate, the effect of tax and other measures adopted in 2010 as well as the additional increase expected in electricity prices in January 2011, are the main reasons for the expected rise in energy prices in 2011. HICP excluding energy is expected to increase by 2,5% in 2011 compared with 0,7% in 2010, mainly reflecting the aforementioned imposition of VAT. In 2012 HICP is expected to increase by 2,4% and HICP excluding energy by 2%. The deceleration is partly due to the mitigation of some of the aforementioned tax and pricing measures.

Compensation, productivity and the labour market

The labour market is still affected by the consequences of the economic crisis, with employment expected to contract by 0,2% during the year (**Table A.12**). With the improvement in economic conditions in 2011 and 2012, employment is expected to register positive growth albeit at a slower pace than the average of 2,6% recorded in the period 2006-2008. The LFS unemployment rate is expected to increase significantly in 2010, reaching 6,9%, while it is anticipated to decrease marginally to 6,6%

TABLE A.12 **Labour market projections**
(annual change,%, unless otherwise indicated)

	2009	2010f	2011f	2012f
Compensation per employee				
December Projections 2010	2,9	1,7	2,3	2,6
June Projections 2010	2,9	1,6	2,1	-
Unit labour costs				
December Projections 2010	3,8	0,8	1,3	1,5
June Projections 2010	3,8	1,7	1,5	-
Productivity				
December Projections 2010	-0,9	0,9	1,0	1,1
June Projections 2010	-0,9	-0,1	0,6	-
Total employement				
December Projections 2010	-0,8	-0,2	0,8	1,3
June Projections 2010	-0,8	-0,4	0,7	-
Unemployment rate (% of labour force)				
December Projections 2010	5,3	6,9	6,6	6,0
June Projections 2010	5,3	7,0	7,0	-

Sources: Cystat, CBC.

and 6% in 2011 and 2012, respectively.

The growth of compensation per employee is expected to slow down significantly in 2010 mainly due to the expected deceleration in the public sector, reflecting the government fiscal consolidation measures, and in particular the zero contractual salary agreements assumed in the central scenario for the period 2010-2012. It is noted that the increase in compensation per employee in the private sector is projected to increase marginally in 2010, but to remain at lower levels than in the public sector. With the improvement in economic conditions as well as the expected increase in COLA compared with the 2010 levels, compensation per employee is projected to increase in 2011 and 2012 but to remain lower relative to the years before the crisis.

Unit labour costs are expected to decelerate significantly as a result of the developments in compensation per employee in 2010. More specifically, they are expected to increase by 0,8% in 2010, while a small acceleration is anticipated for the years 2011 and 2012.

National accounts

As far as the national accounts are concerned, real GDP growth in Cyprus is projected to reach 0,7% in 2010, while further recovery is expected in 2011 and 2012, with GDP increasing by 1,8% and 2,4%, respectively. The projections for 2010 and

2011 have been revised upwards, mainly due to the revision of first quarter GDP and the better than expected results for the second and third quarters of the year. Specifically, seasonally adjusted GDP for the first quarter of 2010 was revised from -0,2% to 0,4%, while this positive outlook was also reflected in the next two quarters.

Based on the latest data for the first three quarters of 2010, GDP increased marginally by 0,3%. This marginal recovery reflects developments in the tourism sector, as well as the significant positive growth rates registered in the financial services sector. Based on economic indicators and current data, the Cyprus economy is expected to register subdued growth of 0,7% in 2010 (**Table A.13**). Specifically, private consumption is expected to register a small reduction of 0,8% in 2010. This is already reflected in: 1) recent data, such as car registrations, which decreased by 15% in the first nine months of 2010; 2) the retail trade index, which registered an almost zero change in the first eight months of the year; and 3) VAT receipts, which decreased in the first nine months of the year. Gross fixed capital formation is expected to further decrease by 6,4% in 2010, mainly due to the slowdown in the construction industry. As far as total exports of goods and services are concerned, a small reduction of 3% is expected to be recorded in 2010 compared with the significant reduction registered in 2009. Exports of goods and services are expected to be affected by increased

TABLE A.13 **National accounts projections in real terms**
(annual change,%)

	2009	2010f	2011f	2012f
GDP				
December Projections 2010	-1,7	0,7	1,8	2,4
June Projections 2010	-1,7	-0,5	1,3	-
Private consumption				
December Projections 2010	-3,0	-0,8	0,6	0,9
June Projections 2010	-3,0	-2,9	0,4	-
Public consumption				
December Projections 2010	5,8	1,0	0,7	3,3
June Projections 2010	5,8	-0,5	0,3	-
Gross fixed capital formation				
December Projections 2010	-12,0	-6,4	4,3	4,4
June Projections 2010	-12,0	-9,9	0,8	-
Exports of goods and services				
December Projections 2010	-11,8	3,0	3,1	3,3
June Projections 2010	-11,8	1,8	3,9	-
Imports of goods and services				
December Projections 2010	-19,8	2,7	3,5	2,4
June Projections 2010	-19,8	-1,1	3,7	-

Sources: Cystat, CBC.

revenues from transportation and financial services as a result of the expected upturn in world economic activity, while the remaining sectors are anticipated to register marginally positive growth rates compared with 2009. At the same time, imports of goods and services are expected to increase by 2,7% in 2010. It must be noted, however, that the expected recovery will depend directly on the speed of recovery of Cyprus's trading partners.

In 2011 GDP is expected to recover further, increasing by 1,8%. Specifically, private consumption is anticipated to register a small growth of 0,6%, while a growth of 4,3% is expected in gross fixed capital formation. Subdued growth of 3,1% and 3,5% is anticipated for exports and imports, respectively.

With respect to 2012, GDP is expected to increase by 2,4%. In particular, private consumption is expected to increase by 0,9%, while gross fixed capital formation is expected to increase by 4,4%.. As regards exports, growth of only 3,3% is expected, while the growth of imports is anticipated to decelerate to 2,4%.

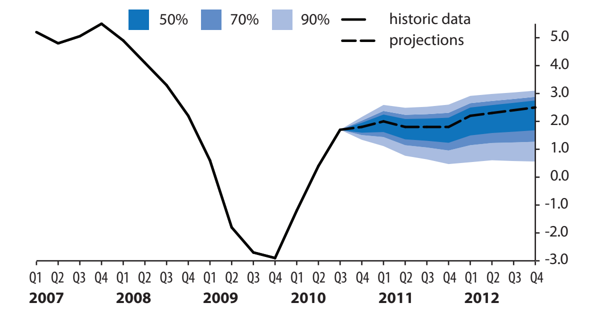
It should be noted that the aforementioned projections are expected to be negatively affected by the possible adoption of further fiscal consolidation measures that have not been taken into account in the current projections, since they were not clearly defined at the time when the projections were being prepared. Public consumption and public investment are expected to be particularly affected. This, in turn, is likely to have a negative indirect impact on other components of GDP, especially private consumption, in 2011. The impact of the fiscal consolidation measures will depend on the type and size of measures adopted. It must, however, be emphasised that in the longer term fiscal consolidation will have positive effects by reinforcing the economy's growth potential.

Fan charts for the macroeconomic projections

The projections for HICP inflation (**Table A.11**, p. 78) as well as those for GDP growth (**Table A.13**, p. 81) are the modal forecasts and are considered as the most likely outcomes given the working assumptions of the Eurosystem. However, due to the tentative nature of the assumptions, the projections are subject to uncertainty.

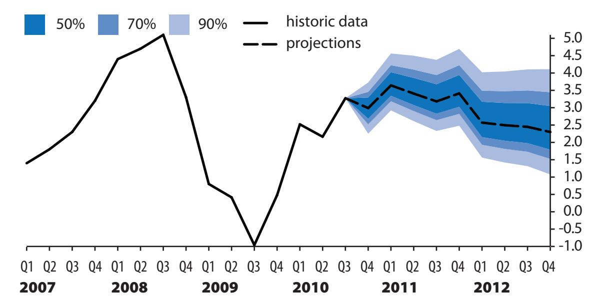
The probability of GDP, HICP inflation and HICP inflation excluding energy forecasts lying around their respective modal projections is depicted in **Charts A.45, A.46** and **A.47**, respectively. The three confidence intervals show the bands in which GDP, HICP inflation and HICP inflation excluding energy are expected to be with a probability of 50%, 70% and 90%. For example, the darkest band includes the modal projection and covers 50% of the probability. The probability distribution, which is based both on statistical methodology and on expert judgement, can either be normal or two

CHART A.45 **Real GPD fan chart**
(annual change, %)



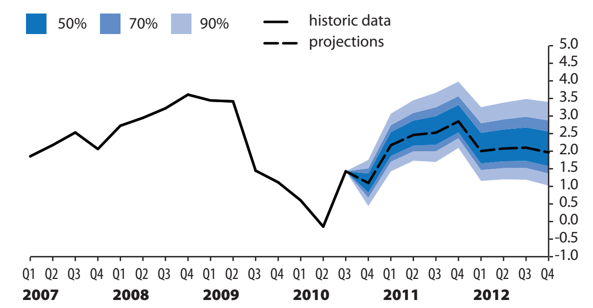
Source: CBC.

CHART A.46 **HICP fan chart**
(annual change, %)



Source: CBC.

CHART A.47 **HICP excluding energy fan chart**
(annual change, %)



Source: CBC.

piece normal with a degree of asymmetry around the modal projections. In particular, the skewed distribution is separated into two unequal parts, above and below the modal forecast[13]. Moreover, the bands of the fan charts widen as the time horizon is extended, indicating the increasing uncertainty of outcomes in the longer term.

With respect to GDP, a larger than expected recovery in the economies of our trading partners is anticipated to have a positive impact on GDP, through exports and the inflow of foreign investments. At the same time, the historically low interest rates and the consequent increase in lending may potentially support investments more than anticipated.

The possible adoption of additional and stricter fiscal consolidation measures will negatively affect GDP projections, especially in 2011. In particular, it is expected that fiscal consolidation will negatively affect both public investment and public consumption, consequently having a negative impact on domestic demand, mainly through private consumption. At the same time, the recent downgrade of the economy by Standard and Poor's in combination with the uncertainty in the markets and the possible deterioration in the prospects of the euro area economy, as a result of the adoption of even stricter fiscal consolidation measures in countries such as Greece, Portugal, Spain and Italy, impose further negative risks. For 2011 the modal forecast has downside risks, which will potentially cause a lower growth

13. The estimation of the confidence intervals of the skewed distribution is based on the methodology developed by the Bank of England and the Sveriges Riksbank.

rate when compared with the central scenario. In conclusion the risk for a downward revision of the modal forecast is more likely.

With regard to HICP inflation, the adoption of further indirect and direct taxation measures is expected to further increase inflation. At the same time, inflationary pressures may stem from the possible larger increases in oil prices and agricultural goods, as well as the possibility of higher credit expansion as a result of low interest rates. Moreover, the prospect of new taxes, as part of any further fiscal consolidation measures, and the probable increase in water prices may increase inflationary pressures. In contrast, further deterioration in consumer confidence and, consequently, retail sales, as well as the possible further deterioration in unemployment and the decrease in wages, are likely to have a dampening effect on inflation. The risks indicate that possible upward deviations in the modal HICP and HICP inflation excluding energy projections have a higher probability of being realised than possible downside deviations.

Comparison of projections for the Cyprus economy

Both the European Commission and IMF autumn 2010 projections for 2010, 2011 and 2012 GDP and HICP inflation are very similar to the CBC projections (**Table A.14**). The only exceptions are the IMF projections for HICP

TABLE A.14 **Comparison of projections for Cyprus economy**
(annual change,%)

		GDP			HICP		
		2010f	**2011f**	**2012f**	**2010f**	**2011f**	**2012f**
European Commission	Autumn 2010	0,5	1,5	2,2	2,8	3,3	2,5
	Spring 2010	-0,4	1,3	-	2,7	2,5	-
IMF	Autumn 2010	0,4	1,8	2,5	2,2	2,3	2,5
	Spring 2010	-0,7	1,9	-	2,7	2,3	-
CBC	December 2010	0,7	1,8	2,4	2,7	3,4	2,4
	June 2010	-0,5	1,3	-	2,9	3,2	-

Sources: CBC, European Commission, IMF.

inflation in 2010 and 2011, which are much lower than the projections of the other organisations. The differences between the projections of international organisations are mainly due to the different information available at the time of preparing these projections and the different working assumptions.

During 2010 GDP is expected to register marginal growth, with the IMF projection being the most pessimistic of the three, anticipating a growth of around 0,4%. On the other hand, the CBC projection of 0,7% GDP growth in 2010 is the most optimistic. In 2011 the Cyprus economy is expected to recover, with the IMF and CBC being the most optimistic, anticipating growth of around 1,8%. On the other hand, the European Commission gives a lower forecast of 1,5%.

As far as inflation expectations for 2010 are concerned, the European Commission projection of 2,8% is the highest, compared with the marginally lower CBC projection of 2,7%. The IMF forecasts a much lower inflation of 2,2%. In 2011 the CBC inflation projection is marginally higher in relation to the European Commission projections, while the IMF forecast is much lower. It must be noted that the IMF projection for inflation is not comparable with the CBC and European Commission forecast possibly due to the exclusion of the imposition of VAT on food and pharmaceutical products, the increase in electricity prices and the imposition of an excise tax on fuels.

In conclusion the CBC forecasts are similar to the projections of the European Commission and the IMF. It must be noted that the three organisations' forecasts have been recently revised upwards, as a result of data revisions for the first quarter and the better than expected data for the second and third quarters of 2010.

SECTION B

Financial Stability Conditions

Introduction

According to the ECB, financial stability can be defined as "a condition in which the financial system - comprising of financial intermediaries[1], markets[2] and market infrastructures[3] - is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities"[4].

This section of the *Bulletin* provides an analysis of the potential risks for the stability of the financial system emanating from the macro-financial environment, by focusing on the household, non-financial corporate and real estate sectors. As regards the domestic financial system, the key developments in the financial markets as well as the main structural developments in the banking sector are reviewed. This edition of the *Bulletin* also includes an analysis of banks' financial condition as well as an assessment of the most significant risks facing the banking sector, which constitutes by far the largest component of Cyprus's broad financial system. Furthermore, the financial condition of insurance companies is analysed, while the main risks facing the insurance sector are assessed. Finally, a review of the key developments regarding the financial market infrastructures as well as an assessment of the potential risks stemming from these infrastructures are provided.

1. MFIs (credit institutions, money market funds, central banks and other institutions) and other financial intermediaries (insurance corporations, occupational pension funds, financial auxiliaries, mutual funds, securities and derivatives dealers and financial corporations engaged in lending).
2. Money and capital markets.
3. Payment, clearing and settlement systems.
4. ECB (2010) *Financial Stability Review*, June.

1. The Domestic Macro-Financial Environment

This section includes an analysis of the leverage and financial condition of households and non-financial corporations (NFCs) as well as an assessment of the potential risks facing these two sectors. Moreover, the key developments regarding the domestic real estate sector activity are described, while information on the financing of real estate by banks is provided.

1.1 Macroeconomic conditions

The domestic macroeconomic conditions, which may have an impact on the stability of the financial system, are analysed in Section A of the *Bulletin*.

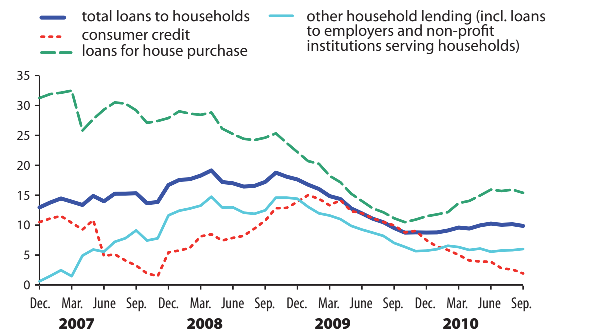
1.2 Household sector

1.2.1 Leverage

MFI loans to domestic households

MFI loans to domestic households[5] increased by 9,9% year-on-year in September 2010. As regards the three components of household lending, loans for house purchase, consumer credit and other household lending[6] grew by 15,4%, 1,9% and 6%, respectively, year-on-year in September 2010 (**Chart B.1**). Following the deceleration exhibited in 2009, the annual rate of growth of total MFI loans to domestic households accelerated from

CHART B.1 **Bank loans to domestic households**
(annual change, %)



Source: CBC.

5. Based on monthly balance sheet data submitted by MFIs to the CBC.
6. Includes, *inter alia*, MFI loans granted to individuals, other than those included in "loans for house purchase" and "consumer credit", such as loans for medical treatment, education and debt consolidation, as well as loans to employers (including own-account workers) and non-profit institutions serving households.

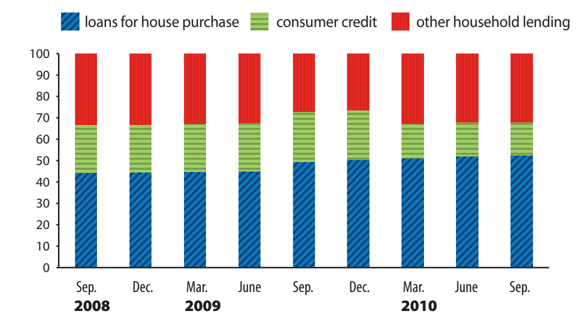
January 2010 onwards but showed signs of stabilisation from the middle of the current year until September. The increase in the liquidity of MFIs that resulted from cheaper funding from the ECB using the three-year special government bonds as collateral in the open market operations, has contributed to the reduction in funding costs for banks and the increased offer of new loans, especially to households for house purchase.

As shown by the results of the latest Bank Lending Survey[7] of October 2010, in the third quarter of the current year banks tightened their lending criteria with respect to housing loans, while credit standards for consumer and other loans remained unchanged. Moreover, the participants in the survey expect the lending criteria for housing loans to tighten further in the fourth quarter of the 2010.

At the end of September 2010, loans to the domestic household sector as a percentage of total outstanding loans to resident non-MFIs rose marginally to 44,8% compared with 44,7% at-end March 2010 and 44,6% at the end of September 2009. Loans for house purchase, consumer credit and other household lending stood at 52,5%, 15,5% and 32% of total loans to the household sector, respectively, at end-September 2010 compared with 51%, 16,1% and 32,9% at the end of March 2010 and 49,4%, 23,3% and 27,2% at end-September 2009, respectively (**Chart B.2**). Consequently, housing loans continue to constitute the largest exposure of the household sector.

Loans to domestic households in foreign currency, which carry foreign exchange risk,

CHART B.2 **Distribution of bank loans to domestic households**
(%)

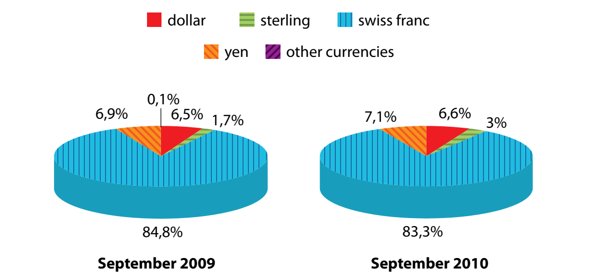


Source: CBC.

7. The results of the survey, which is carried out by the CBC, are based on the opinions of participating banks. The results do not represent the assessment of the CBC. The survey covers about 85% of the loans extended to euro area NFCs and households in Cyprus.

represent only a small fraction of total loans to households. Foreign currency loans to households as a percentage of total outstanding loans to the household sector reached 4,1% at end-September 2010, the same as at the end of March 2010, but slightly down from 4,2% at end-September 2009. At the end of September 2010, 83,3% of foreign currency loans to households was accounted for by Swiss francs, 7,1% by Japanese yen and 6,6% by US dollars compared with 83,6%, 6,9% and 6,7% at end-March 2010 and 84,8%, 6,9% and 6,5% at the end of September 2009, respectively (**Chart B.3**).

CHART B.3 **Distribution of bank loans to domestic households by foreign currency**
(%)

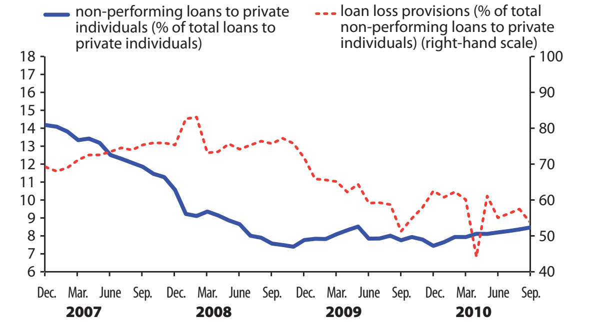


Source: CBC.

Non-performing loans[8, 9]

Non-performing loans to private individuals[10] as a percentage of total outstanding loans to private individuals amounted to 8,5% at end-September 2010 compared with 7,9% at the end of March 2010 and 7,8% at end-September 2009 (**Chart B.4**). Loan loss provisions as a percentage of total non-performing loans to private individuals (coverage ratio) declined to 53,7% at the end of September 2010 from 60,1% at end-March 2010, but they represented an increase compared with 51,3% at the end of September 2009.

CHART B.4 **Non-performing loans to private individuals and loan loss provisions[(1)]**
(monthly data, %)



Source: CBC.
(1) Excludes the co-operative credit institutions.

Household debt

Household debt[11] as a percentage of GDP rose

8. Excluding the co-operative credit institutions.
9. As defined in the relevant CBC directive, non-performing loans include credit facilities, which are in excess of their approved limit or whose repayment of principal or interest or other income is in arrears for more than three months. Funded credit facilities and credit substitutes extended to customers, which are fully secured, are not classified as non-performing.
10. Loans to households excluding loans to employers and non-profit institutions serving households.
11. Based on quarterly financial accounts data (provisional). Includes loans of households and non-profit institutions serving households.

to 129,9% at the end of June 2010 from 124,1% at end-December 2009 and 117% at the end of June 2009. **Chart B.5** exhibits the household debt-to-GDP ratio for the years 2005 to 2010.

Financing conditions

The Cyprus MFI average interest rates[12] on euro-denominated loans for house purchase and consumer loans (new business) to euro area households amounted to 4,96% and 6,82% in September 2010 compared with 4,43% and 6,99% in March 2010, respectively (**Chart B.6**). In comparison, the euro area MFI rates stood at 2,75% and 5,52% in September 2010, respectively.

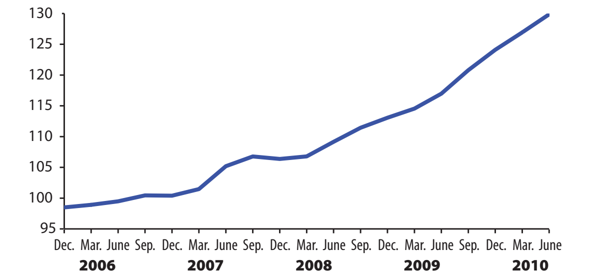
1.2.2 Financial condition[13]

Net financial assets

The household sector's net financial assets (net worth) as a percentage of GDP rose very slightly to 116,6% at the end of June 2010 from 116,3% at end-December 2009, but the increase was more significant when compared with 115,1% at the end of June 2009. **Chart B.7** indicates the household sector's net financial assets as a percentage of GDP for the years 2005 to 2010.

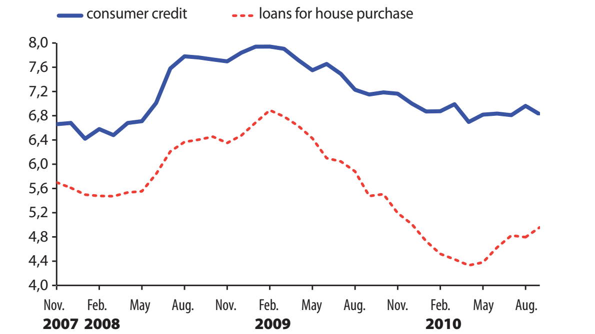
The household sector's financial liabilities expanded by 13,4% year-on-year in June 2010, mainly due to an increase in the value of loans granted, which accounted for 92,1% of the household sector's total financial

CHART B.5 **Household debt as % of GDP**



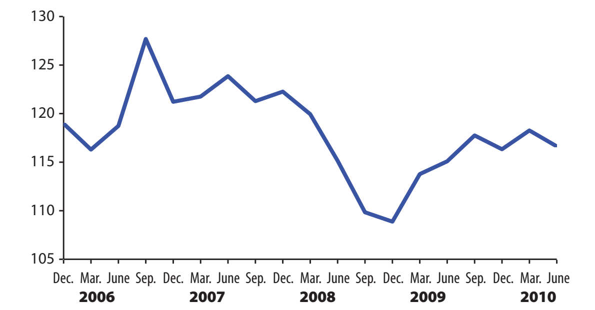
Source: CBC.

CHART B.6 **Cyprus MFI interest rates on euro-denominated loans (new business) to euro area households**
(% per annum, period average)



Source: CBC.

CHART B.7 **Household sector's net financial assets as % of GDP**



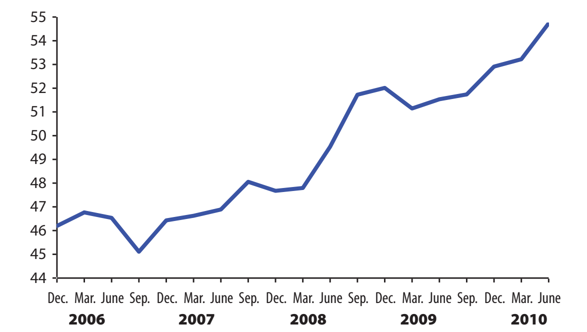
Source: CBC.

12. Floating rate and up to 1 year initial rate of fixation.
13. Based on quarterly financial accounts data (provisional).

liabilities at end-June 2010. As shown in **Chart B.8**, the ratio of financial liabilities to financial assets reached 54,7% at the end of June 2010 compared with 52,9% at end-December 2009 and 51,5% at the end of June 2009.

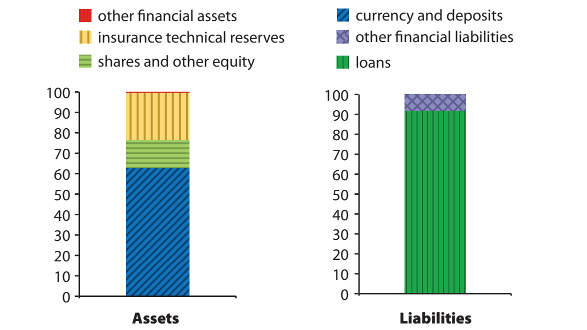
At end-June 2010, cash and bank deposits represented the largest part of the household sector's financial assets, while bank loans constituted the biggest share of the household sector's financial liabilities. **Chart B.9** shows the breakdown of the household sector's financial assets and liabilities at the end of June 2010.

CHART B.8 **Household sector's financial liabilities**
(% of financial assets)



Source: CBC.

CHART B.9 **Distribution of household sector's financial assets and liabilities**
(end of June 2010, %)



Source: CBC.

Deposits

The annual growth of domestic household deposits reached 5,5%[14] at end-September 2010 compared with 5,6% at the end of March 2010 and 4,2% at end-September 2009 (**Chart B.10**). The acceleration in the growth rate of deposits has continued since May of the current year. This is partly due to the higher deposit rates offered by MFIs in an effort to attract customer deposits, which represent their main source of funding. In general, the conservative behaviour of depositors due to the uncertainty regarding the prospects for the Cyprus economy, is reflected in lower consumption, while savings are being placed in interest-bearing deposits. It should be noted that the positive growth rates recorded by overnight deposits continued in September 2010, but at a slightly lower pace compared with the peak reached in March 2010. In particular, the latest

CHART B.10 **Deposits of domestic households**
(annual change, %)

Source: CBC.

14. Based on monthly balance sheet data submitted by MFIs to the CBC.

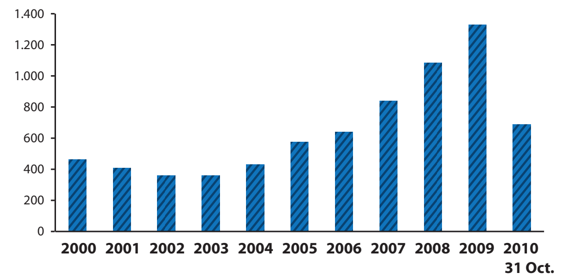
figures for September 2010 show a rise of 5,4% compared with a reduction of 4,9% recorded in September 2009. Deposits with agreed maturity rose by 6,4% in September 2010, accounting for 75,1% of total deposits at the end of the said month. Three-month deposits is the only category that recorded a fall, 0,5%, in September 2010, following a five-month period of positive growth, while a 16% drop was registered in September 2009.

It should be noted that households' deposits accounted for 57,6% of total private sector deposits in the domestic banking system at end-September 2010.

Bankruptcies of natural persons

In the first ten months of 2010, 689 receiving orders regarding natural persons were issued by the appropriate courts of justice, while in the whole of the previous year the number of bankruptcies of natural persons reached 1.329, which indicates that the total for the current year could eventually be near the 2009 figure. **Chart B.11** shows the number of bankruptcies of natural persons for the years 2000 to 2010.

CHART B.11 **Bankruptcies of natural persons**



Source: Department of Registrar of Companies and Official Receiver.

Natural persons who issued dishonoured cheques

In the first eleven months of 2010, the total number of natural persons who issued dishonoured cheques and were recorded in the CBC's Central Information Register declined to 647 compared with 779 in the corresponding period of 2009 (**Chart B.12**). In the period from January to November 2010, the total number of natural persons controlling legal persons who issued dishonoured cheques and were recorded in the Central Information Register increased to 477 compared with 460 in the corresponding period of 2009.

Confidence indicators from surveys of economic sentiment

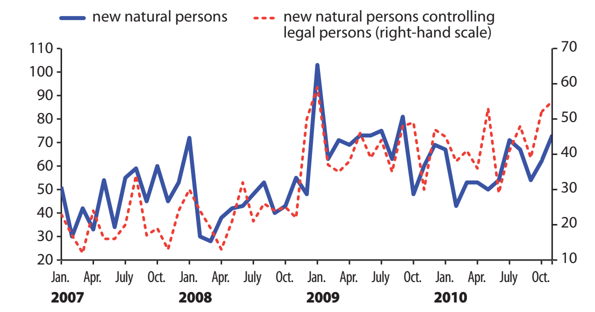
Since the publication of the June 2010 *Bulletin*, aggregate confidence indicators for Cyprus compiled monthly by the European Commission from surveys of economic sentiment carried out in EU member states, show that the Economic Sentiment Indicator (ESI)[15] exhibited an improvement until November 2010, albeit with a temporary deterioration in October 2010 (**Chart B.13**). As regards household expectations, the consumer confidence indicator has, to some extent, improved since June 2010.

In addition, a further analysis of the data regarding consumers shows that household expectations about their financial situation and future unemployment prospects in the next 12 months have worsened (**Chart B.14**).

1.2.3 Risks facing the household sector

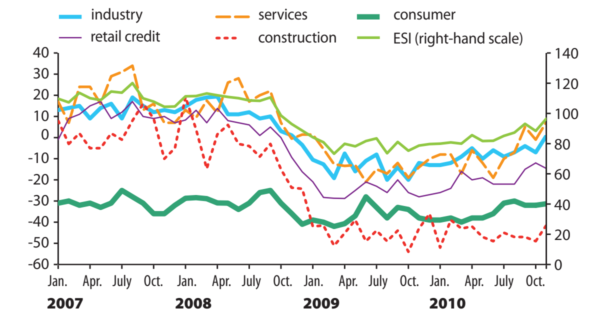
Household debt-servicing capacity is mainly affected by fluctuations in interest rates and income. A potential overvaluation in the housing market could also represent, to a

CHART B.12 **New natural persons recorded in the Central Information Register (dishonoured cheques)**
(monthly data)



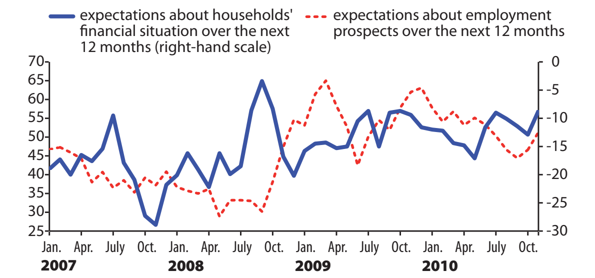
Source: CBC.

CHART B.13 **Surveys of economic sentiment: confidence indicators**(1)



Source: European Commission.
(1) Seasonally adjusted data.

CHART B.14 **Households' financial situation and unemployment expectations**(1)(2)



Source: European Commission.
(1) Seasonally adjusted data.
(2) Households' financial situation and unemployment expectations are components of the consumer confidence indicator.

15. The ESI is composed of the industry confidence indicator (40%), the services confidence indicator (30%), the consumer confidence indicator (20%), the construction confidence indicator (5%) and the retail trade confidence indicator (5%).

lesser extent, a source of risk for household sector balance sheets.

Overall, risks to financial stability originating from conditions in the household sector, although contained, remain on the upside. With the exception of a rise in interest rates on new housing loans observed in the third quarter of 2010, there was a further decline in lending rates in Cyprus during the period under review. However, this has not stopped the overall debt-servicing burden of households from rising further. Moreover, a potential further deterioration in the labour market may pose higher risks to household income and have a negative impact on household debt repayments.

Interest rate risks of households

Since the publication of the June 2010 *Bulletin*, the ECB has maintained key interest rates at a very low level (**Chart A.9**, p. 30). As shown in **Chart B.6** (p. 94), the average Cyprus MFI interest rates on euro-denominated loans (new business) to euro area households have been on a continuous downward path since the spring of 2009, with the exception of an increase in interest rates on new housing loans in the third quarter of 2010. However, these still remain at a higher level compared with the respective euro area MFI rates. This can be attributed mainly to the strong competition in the domestic banking sector for deposits as well as to banks' efforts to maintain the same levels of net interest margins.

As regards mortgage housing loans[16] to

16. Loans which are fully and completely secured by mortgage on residential real estate property, which is or will be occupied or let by the owner, or the beneficial owner in the case of personal investment companies.

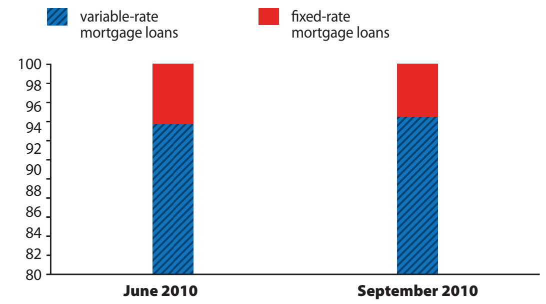
domestic households, the impact of rising interest rates on debt-servicing costs depends on the terms and conditions of individual mortgage contracts. In the case where a mortgage contract provides for a variable rate of interest, households are fully exposed to interest rate risk. The trend of interest rate risk inherent in loan mortgage contracts being undertaken almost in its entirety by the borrower has not changed. Specifically, the share of variable-rate mortgage housing loans to total outstanding mortgage housing loans stood at 95% at the end of September 2010 compared with 94,3% at end-June 2010 (**Chart B.15**). Hence, given the predominance of mortgage housing loans which carry an adjustable rate of interest, households remain vulnerable to potential shocks arising from an increase in lending rates.

In general, indebted low income households tend to face higher risks. However, in order to be able to assess fully the interest rate risks facing households, it must be borne in mind that not all households hold debt, while the characteristics of individual borrowers play a role in determining debt sustainability. In particular, the risks affecting the most financially vulnerable segments of the population cannot be properly addressed by looking at aggregate data.

Risks to household income

Fluctuations in household income, which are directly linked to developments in the labour

CHART B.15 **Distribution of fixed- and variable-rate mortgage loans to households**
(%)



Source: CBC.

market, constitute one of the most important indicators of households' ability to meet their debt-servicing obligations.

As regards domestic macroeconomic conditions, based on the analytical data published by Cystat, the annual growth rate of the economy registered a decline of 0,4% in the first six months of 2010 compared with a contraction of 0,6% in the corresponding period of 2009. This development is not expected to continue in the second half of the current year (**Charts A.30 (a)** and **A.30 (b)** (p. 56). It must be noted that GDP grew annually by 0,5% compared with the same period of 2009. According to Cystat's flash estimate, the annual rate of GDP growth during the third quarter of 2010 was 1,7%, while the annual growth in GDP in the first nine months of the current year reached 0,3%. This development reflects the improved tourism data and, mainly, the positive contribution of financial services.

According to the latest CBC projections, real GDP growth is projected to reach 0,7% in 2010, while further recovery is expected in 2011 and 2012 with GDP increasing by 1,8% and 2,4%, respectively. It should be noted that when the projections were being prepared, the possible adoption of further fiscal consolidation measures was not being taken into account. Hence the outcome of these projections will be negatively affected if the fiscal consolidation measures are actually implemented. The impact of these measures on the economy will depend on their type and size.

As regards the labour market, in the first half of 2010, as a result of the downturn in the Cyprus economy, employment registered a reduction of 0,7% compared with a rise of 0,2% in the corresponding period of 2009. According to data from the Labour Force Survey (LFS), in the first six months of 2010 unemployment increased by 1,9 percentage points, reaching 6,8% (**Chart A.39,** p. 68). Unemployment decreased on a quarterly basis in the second quarter of 2010 compared with the first quarter of the current year, mostly due to the seasonal nature of unemployment related to conditions in the hotel industry. Specifically, unemployment reached 6,4% in the second quarter of 2010 compared with 7,2% in the previous quarter. The most recent available data regarding the the registered unemployed (**Chart A.41**, p. 68) reflect the general trend recorded by the LFS data in recent years. In particular, the rate of registered unemployment in the first ten months of 2010 increased by 1,2 percentage points compared with the corresponding period of 2009, reaching 5,1%. According to the latest CBC macroeconomic projections, the unemployment rate, as defined in the LFS, is expected to rise significantly in 2010, reaching 6,9%, while it is anticipated to decrease marginally to 6,6% and 6% in 2011 and 2012, respectively.

At the same time, domestic inflationary pressures have increased in the first ten months of 2010 compared with the same period of 2009. In particular, the HICP grew by 2,7% in the first ten months of 2010. Based on the latest CBC macroeconomic projections, the HICP is expected to rise to 2,7% in 2010. In 2011 HICP inflation is projected to increase by 3,4%, while in 2012 HICP is expected to expand by 2,5%.

The above developments suggest that the risks related to household disposable income are on the upside.

Risks emanating from residential property prices

According to the latest available data, construction activity recorded a significant decline in the first ten months of 2010. In contrast, interest by Cypriots as well as foreigners in the purchase of residential property presents a more positive picture, which can be attributed to an increase in resales and a reduction in the stock of finished homes.

Risks to financial stability stem from the impact of a potential further weakening of that part of domestic economic activity tied to the residential real estate sector, which would result in a significant decline in house prices. Although such a development could reduce household sector net worth, thus increasing financial stability risks, the probability of a sharp downturn in residential property prices remains low.

In addition, while any potential overvaluation in the housing market could represent a source of risk for household sector balance sheets, since it leads to a corresponding overvaluation of non-financial assets, income conditions continue to constitute the main decisive factor in assessing the risks to household finances.

1.3 Non-financial corporate sector

1.3.1 Leverage

MFI loans to domestic non-financial corporations

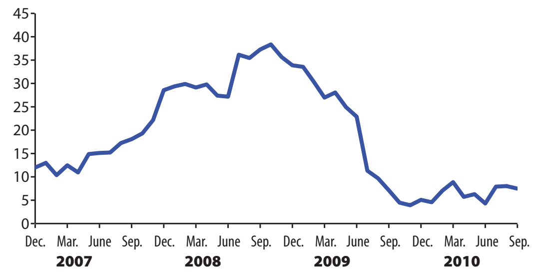
MFI loans to domestic NFCs[17] increased by 7,5% year-on-year in September 2010 (**Chart B.16**). Following the deceleration exhibited in the annual rate of growth of total MFI loans to domestic NFCs in 2009, credit expansion has shown signs of acceleration since January 2010. The use of the three-year special government bonds by banks since December 2009, as collateral in the ECB open market operations, has helped them to raise cheaper funding, thus resulting in a rise in the provision of loans, *inter alia*, to NFCs.

As shown by the results of the latest Bank Lending Survey of October 2010, in the third quarter of the current year banks' lending criteria with respect to loans to NFCs remained unchanged. These are not expected to change neither in the fourth quarter of 2010.

At the end of September 2010, loans to NFCs as a percentage of total outstanding loans to non-MFIs reached 46,5%, down from 47,7% at end-March 2010 and up from 48,3% at the end of September 2009.

Foreign currency loans to NFCs, which

CHART B.16 **Bank loans to domestic non-financial corporations**
(annual change, %)

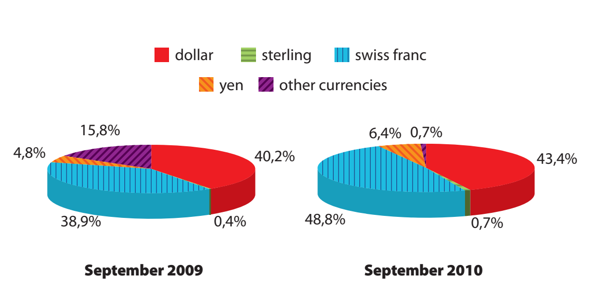


Source: CBC.

17. Based on monthly balance sheet data submitted by MFIs to the CBC.

carry foreign exchange risk, as a percentage of total outstanding loans to NFCs fell to 15% at end-September 2010 from 15,8% at the end of March 2009 and 48,3% at end-September 2009. At the end of September 2010, 43,4% of foreign currency loans to NFCs were accounted for by dollars, 48,8% by Swiss francs, 6,4% by yen and 0,7% by sterling compared with 48,8%, 44,8%, 5,6% and 0,6% at end-March 2010 and 40,2%, 38,9%, 4,8% and 0,4% at the end of September 2009, respectively (**Chart B.17**).

CHART B.17 **Distribution of bank loans to domestic non-financial corporations by foreign currency**
(%)

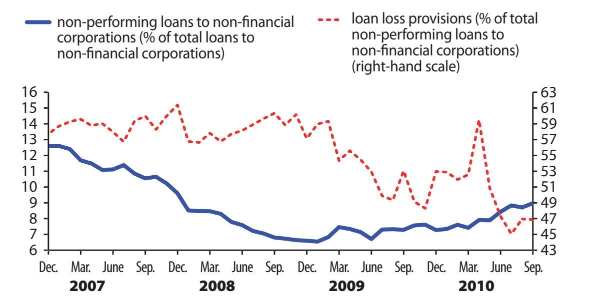


Source: CBC.

Non-performing loans[18]

Non-performing loans to NFCs as a percentage of total loans to NFCs increased significantly to 9% at the end of September 2010 compared with 7,4% at end-March 2010 and 7,3% at the end of September 2009 (**Chart B.18**). Loan loss provisions as a percentage of total non-performing loans to NFCs (coverage ratio) fell to 46,9% at the end of September 2010 compared with 52,6% at end-March 2010 and 53,1% at the end of September 2009.

CHART B.18 **Non-performing loans to non-financial corporations and loan loss provisions(1)**
(monthly data, %)

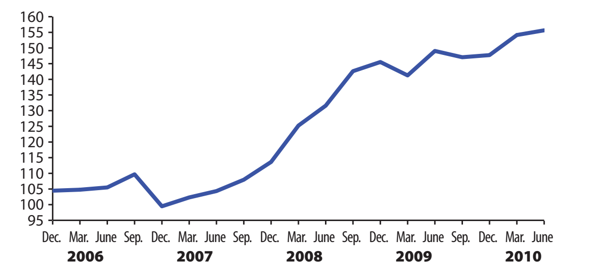


Source: CBC.
(1) Excludes the co-operative credit institutions.

Non-financial corporate debt

Non-financial corporate debt[19] as a percentage of GDP rose to 155,6% at the end of June 2010, from 147,7% at end-December 2009 and 149,1% at the end of June 2009. **Chart B.19** exhibits the non-financial corporate debt-to-GDP ratio for the years 2005 to 2010.

CHART B.19 **Non-financial corporate debt as % of GDP**



Source: CBC.

18. Excluding the co-operative credit institutions.
19. Based on quarterly financial accounts data (provisional). Includes loans and debt securities of financial corporations.

Financing conditions

The Cyprus MFI average interest rates[20] on euro-denominated loans (new business)[21] up to €1 million to euro area NFCs rose from 5,95% in March 2010 to 6,43% in September 2010 (**Chart B.20**). In comparison, the euro area MFI rates stood at 3,34% in September 2010.

At the same time, the Cyprus MFI average interest rates on euro-denominated loans (new business) over €1 million to euro area NFCs increased from 4,61% in March 2010 to 5,77% in September 2010. In comparison, the euro area MFI rates stood at 2,26% in September 2010.

1.3.2 Financial condition[22]

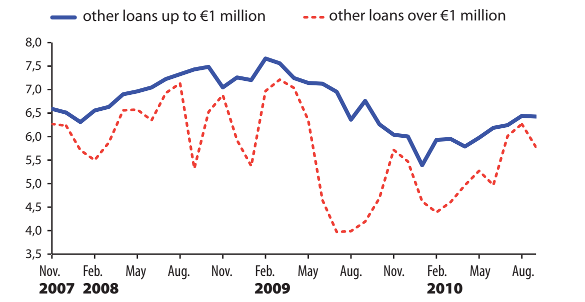
Net financial assets

As shown in **Chart B.21**, the non-financial corporate sector's net financial assets (net worth) as a percentage of GDP reached -172,2% at the end of June 2010 compared with -165,3% at end-December 2009 and -168,4% at the end of June 2009.

The ratio of financial liabilities to financial assets increased marginally to 178,7% at end-June 2010 compared with 178,3% at the end of December 2009, but exhibited a decrease compared with 183,5% at end-June 2009 (**Chart B.22**).

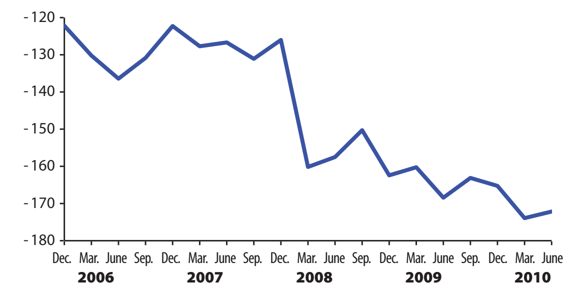
At the end of June 2010, cash and deposits represented the largest part of the non-financial corporate sector's financial assets,

CHART B.20 **Cyprus MFI interest rates on euro-denominated loans (new business) to euro area non-financial corporations**
(% per annum, period average)



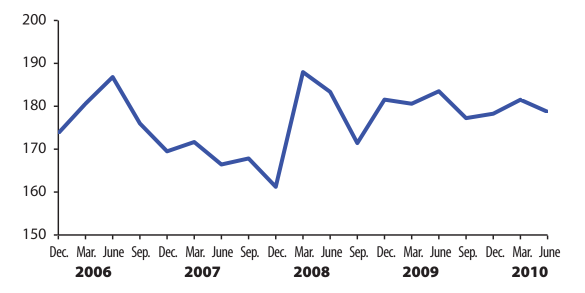
Source: CBC.

CHART B.21 **Non-financial corporate sector's net financial assets as % of GDP**



Source: CBC.

CHART B.22 **Non-financial corporate sector's financial liabilities**
(% of financial assets)



Source: CBC.

20. Floating rate and up to 1 year initial rate of fixation.
21. Loans other than bank overdrafts.
22. Based on quarterly financial accounts data (provisional).

while shares and other equity constituted the biggest component of the sector's financial liabilities. **Chart B.23** exhibits the breakdown of the non-financial corporate sector's financial assets and liabilities at the end of June 2010.

Deposits

As regards the deposits of domestic NFCs (**Chart B.24**), these have been recording positive annual growth rates since May of the current year. In particular, these deposits decreased by 11,9%[23] during the period September 2009-September 2010. The rise exhibited in the deposits of domestic NFCs may be explained by the fact that during the period May-September 2010 banks offered higher interest rates on deposits with agreed maturity up to one year.

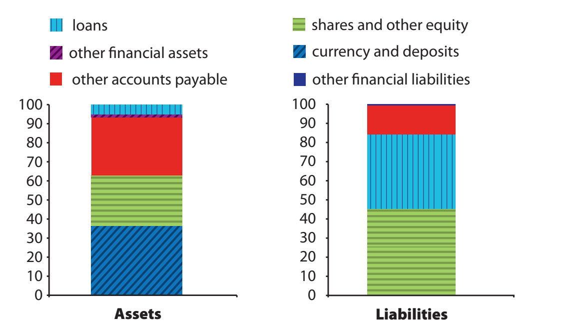
It should be noted that NFC deposits represented around 26% of total private sector deposits in the domestic banking system at the end of September 2010.

Company liquidations

In the first ten months of 2010, 122 winding-up orders were issued by the appropriate courts of justice compared with 159 company liquidations during the whole of 2009 (**Chart B.25**), which indicates that the total for the current year may eventually be smaller than the 2009 figure.

During the period January-November 2010, 17.197 new companies were regis-

CHART B.23 **Distribution of non-financial corporate sector's financial assets and liabilities**
(end of June 2010, %)

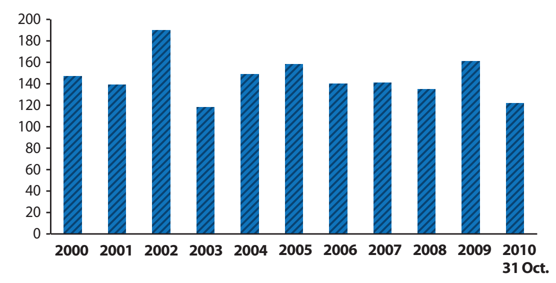


Source: CBC.

CHART B.24 **Deposits of domestic non-financial corporations**
(annual change, %)

Source: CBC.

CHART B.25 **Company liquidations**

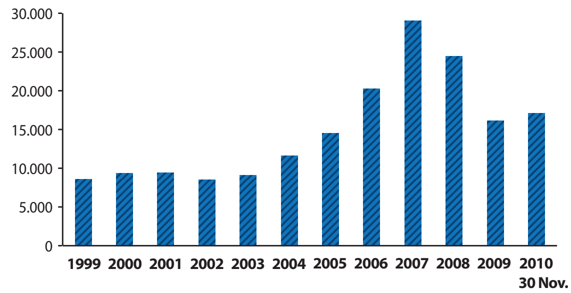


Source: Department of Registrar of Companies and Official Receiver.

23. Based on monthly balance sheet data submitted by MFIs to the CBC.

tered compared with 16.101 new company registrations in the whole of 2009 (**Chart B.26**), which shows that the total for the year will eventually be significantly higher than the 2009 figure. The above development may reflect a rise in corporate sector activity as well as an expansion of the operations of legal and accounting firms.

CHART B.26 **New company registrations**

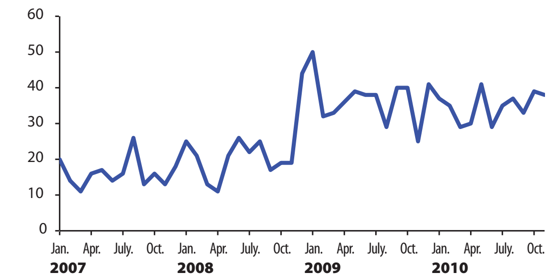


Source: Department of Registrar of Companies and Official Receiver.

Legal persons who issued dishonoured cheques

In the first eleven months of 2010, the total number of legal persons who issued dishonoured cheques and were recorded in the CBC's Central Information Register declined to 383 compared with 400 in the corresponding period of 2009 (**Chart B.27**).

CHART B.27 **New legal persons recorded in the Central Information Register (dishonoured cheques)**
(monthly data)



Source: CBC.

Confidence indicators from surveys of economic sentiment

As shown in **Chart B.13** (p. 97), since the publication of the June 2010 *Bulletin*, the industry and construction confidence indicators have generally fluctuated at low levels. Moreover, the services and retail trade confidence indicators have remained in negative territory during the same period.

1.3.3 Risks facing the non-financial corporate sector

The environment in which NFCs operate is expected to remain difficult, at least in the short term.

The negative domestic macroeconomic conditions that prevailed in the first half of 2010 have adversely affected the earnings and profitability of NFCs. In addition, the higher borrowing costs facing enterprises in Cyprus, compared with other euro area member states, as well as the limited possibility for external financing are expected to contribute to the uncertainty about the short-term profitability prospects of the corporate sector. At the same time, the high level of NFCs' indebtedness renders them less resilient to any potential shocks.

Looking forward, weak profits, high leverage as well as firms' dependence on bank finance remain the key vulnerabilities of the corporate sector.

Earnings and profitability risks

According to the latest CBC projections for the Cyprus economy, real GDP growth is projected to reach 0,7% in 2010, while further recovery is expected in 2011 and 2012 with GDP increasing by 1,8% and 2,4%, respectively. However, the uncertainty surrounding the domectic macroeconomic prospects remains, which, in conjunction with the difficult external operating environment, is expected to have a negative impact on the earnings and profitability of NFCs.

Total net profits of companies listed on the Cyprus Stock Exchange (CSE) fell by 68% in the first six months of 2010 compared with the corresponding period of 2009. This confirms that risks to corporate profitability remain on the upside.

Risks facing leveraged non-financial corporations

Following the deceleration exhibited in 2009, the annual rate of growth of bank lending to the NFC sector has accelerated in 2010. As shown by the results of the latest Bank Lending Survey of October 2010, credit standards for new bank loans to enterprises remained unchanged in the third quarter of the current year, while this trend is expected to continue in the fourth quarter of 2010.

However, bank financing conditions for NFCs remain difficult. In particular, the cost of bank financing facing enterprises remains at a higher level compared with other euro area member states. This is expected to continue to have an adverse impact on company profits. Overall, funding conditions for the NFC sector are not expected to improve significantly in 2011.

At the same time, firms' leverage remains at a high level, rendering them vulnerable to potential shocks. It must be noted that the ability of NFCs to generate internal funding is expected to remain constrained, which will contribute to leverage ratios remaining at a high level and/or further increasing corporate debt burden. This could amplify the effects on the solvency of some firms and lead to an increase in default rates.

1.4 Real estate sector

1.4.1 Key developments in the real estate sector

Domestic real estate sector activity

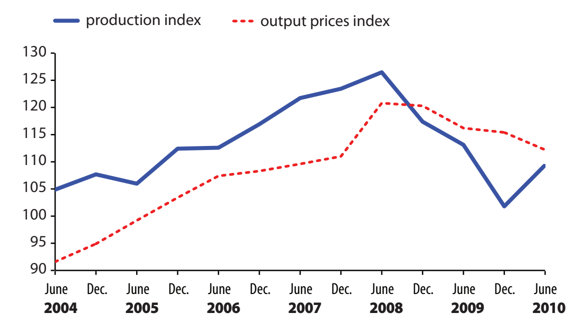
According to the latest available data, the construction sector exhibited a contraction in the first ten months of 2010.

In particular, total cement sales in the domestic market declined by 9,6% in the period January-October 2010 compared with the corresponding period of 2009. **Chart A.34** (p. 59) shows the sales of cement in the domestic market.

In addition, the production index in construction for the first and second quarters of 2010 recorded a yearly average decrease of 5,9% and 3,2%, respectively, compared with the same periods of 2009. With regard to the component indices, a yearly average fall of 7,3% was registered in the second quarter of 2010 for buildings, while a yearly average increase of 13,2% was recorded for civil engineering projects. Furthermore, as shown in **Chart B.28**, the output prices index in construction for the second quarter of 2010 reached 112,2 units, declining by 3,4% compared with the corresponding quarter of 2009.

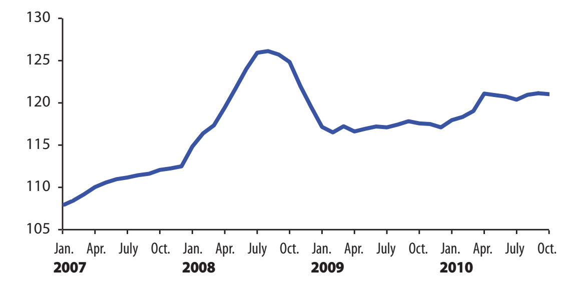
The price index of construction materials for October 2010 reached 121,0 units, registering a rise of 2,9% compared with the same month of 2009 (**Chart B.29**). For the period from January to October 2010, the

CHART B.28 **Production and output prices indices in construction**
(base 2005=100)



Source: Cystat.

CHART B.29 **Price index of construction materials**
(base 2005=100)



Source: Cystat.

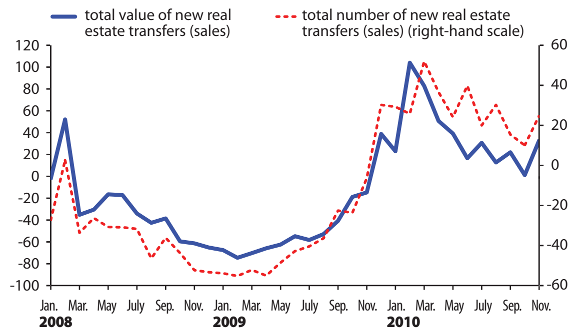
index recorded a small increase of 2,6% compared with the corresponding period of 2009.

In contrast, interest by Cypriots as well as foreigners in the purchase of residential property presents a more positive picture, which can be attributed to an increase in resales or to a reduction in the stock of finished homes.

Specifically, the total number of new real estate transfers (sales) rose by 24,8% year-on-year in November 2010, while an increase of 27,1% was recorded during the period from January to November 2010 compared with the same period of 2009. Similarly, the total value of new real estate transfers (sales) grew by 32,9% year-on-year in November 2010, while a rise of 34,2% was registered in the first eleven months of 2010 compared with the corresponding period of 2009 (**Chart B.30**). Moreover, the volume of new real estate sales contracts registered at the Department of Lands and Surveys decreased by 6,4% year-on-year in November 2010, while a marginal increase of 0,1% was recorded in the period January-November 2010 compared with the same period of 2009 (**Chart B.31**).

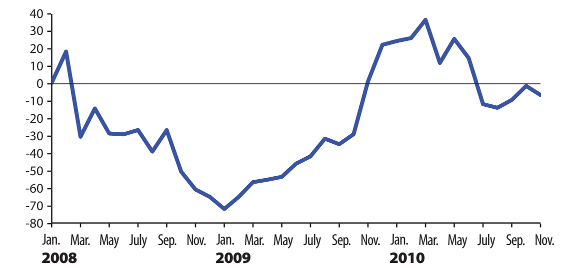
As regards the purchase of residential property by foreigners, the number of new real estate transfers (sales) to foreigners increased by 28,7% during the first eleven months of 2010 compared with the corresponding period of 2009. In parallel, in the period from January to November 2010 the volume of new real estate sales contracts registered to foreigners at the Department of

CHART B.30 **New real estate transfers (sales)**
(annual change, %)



Source: Department of Lands and Surveys.

CHART B.31 **New real estate sales contracts registered**
(annual change, %)



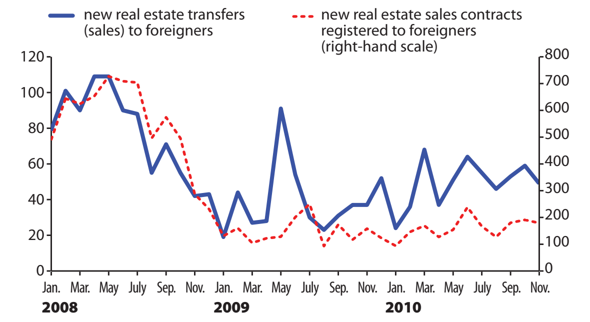
Source: Department of Lands and Surveys.

Lands and Surveys rose by 8,2% compared with the same period of 2009 (**Chart B.32**).

In conjunction with the above, the receipts of the Inland Revenue Department from immovable property tax and stamp duties during the first ten months of 2010 both grew by 24% compared with the corresponding period of 2009. Furthermore, in the period January-October 2010, capital gains tax increased by 19% compared with the same period of 2009.

The volume index of authorised building permits, which constitutes a good indicator of future activity in the construction sector, registered a decrease of 0,6% during the period January-September 2010 compared with the corresponding period of 2009 (**Chart A.38**, p. 62). During the first nine months of 2010, the total value of building permits and the total area of building units decreased by 6,9% and 6,6%,, respectively, compared with the same period of 2009. In addition, in the period January-September 2010, the number of dwellings recorded a fall of 12,4% compared with the corresponding period of 2009.

CHART B.32 **New real estate transfers (sales) and new real estate contracts registered to foreigners**



Source: Department of Lands and Surveys.

Real estate prices

Residential property prices, as indicated by the latest available trends in the CBCs residential property price index[24], registered an average annual decrease of 3,7% in September 2010. Based on real estate valuations collected by the CBC as well as other data relating to the residential property

24. Based on the methodology for compiling the index, which is analysed in Box A.2 on p.p. 64-67.

sector up until September 2010, the CBC estimates that residential real estate prices will fall by an annual average of 3% in 2010 (**Chart B.33**).

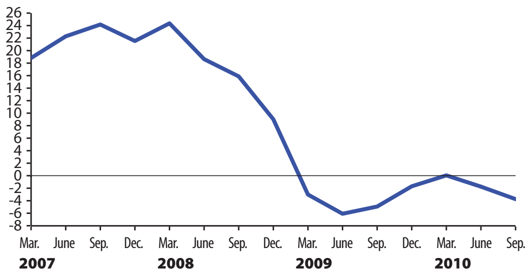
At the same time, according to the RICS Cyprus Property Price Index[25], house and apartment prices in Cyprus both declined on average by 2,5% in the second quarter of 2010. The biggest drop in house and apartment prices was recorded in Paphos (- 4%) and the area of Famagusta - Paralimni (-3,3%), respectively (**Chart B.34**). Commercial property prices fell across all cities by an average of 0,5% for retail shops and 0,4% for warehouses. A reduction was also registered in the prices for office space, which dropped by an average of 2,1%. Rental values for apartments, houses, retail stores and office space in Cyprus declined on average by 0,1%, 1,9%, 1,4% and 2,7%, respectively, in the second quarter of 2010 (**Chart B.35**). In contrast, rents for warehouses increased on average by 0,2% in the first six months of 2010.

1.4.2 Real estate financing by banks

MFI loans to the domestic broad real estate sector

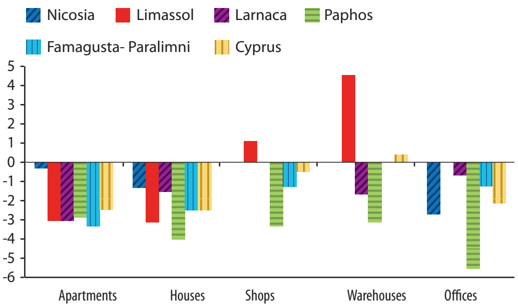
MFI loans to the domestic broad real estate sector[26] represented 20,6% of the total outstanding loans to domestic non-MFIs (excluding loans to MFIs) at end- September 2010 compared with 20,1% at the end of June 2010 (**Table C.23**, p. 202).

CHART B.33 **Residential property price index**
(annual change, %)



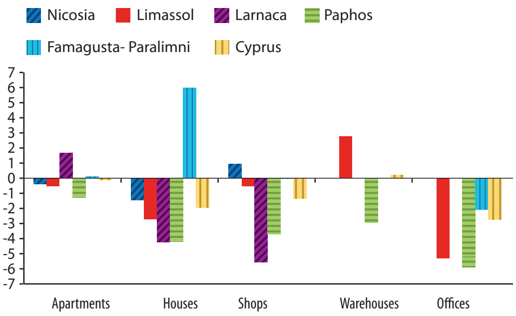
Source: CBC.

CHART B.34 **Average property price**
(quarterly change March-June 2010, %)



Source: RICS Cyprus.

CHART B.35 **Average property rent**
(quarterly change March-June 2010, %)

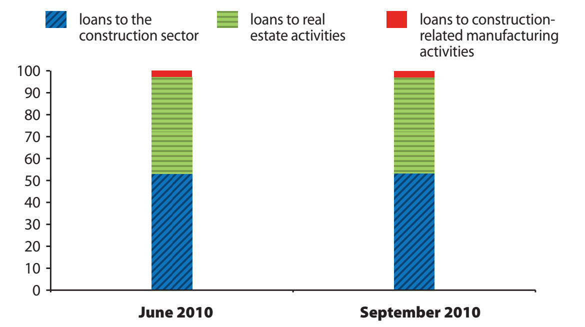


Source: RICS Cyprus.

25. The index monitors the market price and rent across the four main property sectors: offices (central business district), retail (high street), industrial (warehouses) and residential (houses and apartments).
26. Based on monthly balance sheet data submitted by MFIs to the CBC. Excludes loans to households for house purchase.

As regards the three component categories of this sector, loans to the construction sector constituted 11% of the total outstanding loans to domestic non-MFIs (excluding loans to MFIs) at end-September 2010 compared with 10,7% at the end of June 2010. At the same time, loans to real estate activities reresented 9% of the total outstanding loans to domestic non-MFIs (excluding loans to MFIs) at end-September 2010 compared with 8,9% at the end of June 2010. Moreover, loans to construction-related manufacturing activities amounted to 0,6% of the total outstanding loans to domestic non-MFIs (excluding loans to MFIs) at end-September 2010, the same level as at the end of June 2010. The distribution of MFI loans to the domestic broad real estate sector is shown in **Chart B.36**.

CHART B.36 **Distribution of bank loans to the broad real estate sector**
(%)

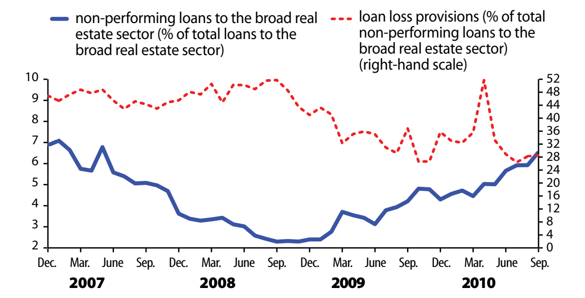


Source: CBC.

Non-performing loans[27]

Non-performing loans to the domestic broad real estate sector as a percentage of total loans to the domestic broad real estate sector rose to 6,5% at end-September 2010 (up from 5,7% at the end of June 2010) (**Chart B.37**). Loan loss provisions as a percentage of total non-performing loans to the domestic broad real estate sector (coverage ratio) fell marginally to 28,6% at end-September 2010 compared with 28,9% at the end of June 2010.

CHART B.37 **Non-performing loans to the broad real estate sector and loan loss provisions[(1)]**
(monthly data, %)



Source: CBC.
(1) Excludes the co-operative credit institutions.

2. The Domestic Financial System

This section provides a description of the key

27. Excluding the co-operative credit institutions.

developments in the domestic financial markets.

2.1 Financial markets

2.1.1 Key developments in the money market

Since the finalisation of the June 2010 *Bulletin*, the upward trend observed in euro money market interest rates in the previous review period was largely maintained over the current period under review. The increase was accompanied by intervals of notable volatility, especially as regards the secured money market interest rates. Against a background of negative developments in Ireland, particularly in October and November 2010, the renewed escalation of sovereign risk and the perceived spillover effects to other EU countries with substantial fiscal imbalances and vulnerable financial sectors, exerted adverse pressures on all segments of the euro money markets impairing liquidity redistribution.

As regards the cost of borrowing in the euro interbank markets, secured and unsecured benchmark money market rates increased across all maturities mirroring the deterioration of liquidity conditions in the euro money market. It is worth noting that the spread between the 1 and 12-month EURIBOR rates, which determines the slope of the money market yield curve, narrowed slightly as a result of the relatively higher rise in the 1-month rate.

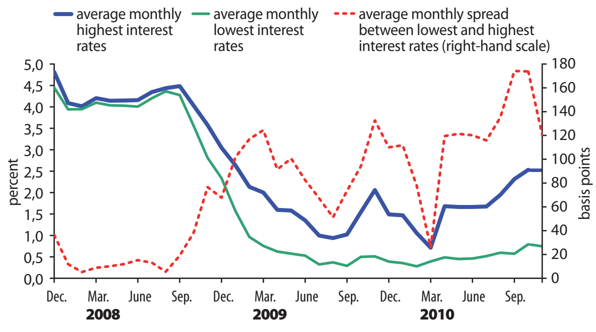
The increase in the euro money market rates can be largely attributed to the termination of the non-standard liquidity support measures of longer maturities initiated by the ECB at the onset of the crisis. In particular, the termination of the 6 and 12-month liquidity-providing operations led to a decline of excess liquidity. The diminishing excess liquidity is likely to have contributed, at least partially, to the higher level of unsecured money market rates. It is also noteworthy that since 18 October 2010, the 3-month EURIBOR has been higher than the ECB's main refinancing operations rate[28].

During the period 18 May-19 November 2010, interbank market activity in Cyprus increased somewhat compared with the previous period under review. At the same time, activity in the longer-term segments exhibited very subdued signs of improvement, although activity in those segments remains rather limited. Thus, the bulk of the activity is still heavily concentrated in the shorter-term segments.

However, the upward trend and higher volatility that were observed in the average monthly highest and lowest interbank rates[29] over the period December 2009–May 2010, persisted over the current review period. The average monthly spread between the highest and the lowest interbank rates[30] has also widened (**Chart B.38**), with the most pronounced values being recorded in the period August-November 2010.

During the period from August to November 2010, the weighted average rate in the domestic interbank market vis-à-vis the interbank EONIA swap rate and the minimum

CHART B.38 **Average monthly interest rates in the interbank market**



Source: CBC.

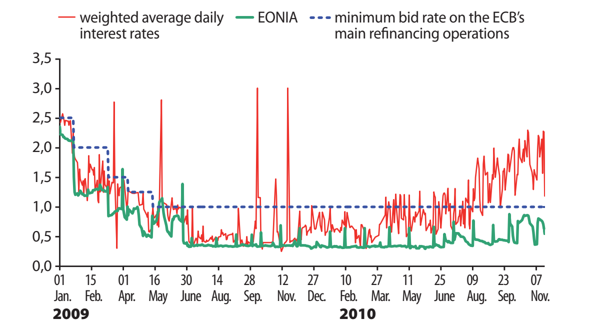
28. This was the first time since 10 July 2009 that the 3-month EURIBOR closed at par and thereafter exceeded the ECB's main refinancing operations rate. In normal market conditions, the 3-month EURIBOR usually lies above the ECB main rate.
29. Cost of short-term funding in euro (with a maturity of up to 7 days) of banks in Cyprus when borrowing from other domestic or foreign banks.
30. With a maturity of up to 7 days.

bid rate for the ECB main refinancing operations, fluctuated greatly. The higher levels of dispersion imply that a number of banks, albeit a small proportion of the total, paid a substantial premium for the aforementioned reference euro rates (**Chart B.39**). The higher borrowing tiering and the upward trend registered during the period under review were in line with the prevailing conditions in the euro money market rates during the same period.

The above developments reflect the sharp persistence of adverse pressures that still linger in the interbank market, even though ample levels of liquidity are maintained in the domestic financial system and at the eurosystem level. It is also evident that the risks emanating from the fragile macroeconomic conditions and external environment and, in particular, counterparty risk, hinder the full normalisation of the market.

Looking ahead, the key factors necessary for the normalisation of the market and the significant improvement in the redistribution of liquidity are the reduction in sovereign credit risk and the suppression of fears as regards potential contagion and feedback effects between the financial sector and the economy.

CHART B.39 **Weighted average daily interest rates in the interbank market (with maturity of up to 7 days)**
(%)



Sources: CBC, ECB.

2.1.2 Key developments in the capital markets

Government bond market

The abrupt escalation of market tensions owing to the upsurge of sovereign credit risk concerns that were observed during the end of the previous review period plagued anew the market for the most part of the period 18 May–November 2010. In the last month of the review period, with Ireland at the epicenter, the adverse developments drove sovereign bond yields of countries with weak fiscal positions and vulnerable macroeconomic conditions considerably higher. At the same time, the resurfaced "flight-to-safety" impetus favoured the safest euro sovereign bonds and in particular, the German bunds.

The ECB's targeted interventions in the dysfunctional sections of the euro bond markets[31] and the establishment of the European Financial Stability Mechanism, partly eased investor concerns about the spread of the sovereign crisis, thus contributing somewhat to the normalisation of the bond markets. However, bond spreads between the fiscally weakest peripheral euro countries and the corresponding German bunds during the period under review have remained at historically high levels. Specifically, the renewed concerns about the sovereign debt crisis sparked by the developments in Ireland and the potential spillover fears, resulted in an abrupt upsurge in volatility leading to a steep increase of the yield of the peripheral euro area countries, (sovereign) bonds.

On 1 November 2010, the Cypriot government proceeded with the issuance of a new eurobond with a €1 billion nominal value in the international markets via

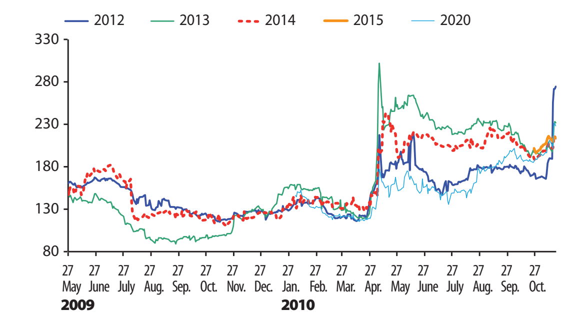
31. Interventions via the "Securities Market Programme" in public and private euro debt securities markets to ensure depth and liquidity.

the Euro Medium - Term Note (EMTN) Programme[32]. The weighted average yield-to-maturity of the bids accepted was 3,84%. The new bond issue, which is expected to cover the government's medium-term external financing needs, has a 5 year duration and carries an annual coupon of 3,75%. In the period under review, no other government bond securities were issued. It must be noted that trading activity in the domestic secondary government bond market, i.e. the Cyprus Stock Exchange, remains extremely low.

Market uncertainty and the ensuing deterioration of investor sentiment, particularly in November 2010, emanating from the re-escalation of the aforesaid concerns and the reappraisal of sovereign credit risk, led anew to a significant widening of the spread between the five Cypriot eurobonds issued through the EMTN programme and the corresponding German bunds. With the month of November 2010 as the reference month, the spread on four of the five eurobonds surged to their highest levels vis-à-vis the corresponding German bunds (**Chart B.40**). It should be borne in mind, however, that trading activity in these bonds has been rather limited. It is also evident that in times of market uncertainty and volatile prices, market-makers are compelled to adjust (widen) their bid-offer prices for their liquidity-providing services accordingly.

The catalyst for the significant dissipation of market tensions and the shrinkage of the

CHART B.40 **Cyprus sovereign bond yield spreads over German bunds**
(daily data, basis points)



Source: Bloomberg.

32. Euro-denominated bonds issued by the Cyprus government under the Euro Medium-Term Note (EMTN) Programme established in 1997.

yield spread and observed volatility close to the pre-crisis levels are expected to be the efficacy of the government's fiscal adjustment measures and the recovery prospects of the domestic and the EU economy in general. Swings in market sentiment will not moderate substantially if contagion fears associated with the sovereign crisis spreading to other fiscally vulnerable, debt-laden euro area countries are not confined considerably.

Equity market

Major developments in the CSE concerning the period 18 May-19 November 2010 were driven by the strong uncertainty and the notable swings in investor sentiment, which were in line with the major macroeconomic developments in Cyprus as well as the prevailing economic sentiment in the euro area, especially Greece.

The current period under review can be broadly divided into three distinct phases. The first is the period May-June 2010[33], during which the stock market continued its downward path primarily driven by fears of potential contagion from the Greek sovereign debt crisis. The second is the period July-October 2010, during which the ECB's interventions in poorly functioning segments of the eurobond markets, the establishment of the European Financial Stability Mechanism and the finalisation of the economic rescue package to Greece, had, albeit with some delay, a largely positive

33. On 8 June 2010, the CSE General Index, and all its major sub-indices, fell to its lowest level for the year.

effect, easing investor concerns and propelling the market on a correction path. However, the adverse developments in Ireland, particularly in early November 2010[34], triggered the sudden re-escalation of sovereign risk and contagion fears for the other peripheral European countries with weak macroeconomic conditions.

In November 2010, the abrupt intensification renewal of market fears and resulting uncertainty, exerted a significant downward pressure on the CSE's General Price Index (main and parallel Market). The Index fell to 1.143,26 points, down by 6,9% for the current review period and by 28,4% over the period 1 January–19 November 2010 (**Chart B.41**). In comparison, the FTSE/CySE 20 Index recorded marginally higher losses declining to 387,13 points, 7,2% for the period under review and 28,8% since the beginning of the year. Also, the total profits of all companies listed on the CSE for the first half of 2010 fell by 68% compared with the first half of 2009.

During the period April-October 2010, the total capitalisation of the market[35] shrunk slightly by 0,6% to €6,13 billion at end-October 2010, while the average value of daily transactions increased. It must be noted that this growth was solely due to a number of extremely large transactions in bank shares. At the end of June 2010, the ratio of total market capitalisation to GDP dropped to 29,9% compared with 42,3% at end-December 2009.

In the period under review, share prices of

CHART B.41 **Cyprus Stock Exchange general price index (main and parallel market)**
(daily data, 3 September 2004=1000)

Source: CSE.

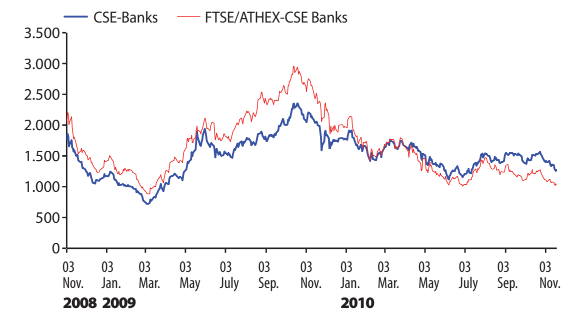
34. This review was conducted based on developments until 20 November 2010, i.e. before the Council's decision to provide financial assistance to Ireland via the European Financial Stability Mechanism.

35. Excluding the investment companies market.

the listed domestic banks were greatly affected by negative macroeconomic conditions both in Cyprus and Greece, which inevitably had an impact on the sector's current and projected profitability. It is noteworthy that over the review period, the CSE Bank Index demonstrated higher resilience to the adverse investor sentiment than the FTSE/ATHEX-CSE Banks Index. The former registered losses of 6,3% compared with the latter, which declined by 16,2% (**Chart B.42**). The cumulative market share of the three largest banks listed on the CSE rose to 73,8% of total market capitalisation as at end-October 2010 compared with 71,2% at the end of December 2009.

Looking forward, over the short-term horizon, the prevailing uncertainty and fears regarding the recovery path of the domestic economy and, to a considerable extent, the prevailing macroeconomic conditions in Greece, are likely to have a negative impact on the stock market's performance. In the long run, investors' aggregate sentiment and the performance of the banking sector, which will continue to be adversely affected by the prevailing macroeconomic developments, are expected to determine the direction of the market.

CHART B.42 **CSE-Banks and FTSE/ATHEX-CSE Banks indices**
(daily data, 3 September 2004=1000 and 31 October 2008=2000)



Source: CSE.

2.2 Banking sector

Banks in Cyprus play by far the most significant role in financial intermediation. Specifically, the total consolidated assets of the banking sector represented 81,9%[36] of the

36. Based on quarterly financial accounts data (provisional).

total domestic financial system[37] assets at end-June 2010. Moreover, the total consolidated assets of domestic banks reached 603% of GDP at the end of June 2010.

In light of the above, the assessment of the stability of the banking sector and its shock-absorption capacity is crucial when analysing overall financial stability.

TABLE B.1 **Banking sector capacity indicators**[1]
(end of 2009, non-consolidated data)

	CY	MU16	EU27
Number of credit institutions	155	6.458	8.358
Population per credit institution	5.148	50.959	59.860
Population per branch	858	1.766	2.131
Population per ATM	1.300	1.033	1.168
Population per employee	64	165	171
Population density	87	127	115
Assets per employee (€ million)	11.138	13.616	13.156

Sources: CBC, ECB.
(1) Includes the co-operative credit institutions.

2.2.1 Key structural developments in the banking sector

This section provides an overview of the main structural developments in the Cyprus banking sector which took place during the period January-November 2010.

Tables C.21 (p. 200) and **B.1** exhibit a number of key structural indicators and capacity indicators of the banking sector relative to the population for the years 2006-2009 and 2009, respectively[38].

TABLE B.2 **Banking sector structure**[1]
(end of October 2010)

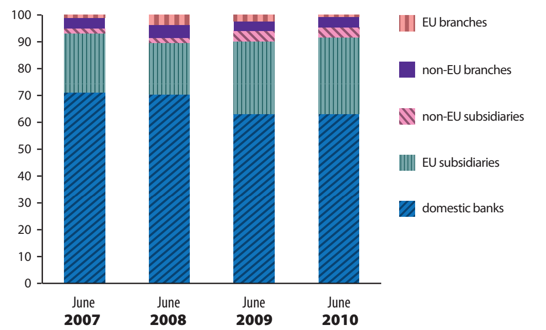
	Number of banks
Domestically-controlled banks	7
Foreign-controlled banks	34
EU subsidiaries	6
EU branches	9
Non-EU subsidiaries	2
Non-EU branches	17
Total	**41**

Source: CBC.
(1) Excludes the co-operative credit institutions.

Domestic banking market structure

As shown in **Table B.2,** there are currently 41 banks operating in Cyprus, comprising of 7 domestically-controlled banks and 34 foreign-controlled banks (of which 8 are subsidiaries and 26 are branches of foreign banks). The banking landscape continues to be dominated by domestic banks, which represented 63,1% of total consolidated banking system assets at end-June 2010 (**Chart B.43**). Foreign bank subsidiaries and branches constituted 32,3% and 4,6% of total consolidated banking system assets at the

CHART B.43 **Market shares of banks**
(% of total consolidated assets)



Source: CBC.

37. Includes MFIs, other financial intermediaries, insurance corporations, occupational pension funds and financial auxiliaries.
38. ECB (2010) *EU Banking Structures*, October.

BOX B.1: Establishment of the European Systemic Risk Board (ESRB) – macro-prudential policy

Establishment of the ESRB

The 2007-2009 global financial crisis revealed a major failure in the surveillance and assessment of systemic risk in the financial system. This has prompted a careful review of a wide range of policy areas, with the macro-prudential orientation of financial supervision attracting particular attention. Macro-prudential supervision focuses on the risks to the financial system, which may derive from the collective behaviour of individual financial institutions, the interlinkages between financial intermediaries and across markets as well as the macro-economic environment. It aims at identifying, monitoring and assessing potential risks and vulnerabilities that pose a threat to the financial system as a whole.

In September 2010, the European Parliament adopted a regulation to entrust macro-prudential supervision at the EU level to a new body, the European Systemic Risk Board (ESRB), with the objective of increasing the focus on systemic risk within the framework of financial supervision. The ESRB, which will start its operations in January 2010, will be responsible for the macro-prudential oversight of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. By contributing to the smooth functioning of the internal market it will ensure that the financial sector makes a sustainable contribution to economic growth. The task and competence for the ESRB Secretariat has been conferred on the ECB. In this respect, the ECB will provide the administrative, logistical, statistical and analytical support to the ESRB.

The objective of the ESRB will be threefold. First, it will monitor, identify and prioritise systemic risks to financial stability. The development of a sound analytical framework is key to the achievement of this task. The second objective will be to translate risk assessments into actions by the relevant authorities. The ESRB will provide specific guidance on how to react to systemic risks once they have been identified. This will be done by issuing warnings to prompt early responses to avoid the build-up of wider problems, and eventually a future crisis, as well as recommendations for remedial action in response to those risks.

Therefore, the lack of effectiveness in following up policy concerns on risks with consistent actions, which is one of the main weaknesses of the existing financial stability framework, will be addressed. The ESRB, European and national authorities will act together so that risk warnings will not go unheeded, as has occasionally happened in the past. The third objective will be to improve the interaction between micro and macro-prudential analysis so as to enhance the effectiveness of systemic risk assessment. In this connection, the ESRB will help serve as an important forum for the exchange of qualitative and quantitative information between the ECB, the national central banks and the financial supervisory authorities.

Macro-prudential policy

In the run-up to the global financial crisis there was a large build-up of leverage and liquidity mismatches across the international financial system. This left the system vulnerable to adverse changes in the macroeconomic and market environment, and hence sowed the seeds of the problems that emerged. Thus, an effective macro-prudential regime must employ tools that increase the resilience of the financial system to shocks that originate not only from external sources but also from within the financial markets[1]. One of the key challenges is to re-orient prudential regulation towards risk across the system as a whole, that is, so-called systemic risk. This can be defined as "the risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy"[2]. This is the role of macro-prudential policy, which has been a key missing element from the policy framework[3]. In the past few decades, there has been a large gap between macroeconomic policy and the regulation of individual financial institutions. If macro-prudential policy had been able to increase the resilience of the system and to moderate the rapid expansion in the supply of credit to the economy, especially to the financial sector, the magnitude of the crisis would have been less extensive and, accordingly, less costly.

Macro-prudential policy focuses on the interactions between financial intermediaries, markets, market infrastructure and the wider economy. It complements the micro-prudential focus on the risk

1 Group of Thirty (2010) *Enhancing Financial Stability and Resilience: Macro-Prudential Policy, Tools, and Systems for the Future*, October.
2. IMF, FSB and BIS (2009) *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, October.
3. Bank of England (2009) "The role of macro-prudential policy", Discussion Paper, November.

position of individual institutions, which largely takes the rest of the financial system and the economy as given. Clearly, neither type of policy is a substitute for sound risk management in the private sector, which should as far as possible internalise the risk of potential losses.

In general, macro-prudential policy has two practical objectives[4]. The first is to strengthen the financial system's resilience to economic downturns and other adverse aggregate shocks. The second is to actively limit the build-up of risks that arise and propagate internally in the financial system. Such leaning against the financial cycle seeks to reduce the probability or magnitude of a financial bust. These aims are not mutually exclusive. They both go beyond the purpose of micro-prudential policy, which is to ensure that individual firms have sufficient capital and liquidity to absorb shocks to their loan portfolios and funding. Macro-prudential policy takes into account risk factors that extend further than the circumstances of individual firms. These include shock correlations and the interactions that arise when individual firms respond to shocks. Such factors determine the likelihood and consequences of the systemically important shocks that macro-prudential policy seeks to mitigate.

Macro-prudential policy aims to limit systemic risk by addressing the two key externalities of the financial system[5]. The first is joint failures of institutions because of interlinkages and common exposures among them. The second externality is procyclicality, which is the phenomenon of amplifying feedbacks within the financial system and between the financial system and the macroeconomy. As we have seen in the past, procyclicality can promote the emergence of unsustainable booms. As boom turns to bust, procyclicality can magnify the disruption in the financial cycle and cause a deep economic recession.

Macro-prudential tools

Authorities may deploy a wide range of tools to secure financial stability. These tools may broadly be categorised as macroeconomic policies (monetary, fiscal or exchange rate) or regulatory actions. The instruments used for macro- and micro-prudential regulation are often the same. What makes macro-prudential different from micro-prudential regulation is primarily the purpose of the regulatory action. While micro-prudential regulation aims at securing the financial viability of individual institutions, macro-prudential regulation aims at securing the stability of the financial

4. Committee on the Global Financial System (2010) "Macro-prudential instruments and frameworks: a stocktaking of issues and experiences", CGFS Papers No. 38, May.
5. BIS (2010) *80th Annual Report*.

system. Examples of macro-prudential tools include capital and liquidity requirements with a "buffer" character, dynamic provisioning, limits on leverage in particular types of lending contract such as loan-to-value (LTV) or loan-to-income (LTI) ratios, restrictions on foreign exchange lending, constraints on currency mismatches, open foreign exchange position limits, concentration limits and countercyclical capital subcharges.

In most economies, macro-prudential policy frameworks are at an early stage of development. Macro-prudential interventions have taken the form of adjustments or add-ons to instruments already used for micro-prudential or liquidity management purposes. To date, most experience with macro-prudential policy has focused on judgmental, rather than rules-based, use of instruments. The aims have mostly been to enhance financial system resilience rather than to moderate aggregate financial cycles, though there are examples where instruments have been used with a combination of both aims. The evidence for their effectiveness is tentative. The independent effect of macro-prudential instruments is hard to isolate, given that they have come into use only recently in most cases, and often in conjunction with other stabilisation measures such as monetary policy responses. Authorities that have used them generally report that they helped to protect the financial system from downturns, but made a lesser contribution to moderating the financial cycle.

Thus for, macro-prudential instruments have been used mainly to limit the amount of credit supplied to specific sectors seen as prone to excessive credit growth, especially property investment and development. In addition, some emerging market economies have used reserve requirements to prevent the build-up of domestic imbalances arising from volatile cross-border capital flows. Measures targeting the size and structure of financial institution balance sheets for macro-prudential purposes have been less common, with the exception of Spain's dynamic provisioning system, which has now been in place since mid-2000. The Spanish authorities consider this instrument to have both a micro-prudential purpose, as it is applied to individual institutions, and also a macro-prudential role, due to its countercyclical impact, which dampens excess procyclicality within the financial system. This is a rule-based scheme that requires banks to set aside general provisions (also referred to as 'dynamic' or 'statistical' provisions) against performing loans during phases of rapid credit expansion, which can then be drawn down in a recession when credit retrenchment appears, according to a formula. Under the Spanish system, general provisions are intended to complement specific provisions made against loans, which already show signs of impairment. Experience in Spain has shown that dynamic provisioning has successfully protected banks from the risk of underprovisioning during the boom phase and contributed towards enhancing the resilience of the Spanish banking sector. It has been less effective, however, in moderating the financial cycle[6].

6. Saurina, J. (2009) "Dynamic provisioning: the experience of Spain", in *Crisis Response: Public Policy for the Private Sector*, Note No. 7, World Bank, July.

end of June 2010, respectively.

During the first ten months of 2010, one foreign bank, namely "AS LTB Bank" of Latvia, an EU member state, exercised its right of the freedom of establishment in Cyprus to provide banking services through a branch, in accordance with article 10A(1) of the *Banking Law, 1997*, as subsequently amended. As regards mergers and acquisitions in the domestic banking market, the Mortgage Bank of Cyprus merged with the Bank of Cyprus Public Company Ltd in June 2010. In addition, in January 2010 Société Générale de Banque au Liban SAL acquired 57,7% of the share capital of Société Générale Cyprus, while the above participation was raised to 100% in September 2010.

Consolidation in the co-operative credit sector continued during the current year, with the number of co-operative credit institutions falling to 110 at end-October 2009 compared with 119 at the end of December 2009. It is expected that the number of co-operative credit institutions will decline to 101 by the end of 2010 with the finalisation of nine more mergers.

International presence of Cypriot banking groups

In contrast to previous years, during which the three main domestic banking groups, namely the Bank of Cyprus Public Company Ltd, Marfin Popular Bank Public Co. Ltd and Hellenic Bank Public Company Ltd, had embarked on a significant geographical diversification overseas, the further expansion of these banking groups into foreign markets that took place in the first ten months of 2010 was very limited. Specifically, in March 2010 the CBC granted its final approval to the Hellenic Bank Public Company Ltd for the possession of 100% of the share capital of LLC CB Hellenic Bank established in Russia, which is expected to commence operations on 1 January 2011.

Moreover, the application of the National Bank of Greece (Cyprus) Ltd to open a Representative Office in Moscow was approved by the CBC in March 2010.

Banking regulatory developments

As regards developments in the banking regulatory framework, the CBC issued a number of new directives to banks during the period January-November 2010. In chronological order, the Amending Directive for the Calculation of the Capital Requirements and Large Exposures of Banks of 2010 was published in the *Official Gazette of the Republic of Cyprus* in March 2010. The purpose of the Amending Directive is to strengthen the general capital requirements framework governing banks.

The (Amending) Directive on the Framework of Principles of Operation and Criteria of Assessment of Banks' Organisational Structure, Internal Governance and Internal Control Systems of 2010 was published in the *Official*

Gazette in June 2010. The said amendment has added Annex 4 to the Directive, which prescribes the basic principles and internal control procedures for the management of compliance risk.

In September 2010, the Directive on the Exchange of Data regarding the Assessment of Customers' Creditworthiness of 2010 was published in the *Official Gazette*. The aforementioned Directive aims at contributing to the safeguarding of the quality of the data provided by those banks that participate in data exchange arrangements regarding the assessment of customers' creditworthiness.

The Amending Directive on the Computation of Prudential Liquidity in Euro of 2010 as well as the Amending Directive on the Computation of Prudential Liquidity in Foreign Currency of 2010 were published in the *Official Gazette* in September 2010. The aim of the Amending Directives is to strengthen the general framework of prudential liquidity of banks.

Finally, the draft law on the issue of covered bonds by approved institutions and the conduct of covered bond business by institutions with covered bond obligations has been approved by the Council of Ministers and will be submitted to the House of Representatives for voting. The draft law will enable credit institutions approved by a competent authority to issue bonds in such a way that claims by holders of these bonds will be secured on the assets of the issuing credit institution.

2.2.2 Banks' financial condition

The analysis of banks' financial condition in the first half of 2010 that follows is based, unless otherwise stated, on aggregate cross-border and cross-sector consolidated data (excluding insurance companies), which cover the entire banking system[39]. In certain cases where it is reported explicitly, the analysis concerns only domestic banks. Since 2008 the reporting framework of the said data has been based on the Financial Reporting Framework (FINREP) and the Guidelines on Common Reporting (COREP) developed by the Committee of European Banking Supervisors (CEBS).

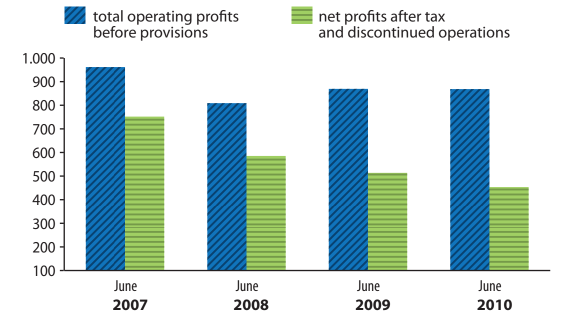
Table C.22 (pp. 201-202) shows a number of key aggregate indicators of the Cyprus banking sector.

Earnings and profitability

In the first six months of 2010, as a result of the negative developments recorded in the Cyprus economy and the unfavourable external environment in which banks operated, banks' total operating profits decreased slightly by 0,1% compared with the corresponding period of 2009 (**Chart B.44**). In addition, in the same period, banks' net profits after tax and discontinued operations decreased by 11,7% compared with the same period of 2009.

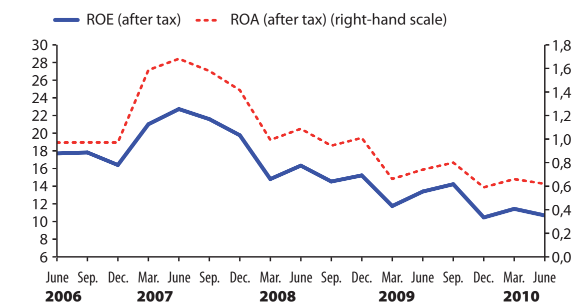
As shown in **Chart B.45**, the annualised return on equity (ROE) (after tax) in the first half of 2010 fell to 10,7%, down from 13,4%

CHART B.44 **Total operating profits before provisions and net profits after tax and discontinued operations**
(€ million)



Source: CBC.

CHART B.45 **Return on equity (ROE) and return on assets (ROA)**
(%)



Source: CBC.

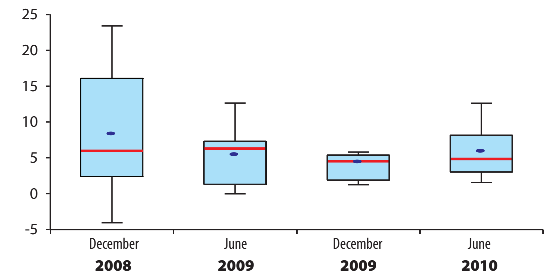
39. Includes all domestically and foreign-controlled banks operating in Cyprus but excludes the co-operative credit institutions.

in 2009, while the annualised return on assets (ROA) (after tax) decreased to 0,6%, down from 0,7% in 2009. The ROE of domestic banks continued to improve in the first half of 2010, as illustrated by the upward shift of the distribution of ROE figures for all domestic banks (**Chart B.46**). The dispersion of ROE across domestic banks has widened. As shown by the distribution of ROA for all domestic banks (**Chart B.47**), in the first six months of 2010 both the minimum-maximum range and the inter-quartile range shifted upwards, while the median ROA value as well as the degree of dispersion of ROA across domestic banks remained at the same levels.

During the first half of 2010, banks' total operating income rose by 4,9% compared with the corresponding period of 2009 (**Chart B.48**). Banks continue to obtain the largest part of their earnings from net interest income, which has traditionally been a comparatively more stable source of income than net fees and commissions or capital gains on financial and foreign exchange transactions that are more sensitive to unfavourable price developments in international financial markets. In particular, net interest income increased by 16,2% in the first six months of 2010 compared with the same period of 2009, accounting for 74,8% of total operating income compared with 67,6% in the corresponding period of 2009.

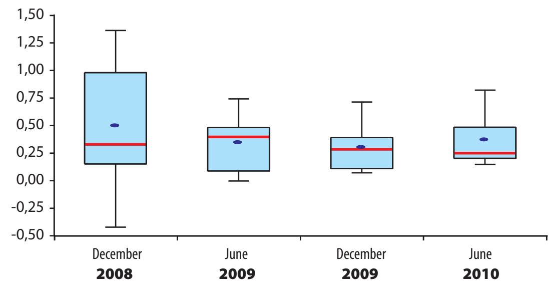
At the same time, net non-interest income registered a significant decrease of 18,5% in the first half of 2010 compared with the same

CHART B.46 **Dispersion of ROEs for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; %)



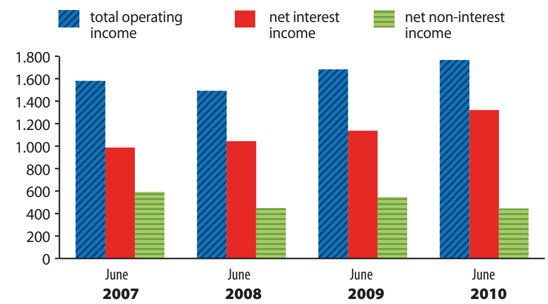
Source: CBC.

CHART B.47 **Dispersion of ROAs for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; %)



Source: CBC.

CHART B.48 **Total operating income, net interest income and net non-interest income**
(€ million)



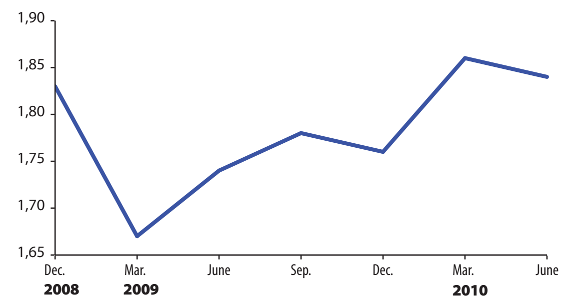
Source: CBC.

period of 2009, mainly due to a fall in trading revenues. During the same period, net non-interest income represented 25,2% of total operating income compared with 32,4% in the first six months of 2009. As regards the two main components of non-interest income, gains on financial and foreign exchange transactions decreased by 37,2% in the period from January to June 2010 compared with the corresponding period of 2009, accounting for 7,9% of total operating income (down from 13,3% in the same period of 2009). Net fees and commissions income grew marginally by 0,1%, with their contribution to total operating income falling to 15,8% (down from 16,6% in the corresponding period of 2009).

Despite the strong competition in the domestic banking market and banks' higher funding costs, which can be mainly attributed to high deposit rates, net interest margin[40] widened to 1,84% in the first six months of 2010, down from 1,74% in the same period of 2009 (**Chart B.49**).

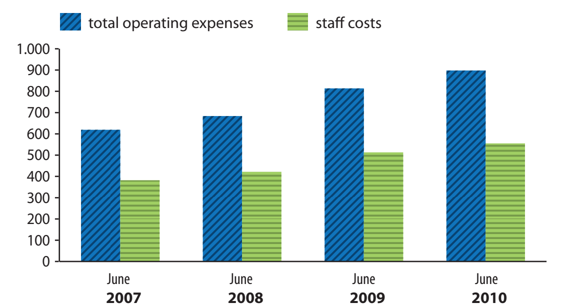
Total operating expenses rose by 10,3% in the first half of 2010 compared with the corresponding period of 2009 (**Chart B.50**). Staff costs recorded an increase of 8,2% in the first six months of 2010 compared with the same period of 2009, accounting for 61,8% of total operating expenses compared with 63% in the corresponding period of 2009. The higher rate of growth in operating costs against the lower rate of increase in operating revenues, has led to a slight deterioration in the cost-to-income ratio from 48,4% in the first six months of 2009 to

CHART B.49 **Net interest margin**
(%)



Source: CBC.

CHART B.50 **Total operating expenses and staff costs**
(€ million)



Source: CBC.

40. Net interest income as a percentage of average interest bearing assets.

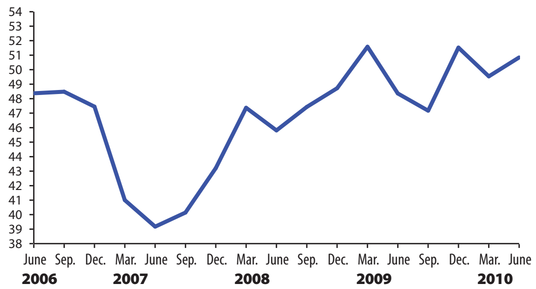
50,8% in the same period of 2010 (**Chart B.51**). As regards domestic banks, operating efficiency in the period under review has improved, as indicated by the small downward shift in the inter-quartile range of the distribution of cost-to-income ratios of all domestic banks, while the median value has increased (**Chart B.52**).

Asset quality

Turning to the asset quality indicators, non-performing loans per total loans rose to 7,2% at end-September 2010 compared with 5,9% at the end of December 2009 (**Chart B.53**), reflecting the deterioration in the quality of banks' loan portfolios in the period under review. During the second half of 2010, the dispersion of non-performing loans as a percentage of total loans for all domestic banks remained wide, while the inter-quartile range shifted slightly upwards (**Chart B.54,** p. 136). It must be noted that bank loans are granted against tangible collateral, the largest part of which is in the form of real estate. This constitutes a significant credit risk mitigating factor but is not taken into account in the calculation of the said indicators. However, it should be mentioned that non-performing loan ratios are typically pro-cyclical and may actually decrease in periods of strong credit growth, while they can be lagging indicators of the credit risk actually facing banks.

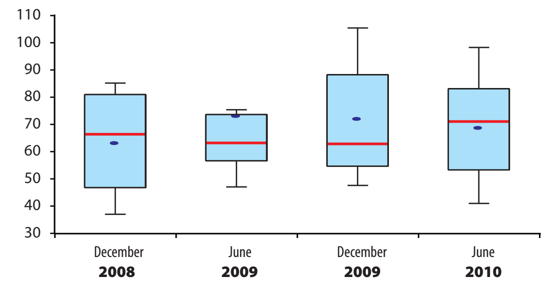
Total loan loss provisions per total non-performing loans (coverage ratio) dropped to

CHART B.51 **Cost-to-income ratio**
(%)



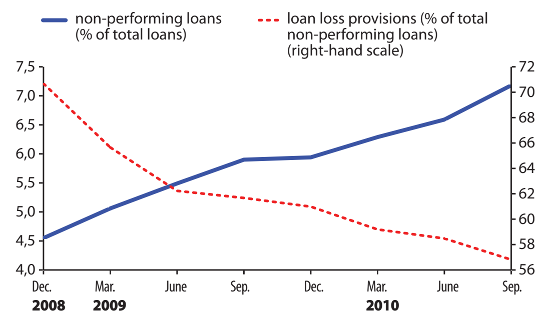
Source: CBC.

CHART B.52 **Dispersion of cost-to-income ratios for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; %)



Source: CBC.

CHART B.53 **Non-performing loans and loan loss provisions**
(%)



Source: CBC.

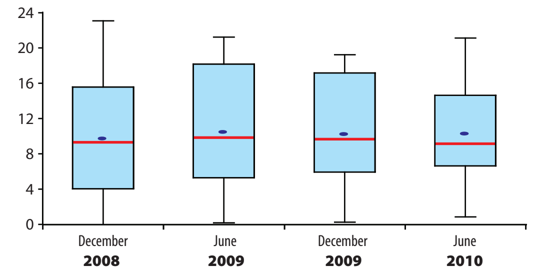
56,8% at the end of June 2010 compared with 61% at end-December 2009. The dispersion of the coverage ratios across all domestic banks has increased (**Chart B.55**), which is reflected in a wider inter-quartile range, while the decrease in the median value shows that the aforementioned indicator has declined in the case of most domestic banks.

Banks' impairment on financial assets represented 0,5% of total assets in the first six months of 2010, exhibiting a marginal increase from 0,4% in the corresponding period of 2009.

Capital adequacy

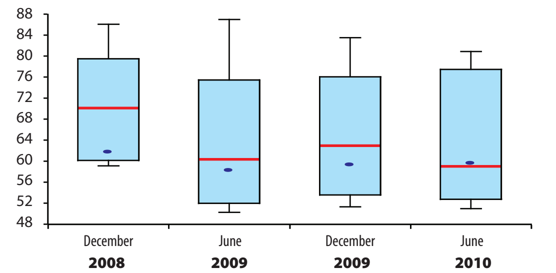
The capital buffer available in the Cyprus banking system to cope with unexpected losses declined slightly to 4% at the end of June 2010 compared with 4,1% at end-December 2009, mainly due to decreased profits as well as a rise in risk-weighted assets in the banking book. At the same time, banks' overall solvency ratio declined marginally to 12% at the end of June 2010, down from 12,1% at end-December 2009 (**Chart B.56**). Overal solvency ratios of domestic banks decreased slightly in the first half of 2010, as illustrated by the downward shift of their distribution, while the median value remained unchanged (**Chart B.57,** p. 137). However, the capital position of the banking system remains adequate, with banks' overall solvency ratio standing at well above the minimum regulatory requirement of 8% applied to individual banks.

CHART B.54 **Dispersion of non-performing loans for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; % of total loans)



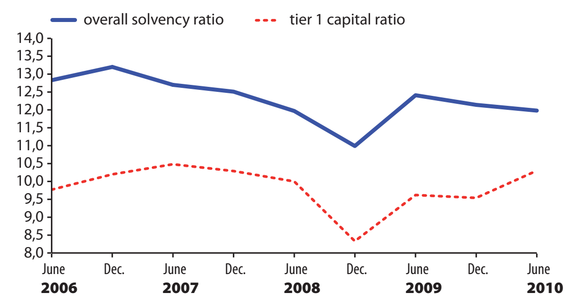
Source: CBC.

CHART B.55 **Dispersion of coverage ratios for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; loan loss provisions as a % of non-performing loans)



Source: CBC.

CHART B.56 **Overall solvency and Tier 1 capital ratios**
(%)



Source: CBC.

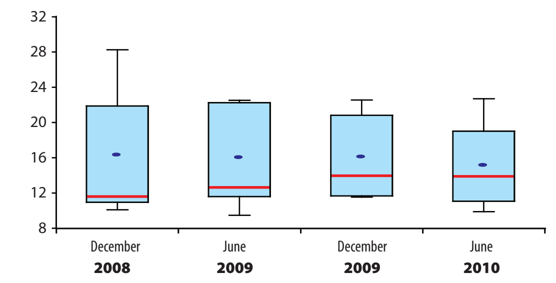
Banks' Tier 1 capital ratio increased to 10,3% at the end of June 2010 compared with 9,5% at end-December 2008. As illustrated by the upward shift in the inter-quartile range, Tier 1 capital ratios of domestic banks increased in the first half of 2010 (**Chart B.58**). The dispersion of Tier 1 ratios across domestic banks has decreased, reflected in a narrower inter-quartile range, while the median value of Tier 1 ratios remained at the same level.

It must be noted that, during the second half of 2010, the three domestic banking groups have taken action to strengthen their capital base. Specifically, in October 2010 Bank of Cyprus Public Company Ltd successfully completed the increase of its share capital through the issue of 172,6 million new shares, raising €345 million in capital. In addition, in October 2010 Hellenic Bank Public Company Ltd issued non-cumulative perpetual capital securities amounting to €141,4 million. Moreover, in November 2010 Marfin Popular Bank Public Co. Ltd announced a capital increasing plan of €488,6 million through a rights issue to existing shareholders and the issue of convertible capital securities of up to €660 million in total. The aforementioned increases of capital are expected to strengthen the capital ratios of the three banking groups.

Liquidity

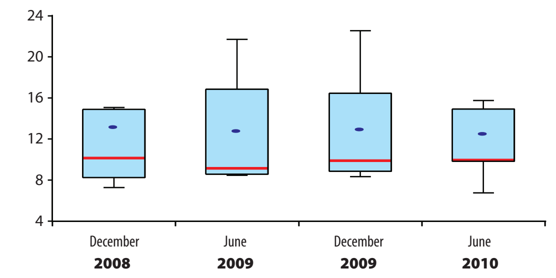
In the first six months of 2010, a number of indicators showed an increase in banking system liquidity. Firstly, on a non-consol-

CHART B.57 **Dispersion of overall solvency ratios for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean; %)



Source: CBC.

CHART B.58 **Dispersion of Tier 1 capital ratios for all domestic banks**
(minimum, maximum, inter-quartile range, median, mean %)



Source: CBC.

idated basis[41], total loans and advances to customers per amounts owed to customers (loan-to-deposit ratio) decreased to 88,4% at the end of September 2010 (down from 96,5% at end-March 2010 and 100,8% at the end of September 2009) (**Chart B.59**). In addition, as shown in **Chart B.60**, the banking sector's customer funding gap, which represents the proportion of customer loans not covered by customer deposits, reached -13,1% at end-September 2010 compared with -3,7% at the end of March 2010 and -0,7% at end-September 2009. These trends reflect the higher growth of deposits against the increase in loans.

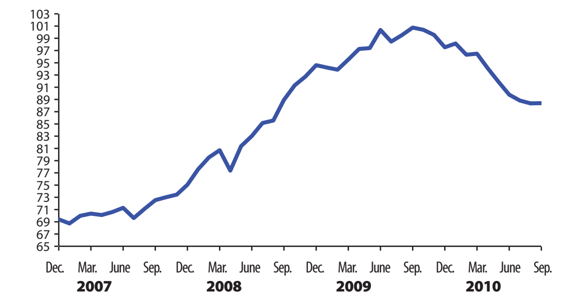
Moreover, the cash and trading assets ratio dropped to 7,1% at the end of June 2010 compared with 8,2% at end-December 2009 (**Chart B.61**). Furthermore, the cash, trading and available-for-sale assets ratio declined to 11,3% at the end of June 2010 from 16,2% at end-December 2009.

At the same time, as shown in **Chart B.62,** p. 139), the interbank market dependence ratio increased to 32,2% at the end of June 2010 compared with 30,7% at end-December 2009. Also, the funding base stability ratio dropped to 60,4% at the end of June 2010 from 61,4% at-end December 2009.

Balance sheet structure

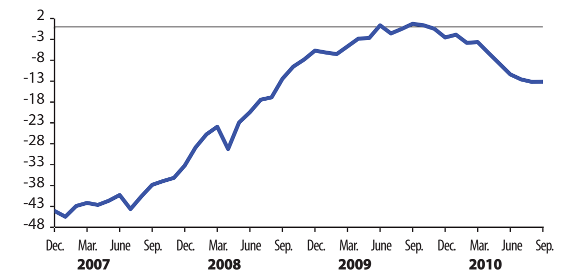
On the consolidated balance sheet asset side, loans and advances to customers and credit institutions accounted for 64,1% of total consolidated banking assets at the end of

CHART B.59 **Loan-to-deposit ratio**
(monthly data, %)



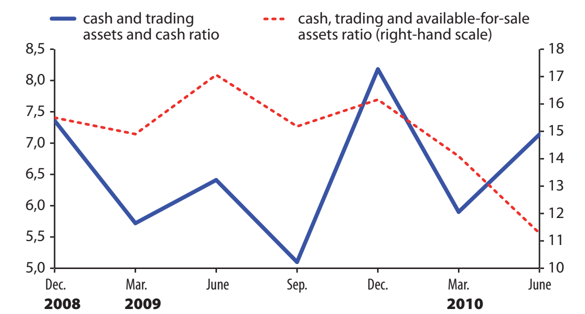
Source: CBC.

CHART B.60 **Customer funding gap**
(% of total loans to customers)



Source: CBC.

CHART B.61 **Cash and trading assets and cash, trading and available-for-sale assets ratios**
(%)



Source: CBC.

41. Based on monthly balance sheet data submitted by MFIs to the CBC.

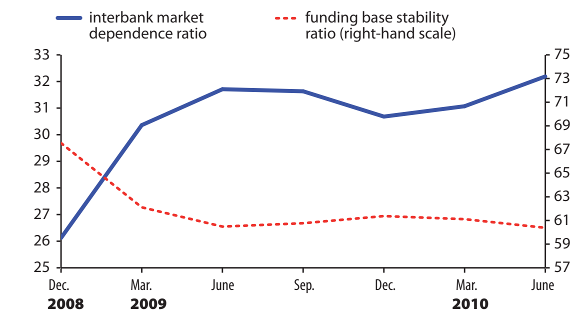
June 2010 compared with 70,4% at end-December 2009 (**Chart B.63**). In addition, at the end of June 2010, total debt instruments comprised 24,8% of total consolidated banking assets compared with 17,8% at end-December 2009. On the consolidated balance sheet liability side[42], deposits from customers represented 52,9% of total liabilities at the end of June 2010 compared with 54% at end-December 2009. At the same time, deposits from credit institutions constituted 34,1% of total liabilities at the end of June 2010 compared with 32,6% at end-December 2009.

The analysis of bank loans to Cyprus residents by economic activity, on a non-consolidated basis[43], (**Chart B.64** and **Table C.23**, p. 202) shows that loans to the broad real estate sector represented 20,6% of total outstanding loans to non-MFIs at the end of September 2010 compared with 20,1% at end-June 2010. Loans to the wholesale and retail trade sector constituted 9,1% of total outstanding loans to non-MFIs at the end of September 2010, down slightly from 9,3% at end-June 2010. In addition, loans to the accommodation and food service activities sector represented 4,3% of total outstanding loans to non-MFIs at the end of September 2010 compared with 4,4% at end-June 2010. Moreover, loans to the financial and insurance activities sector (excluding monetary intermediation) constituted 6,7% of total outstanding loans to non-MFIs at the end of September 2010 compared with 7% at end-June 2010.

On a non-consolidated basis[44], at the end of September 2010 69,2% of deposits were

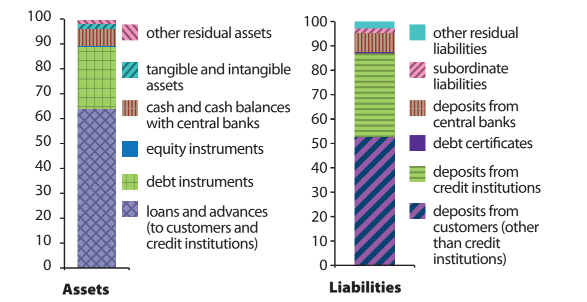
42. Excludes equity. As a result, the total assets of the consolidated balance sheet do not equal the total liabilities.
43. Based on monthly balance sheet data submitted by MFIs to the CBC.
44. Based on monthly balance sheet data submitted by MFIs to the CBC. Includes deposits from both Cypriot residents and non-residents.

CHART B.62 **Interbank market dependence and funding base stability ratios**
(%)



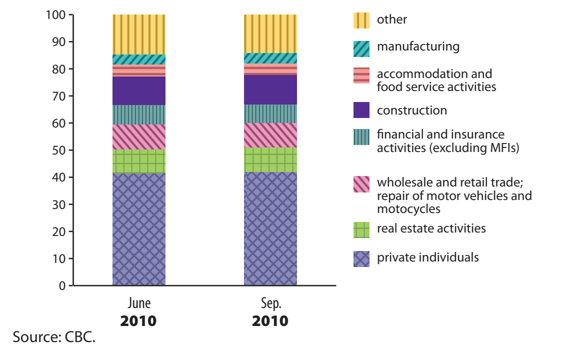
Source: CBC.

CHART B.63 **Balance sheet structure**
(end of June 2010, %)



Source: CBC.

CHART B.64 **Distribution of bank loans to Cyprus residents by economic activity**
(%)



Source: CBC.

denominated in euros and 30,8% in foreign currencies compared with 72,8% and 27,2%, respectively, at end-September 2009 (**Chart B.65**). As regards the distribution of bank deposits by geographical origin, at end of September 2010, 77,4% of euro-denominated deposits emanated from domestic residents, 6,9% from residents of other euro area countries and 15,7% from residents of third countries compared with 83,7%, 2% and 14,3%, respectively, at end-September 2009, respectively (**Chart B.66**). At the end of September 2010, 86,6% of foreign currency deposits was accounted for by dollars, 7,3% by sterling, 0,6% by Swiss francs and 0,1% by Japanese yen compared with 82,6%, 12%, 0,5% and 0,1%, respectively, at end-September 2009 (**Chart B.67**).

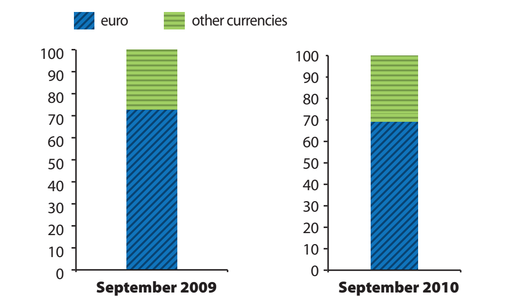
Off-balance sheet items

As shown in **Chart B.68** (p. 141), the ratio of financial guarantees and other commitments given to total assets declined slightly to 1,9% at the end of June 2010 compared with 2% at end-December 2009. In addition, the ratio of loan commitments given to total assets amounted to 1,9% at the end of June 2010, the same level as at end-December 2009. These figures indicate that banks' off-balance sheet exposures are not sizeable.

2.2.3 Risks facing the banking sector

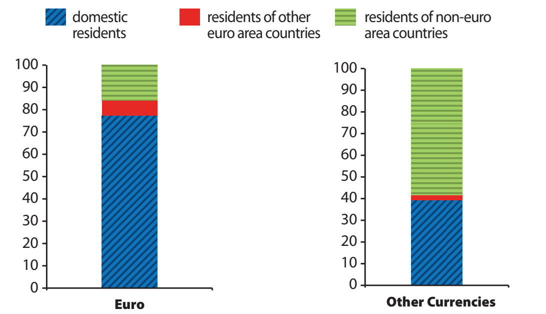
This section of the *Bulletin* provides an assessment of the main potential risks facing

CHART B.65 **Distribution of bank deposits by currency**
(%)



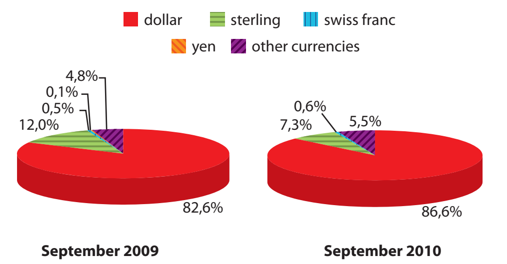
Source: CBC.

CHART B.66 **Distribution of bank deposits by geographical origin**
(end of September 2010, %)



Source: CBC.

CHART B.67 **Distribution of bank deposits by foreign currency**
(%)

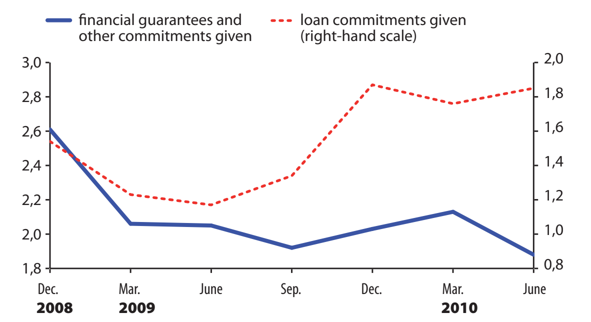


Source: CBC.

banks. It should be noted that the key risks identified should not necessarily be seen as the most probable outcome, but rather as factors that could potentially have a negative impact on banks.

The analysis presented below focuses on the risks stemming from banks' activities in Cyprus. The risks associated with the international operations of domestic banking groups are assessed at the end of this section.

CHART B.68 **Off-balance sheet items**
(%)



Source: CBC.

Earnings and profitability risks

The accumulation of profits is important in strengthening banking sector resilience by generating capital buffers against potential future losses. Overall, banks in Cyprus, which typically have business models focusing on traditional intermediation activities and derive the largest part of their earnings from interest income, weathered the unfavourable domestic macroeconomic environment well in the first half of 2010 and remained profitable.

In the first six months of 2010, banks' total operating profits before provisions remained roughly the same compared with the corresponding period of 2009. However, during the same period, net profits after tax and discontinued operations declined, mainly due a fall in net non-interest income as well as an increase in loan loss provisions.

Despite the projections for a muted recovery of the Cyprus economy in 2011, the challenges for banks' earnings from core activities in the period ahead remain significant.

Looking at the main components of banks' income, a potential decline in new lending in the domestic market, especially when coupled with a potential downward pressure on banks' net interest margins, will adversely affect net interest income. The tightening of banks' credit standards for loans to households for house purchase currently in force, in conjunction with a potential fall in demand for credit to both households and NFCs, may lead to lower lending volumes and thus depress banks' revenues. The near-term outlook for earnings on the non-interest income side also remains uncertain as conditions regarding the trading of financial assets as well as the significant volatility exhibited in capital markets may cause the value of banks' asset portfolios to fluctuate.

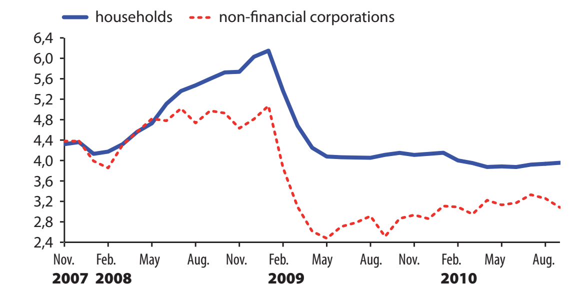
Furthermore, since the share of lending at variable rates is dominant, in the event of a potential increase in lending rates the capacity of households and NFCs to meet their debt-servicing obligations is expected to be limited. This would contribute to a weakening in the quality of banks' assets and the increase in loan loss provisions, thus reducing their profitability.

It must be noted that banks' cost of funding through their main source, namely deposits, remains at a high level. The strong competition for attracting deposits (mainly fixed-term deposits) in the domestic banking sector has led banks to maintain the rates offered on new deposits at significantly higher levels than the respective rates in other euro area countries. In particular, Cyprus MFI interest rates[45] on euro-denominated deposits (new business) by euro area households and NFCs increased from 3,95% and 2,95% in March 2010, respectively, to 3,96% and 3,08% in September 2010, respectively (**Chart B.69**). In comparison, euro area MFI interest rates on euro-denominated deposits (new business) by euro area households and NFCs stood at 2,35% and 1,11% in September 2010, respectively.

The increased cost of funding has led banks to continue to pass the higher funding costs on to new and existing borrowers to compensate for the reduced income. This has resulted in the widening of banks' net interest margin, which rose to 1,84% in the first half of 2010 compared with 1,74% in the same period of 2009.

Given the uncertainty as regards the outlook for the domestic macroeconomic environment in which banks operate, a significant improvement in the operating profits of the banking sector is not expected in the short term.

CHART B.69 **Cyprus MFI interest rates on euro-denominated deposits (new business) by euro area residents**
(% per annum, period average)

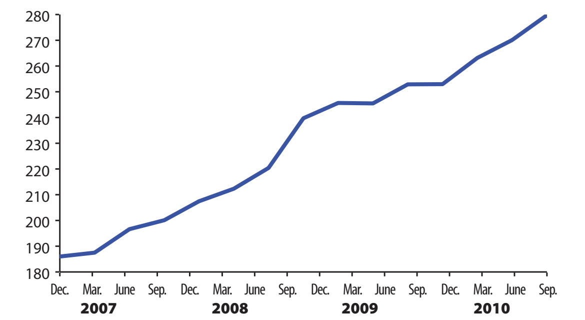


Source: CBC.

Credit risk

Bank credit to the private sector[46] rose by 8,9% year-on-year in June 2010 and reached 279,8% of GDP at the end of June 2010 compared with 263,2% at end-December 2009 and 252,9% at the end of June 2009 (**Chart B.70**). The annual growth rate of loans to the domestic private sector has remained

CHART B.70 **Bank credit to the private sector as % of GDP**



Source: CBC.

45. With agreed maturity of up to 1 year.
46. Based on monthly balance sheet data submitted by MFIs to the CBC. Includes MFI loans to Cyprus residents and MFI holdings of securities issued by Cypriot residents (excluding MFIs and general government).

BOX B.2: Assessment of the shock-absorption capacity of the Cyprus banking sector on the basis of stress testing results

Stress testing exercises conducted by the CBC

In assessing the stability of the Cyprus banking sector, the CBC conducted the last bi-annual "top-down" stress testing exercise on the basis of end-June 2010 data. This exercise aimed at evaluating the resilience of the Cyprus banking system to a range of hypothetical adverse shocks and scenarios. A number of shocks concerning individual risk factors, namely credit risk, market risk (interest rate risk, foreign exchange rate risk and equity price risk) and liquidity risk were considered. A number of scenarios, which included various combinations of shocks concerning individual risk factors, were also applied. The aggregate results of the above stress testing exercise suggest that the banking sector's shock-absorption capacity remains satisfactory.

In addition, the CBC carried out the most recent bi-annual "bottom-up" stress testing exercise[1] on the basis of end of June 2010 data. The aim of the said exercise was to assess the resilience of the Cyprus banking sector to a number of hypothetical adverse shocks and scenarios. Several potential shocks were considered, regarding individual risk factors, namely interest rate risk, foreign exchange rate risk, asset price risk (equity price risk and real estate price risk), credit risk, concentration risk and net interest margin risk. For liquidity risk, a number of scenarios were included. Furthermore, a number of multi-factor scenarios, which included various combinations of shocks concerning individual risk factors, were applied.

Specifically, the above stress testing exercise included, *inter alia*, the following potential shocks: parallel upward and downward shifts in the yield curve, an increase or decrease in interest rates, the depreciation or appreciation of the euro against all other currencies, a fall in equity prices, a decline in residential and commercial real estate prices, an increase in non-performing loans, the default of the three or five largest exposures, loans to several sectors of economic activity becoming non-performing, a fall in bond prices and a drop in net interest margin. As regards liquidity risk, four combinations of individual shocks (scenarios) were

1. The exercise was conducted for the first time in 2008 as part of the assessment of the Cyprus financial sector by the IMF under its "Financial Sector Assessment Programme (FSAP)". The results of this biannual exercise are now submitted to the IMF on a regular basis as part of the bilateral Article IV Consultation.

considered and their impact on two liquidity ratios was quantified. Finally, a number of multi-factor scenarios were considered, which included various combinations of shocks regarding individual risk factors (an increase in non-performing loans, a decline in residential and commercial real estate prices, a decrease in interest rates, the appreciation of euro against all other currencies and a fall in equity prices).

As expected, the results of the above stress testing exercise indicated that out of all the shocks that were applied, those regarding credit risk had the largest impact on banks' capital adequacy ratio. Overall, the aggregated results show that the four systemically important banks which participated in the bottom-up stress testing exercise remain resilient to potential shocks.

EU-wide stress testing exercise

In July 2010, following a mandate assigned by the ECOFIN Council, the Committee of European Banking Supervisors (CEBS) conducted an EU-wide stress test exercise in cooperation with the ECB, the EU national supervisory authorities and the European Commission. The stress testing exercise was carried out at the individual bank level using a sample of 91 banking groups from EU member states, which represent at least 50% of the banking system assets in each country on a consolidated basis. Among the banks that participated in the above exercise were the two largest Cypriot banks, namely the Bank of Cyprus Public Company Ltd and Marfin Popular Bank Public Co Ltd. The objective of the exercise was to assess the overall resilience of EU banks to absorb further shocks with regard to credit and market risks, including sovereign risk.

The stress testing exercise assessed two commonly agreed scenarios: (a) the benchmark scenario, which is in line with the current macroeconomic forecasts for 2010 and 2011 and (b) the adverse scenario, which incorporates extreme risks, mainly sovereign risk, and an economic downturn. It must be noted that the possibility that the adverse scenario does actually materialise is very low. In conjunction with an economic downturn, the adverse scenario assumes a significant increase in interest rates, which, however, is deemed as an unlikely event. The latter has been included in the assumptions of the scenario in order to capture a possible increase in government bond yields.

As regards the two Cypriot banks that participated in the above stress testing exercise, the Tier 1 capital ratio for the Bank of Cyprus and Marfin Popular Bank under the benchmark scenario stood at at 10,9% and 10%, respectively, in 2011. Under the adverse scenario, the Tier 1 capital ratio fell to 9,4% for the Bank of Cyprus and 8,5% for Marfin Popular Bank in 2011. Upon the implementation of the additional sovereign risk scenario, the Tier 1 capital ratio of Bank of Cyprus and Marfin Popular Bank stood at 8,0% and 7,1%, respectively, at end-2011.

Overall, the results of the EU-wide stress tests confirm the resilience of the European banking sector and that of the Cyprus banking sector in particular. The individual results of the two Cypriot banks that participated in the exercise showed the capacity of the domestic banking system to absorb potential shocks. It should be noted that the above stress testing exercise is expected to be repeated at the beginning of 2011.

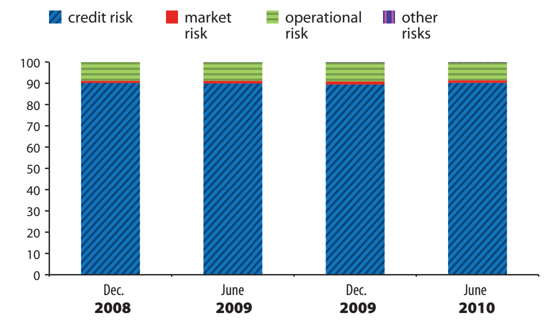
close to the long-term average of 10%, supported by the use of the three-year special government bonds as collateral by banks to obtain cheaper funding from the ECB. The liquidity raised has been used for granting loans, mainly to households for house purchase.

It must be noted that credit risk remains the most significant risk to which banks are exposed. In this regard, the capital allocated by banks for credit risk stood at 90,2% of the total consolidated capital requirements for the banking system at end-June 2010 compared with 89,4% at the end of December 2009 (**Chart B.71**). **Chart B.72** shows the distribution of credit risk capital requirements by exposure class.

The deterioration in the quality of banks' loan portfolios continued in 2010, following a trend that had started in 2009. The adverse domestic macroeconomic environment had a negative impact on the financial condition of households and NFCs, thus reducing their debt-servicing capacity, which led to a significant increase in non-performing loans. However, the rate of growth of accumulated provisions was lower than the rate of expansion of non-performing loans, which resulted in the coverage ratio continuing its downward path of the past two years. The uncertainty as regards the domestic macroeconomic prospects may further adversely affect the quality of banks' loan portfolios in the near term, leading to increased loan loss provisioning.

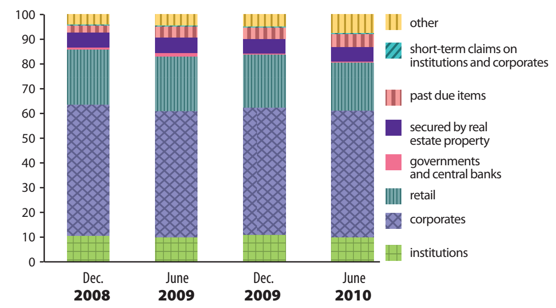
As regards household sector credit risk, the

CHART B.71 **Breakdown of capital requirements by type of risk**
(%)



Source: CBC.

CHART B.72 **Breakdown of credit risk capital requirements by exposure class**
(%)



Source: CBC.

results of the latest Banking Lending Survey of October 2010 show that in the third quarter of the current year participating banks tightened their criteria for housing loans as indicated, mainly, by the increase in spreads between lending and deposit rates. According to the survey participants, credit standards are expected to be tightened further in the fourth quarter of 2010. Household sector credit risk is expected to remain on the upside in 2011 as the rise in unemployment in the current year may have a negative impact on households' ability to service their debt. This may lead to an increase in non-performing loans.

At the same time, although an abrupt and further sharp downturn in residential property prices is not expected, a potential new house price correction can adversely affect household net worth. If combined with unfavourable labour market and disposable income developments, this could also weaken households' debt-servicing capacity, thus leading to asset quality problems for banks. It must be noted that mortgages account for the largest part of credit to households. Furthermore, in general, any fall in real estate prices may have a negative impact on the value of collateral, thus diminishing the ability of households and NFCs to obtain financing from banks and, given the importance of real estate as loan collateral, could also increase banks' collateral risk.

The environment in which NFCs operate remains challenging. Any potential substantial reduction in the debt-servicing capacity of corporations may lead to future asset quality problems for banks and, consequently, adversely affect their financial results. However, it must be noted that the results of the Bank Lending Survey of October 2010 suggest that participating banks kept their lending criteria to loans to NFCs in the third quarter of 2010 unchanged. According to survey participants, credit criteria for NFCs are expected to remain the same in the fourth quarter of the current year.

Firms' considerable debt burden remains an important vulnerability of corporate sector balance sheets. This implies that refinancing pressures are likely to emerge in the medium-term. The level of NFCs' leverage followed a steady upward trend during the period preceding the global financial crisis amidst a favourable macroeconomic environment at the time. As a result, in the present macroeconomic context, the corporate sector looks vulnerable to potential shocks to cash flows or debt-servicing costs as well as to possible disruptions in the refinancing of existing loans and short-term debt.

Counterparty risk

The counterparty risk facing banks in Cyprus remains on the upside given their exposures to other credit institutions through the interbank market and, mainly, considering their sizeable investment portfolio of fixed-income securities and other debt instruments. At the end of September 2010, banks' total holdings in other euro area banks and in banks from the rest of the world (non-euro area EU banks and non-EU banks) stood at €10,2 billion and €11,9 billion, respectively, on a non-consolidated basis[47].

As far as the exposures of domestic banks to Greek sovereign bonds are concerned, these amounted to €5,7 billion at the end of September 2010 compared with €5,2 billion at end-March 2010. However, most of these exposures, which are of the order of 88%, are classified as held to maturity investments that are not subject to value adjustments effected by potential fluctuations in market prices.

It must be noted that the remedial measures taken by governments and central banks in support of the banking sector in various countries as well as by the ECB have, to a great extent, helped to ease market tensions and considerably alleviate concerns associated with counterparty risk.

Market risk

Market risk facing banks remained on the upside in 2010, mainly as a result of the high volatility exhibited in bond and stock markets.

However, the capital allocated by banks for market risk was quite limited, amounting to only 1,3% of the total consolidated capital requirements for the banking system at the end of June 2010 compared with 1,4% at end-December 2009. However, it should be noted that this does not annul the need for systematic monitoring and effective

47. Based on monthly balance sheet data submitted by MFIs to the CBC.

management of market risk as well as the adoption of prudent investment strategies by banks themselves.

Banks are subject to interest rate risk, which is related mainly to developments in the shape of the yield curve. This has implications for income derived from the banking book and from fixed-income assets held in the trading book. At end-September 2010, banks' holdings of fixed-income securities issued by general government and MFIs, on a non-consolidated basis[48], comprised 12,9% and 3,8% of total banking sector assets, respectively, compared with 9,8% and 6,6% at the end of September 2009. The share of corporate bonds, excluding bonds issued by other banks, in total banking sector assets stood at 0,4% at end-September 2010, down from 1,8% at the end of September 2009. It must be borne in mind that banks tend to hedge their open position in fixed-income portfolio holdings using interest rate derivatives.

As regards equity price risk, the share of banks' equity investments (excluding shares in group undertakings and participating interests), on a non-consolidated basis[49], declined to 0,4% of total banking sector assets at end-September 2010 from 0,3% at the end of September 2009. Therefore, equity-investment related risks remain limited.

Banks' direct exposures to foreign exchange risk are also not significant, while the associated risks are adequately hedged. In this regard, the ratio of banks' overall net

48. Based on monthly balance sheet data submitted by MFIs to the CBC.
49. Based on monthly balance sheet data submitted by MFIs to the CBC.

open position in foreign exchange to capital remains at a low level.

Funding liquidity risk

Customer deposits remain the main source of funding for domestic banks. In this regard, Cypriot banks have continued to focus their strategies on attracting new or maintaining exisiting deposits, in an effort to reduce customer funding gaps. The customer deposit base of banks remains strong. This is reflected in the loan-to-deposit ratio, which stood at the satisfactory level of 88,4% at the end of September 2010.

However, in their effort to increase their deposit base, especially fixed-term deposits, banks have maintained the high interest rates offered on deposits. As a result, banks' cost of funding has remained at an elevated level.

As regards the cost of funding in the interbank market, interest rates in both the unsecured and secured segments of the money marjet recorded an increase. However, it must be noted that the dependence of banks in Cyprus on interbank funding remains limited.

In the first ten months of 2010, banks made use of alternative sources of funding. Specifically, the three-year special government bonds totalling about €3 billion have been used by banks as collateral for raising cheaper funds from the ECB. The liquidity made available resulted in the offer of loans, mainly to households for house purchase.

In addition, banks' access to capital markets exhibited a gradual improvement over the course of 2010, enabling them to tap the market through the issue of new shares and debt securities.

At the same time, the draft law on the issue of covered bonds by approved institutions and the conduct of covered bond business by institutions with covered bond obligations has been approved by the Council of Ministers and will be submitted to the House of Representatives for voting. Covered bonds constitute an additional source of funding for credit institutions, providing the possibility for medium- and/or long-term funding with favourable terms stemming from their special features and, mainly, from the reduced risk taken by investors due to the fact that such bonds are secured by mortgage loans or government securities.

However, current financial market conditions continue to impede banks' funding through the issue of other forms of debt instruments e.g. preference shares/subordinated debt and hybrid Tier 1 capital.

It should be noted that the strict but simple prudential regulations on banks' liquidity, which have long been prescribed by the CBC, as well as the prudent liquidity management practices of banks themselves, have helped to shield the domestic banking system from the severe liquidity problems that emerged in the banking sectors of other countries during the global financial crisis of 2007-2009. The effectiveness of these prudential liquidity requirements has long been acknowledged in the assessment reports of the Cyprus banking system issued by international organisations such as the IMF and the credit rating agencies.

Operational risk

Since the first half of 2008, on the basis of the CBC Directive on the Calculation of the Capital Requirements and Large Exposures of Banks, all banks incorporated in Cyprus are required to calculate capital requirements against, *inter alia*, operational risk[50]. According to the provisions of the directive, the methodological approach adopted by credit institutions regarding operational risk is based on the complexity and the magnitude of the risks undertaken by banks and covers all business areas both at bank and group levels.

At the end of June 2010, the capital allocated by banks for operational risk amounted to 8,3% of the total consolidated capital requirements for the banking system compared with 9% at end-December 2009.

Risks stemming from the international activities of Cypriot banking groups

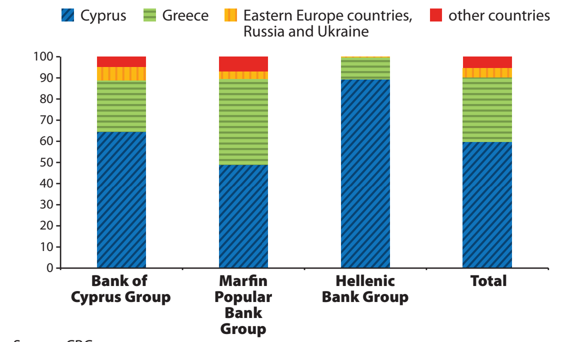
The strong competition and saturation in the domestic banking market have triggered significant international expansion by the three largest domestic banking groups, namely the Bank of Cyprus Public Company Ltd, Marfin Popular Bank Public Co. Ltd and

50.The risk of loss emanating from inadequate or failed internal processes, people and systems or from external events, including legal risk.

Hellenic Bank Public Company Limited, in the form of mergers and acquisitions and/or organic growth. Banks have been expanding their branch network in Greece and, more recently, have been increasingly focusing on Eastern European countries as well as Russia and the Ukraine. These new markets provide ample growth opportunities and banks are also keen to further extend the business relationships with their existing clients currently serviced by banks' international business departments.

At the end of June 2010, the overseas operations of the Bank of Cyprus Public Company Ltd, Marfin Popular Bank Public Co. Ltd and Hellenic Bank Public Company Limited represented around 40% of the total consolidated assets of these banking groups. At end-June 2010, the total assets of the three domestic banking groups in Greece constituted 30,5% of their total consolidated assets, while their total assets in Eastern European countries, Russia and the Ukraine represented 4,4% of their total consolidated assets (**Chart B.73**). Moreover, at the end of September 2010, loans and advances granted by the three banking groups to customers (excluding other credit institutions) in Greece amounted to approximately 38%, 53% and 22% of total group loans, respectively. Furthermore, at end-September 2010, loans and advances granted by the Bank of Cyprus Public Company Ltd and Marfin Popular Bank Public Co. Ltd to customers (excluding other credit institutions) in Eastern European, Russia and the Ukraine, constituted around

CHART B.73 **Distribution of assets of Cypriot banking groups by country**
(end of June 2010, %)



Source: CBC.

8% and 5% of total group loans, respectively.

The expansion of banks in overseas markets, while entailing significant benefits such as the diversification of business operations and the associated reduction in the sensitivity to potential shocks in the domestic market, exposes banks to country risks.

Global economic growth prospects have weakened compared with the beginning of the year, as new concerns have arisen in relation to the robustness of economic recovery. The prevailing uncertainty about the macroeconomic prospects is fuelled predominantly by the big fiscal challenges facing a number of euro area countries. The debate on the possibility of a double-dip recession became more intense at the beginning of the third quarter of 2010, when fiscal developments in Europe led credit rating agencies to downgrade the creditworthiness of Greece, Portugal, Spain, Ireland and Italy. Most European governments cut back on expenditure, while the risk of further deterioration in public finances remains. In November 2010, the spreads between certain sovereign and German bonds rose at historical levels, mainly due to the revival of Ireland's banking sector problems. Overall, the international macroeconomic environment remains uncertain.

As regards the Greek economy, this exhibited further deterioration in 2010, thus exerting negative pressure on the stability of the country's financial system. In the first half of 2010, GDP declined by 3% compared with the corresponding period of 2009, while for the whole of the current year this negative growth is expected to reach about 4%[51]. The recession is anticipated to continue in 2011 but at a slower pace. In light of the above, unemployment is expected to exceed 12% in 2010, while average real income is anticipated to decline by 8% in the economy as a whole and by 17% in the public sector, with high inflation being one of the driving factors. At the same time, in November 2010 the upward review of the 2009 budget deficit brought back the fears for new, even tougher, austerity measures. It must be noted that a positive development was the activation at the beginning of May 2010 of the support mechanism for the Greek economy by euro area member states and the IMF, based on the agreed three-year programme of fiscal consolidation and structural reform. Also, the ECB contribution has been very important though the provision of liquidity to Greek banks by accepting Greek sovereign debt (or bonds secured by the Greek state) as collateral in the ECB open market operations.

The significant contraction of the Greek economy has increased the pressure exerted on the financial position of households and NFCs. Credit risk remains the most significant type of risk facing Cypriot banking groups operating in Greece as the largest part of their activities concerns the provision of loans to households and enterprises. In Greece, credit risk arising from housing and consumer loans is expected to remain heightened in 2011.

51. Bank of Greece (2010) *Monetary Policy - Interim Report*, October.

The reduction in purchasing power, the increase in the tax burden and the anticipated rise in employment are all expected to further adversely affect the financial position of households and, consequently, their debt-servicing capacity. At the same time, the outlook for credit risk arising from loans granted to NFCs by domestic banking groups in Greece looks negative for 2011. The unfavourable macroeconomic conditions are expected to lead to a reduction in production activity and corporate sales and thus to a rise in arrears. These are anticipated to result in an increase in non-performing loans and loan loss provisions, with negative repurcussions on bank profitability.

Turning to the economies of Eastern Europe, Russia and the Ukraine, the recession of 2009 receded significantly in the first half of 2010. However, the annual GDP growth rate remained negative in several countries in the region in the first six months of the current year. For the whole of 2010, positive economic growth is expected in most of these countries. Looking at the macroeconomic environment that has been shaped in the countries of Eastern Europe, Russia and the Ukraine, the challenges for Cypriot banking groups operating in the region are: (i) the elevated credit risk, which remains the most significant type of risk facing banks operating in the region, due to the deterioration in the financial position of households and NFCs; (ii) the need to maintain adequate levels of liquidity and capital by the local business units (subsidiaries and branches); and (iii) the adjustment of businesses to the new prevailing conditions. However, it must be stressed that the exposure of the Cypriot banking groups in the countries of Eastern Europe, Russia and the Ukraine, as a percentage of total consolidated group assets, remains limited.

2.2.4 Overall assessment and outlook

In the first half of 2010, for which the latest consolidated data for the Cyprus banking sector are available, banks in Cyprus had to cope with the negative developments in the domestic economy as well as operate in an unfavourable external environment. As a result, banks' total operating profits before provisions remained roughly at the same level compared with the corresponding period of 2009, while net profits declined. At the same time, despite banks' high funding costs, which can be mainly attributed to higher deposit rates compared with other euro area member states, net interest margin exhibited a small increase in the first six months of 2010. A number of indicators show an increase of liquidity in the banking system during the period under review. In parallel, banks' capital adequacy remained satisfactory, with the overall solvency ratio reaching 12% at the end of June 2010, well above the minimum regulatory requirement of 8%

applied to individual banks. The Tier 1 capital ratio of banks also exhibited an increase at end-June 2010. In contrast, banks' asset quality deteriorated, with the ratio of non-performing loans to total loans recording significant growth from 5,9% at the end of December 2009 to 7,2% at end-September 2010.

In the near term, banks face a number of potential risks. Firstly, despite the muted domestic economic prospects for 2011, banks' policy of tightening credit standards for loans to households for house purchase, in conjunction with a potential slowdown in demand for new lending by both households and NFCs, may lead to a deceleration in credit expansion, which could adversely affect banks' earnings and profitability.

Credit risk stemming from lending to households and NFCs remains elevated, while any potential reduction in their debt-servicing capacity may lead to future asset quality problems for banks. This could result in an increase in loan loss provisions and thus have a negative impact on banks' bottom-line results.

The counterparty risk facing banks in Cyprus also remains on the upside given their exposure to other credit institutions through the interbank market, and especially considering their significant investment portfolio in fixed-income securities and other debt instruments. It must be noted, however, that the remedial measures taken by governments and central banks in support of the banking sectors in many countries, as well as by the ECB, have, to a great extent, helped to ease market tensions and considerably alleviate concerns associated with counterparty risk.

At the same time, market risk facing banks remains limited.

In contrast, banks' funding liquidity risks continue to be significant as a result of the increased cost of funding emanating, mainly, from the high deposit rates in the domestic market, which can be attributed to strong competition among banks. However, the use of the three-year special government bonds as collateral by banks for raising cheaper funds from the ECB, has helped to alleviate banks' funding needs.

At the same time, the risks originating from the presence of the three largest domestic banking groups in overseas markets have also increased due to the deterioration in macroeconomic conditions in some of the countries, especially Greece, in which these groups operate. The significant contraction in economic activity in Greece has put additional pressure on the financial position of households and NFCs. Credit risk remains the most important type of risk facing the Cypriot banking groups as the largest part of their activities in Greece concerns the provision of loans to households and enterprises.

In conclusion, banks in Cyprus remain sound, exhibiting satisfactory levels of liquidity and solvency. However, despite the muted domestic economic growth prospects for 2011, potential risks, especially credit risk, facing the banking sector are expected to remain elevated in the near term. The domestic banking groups operating in Greece are confronted with heightened risks and more challenges due to the significant deterioration of the country's macroeconomic conditions.

2.3 Insurance sector

This section reviews the major developments in the domestic insurance sector and provides an assessment of the activity and potential risks that the insurers are exposed to. It should be noted that the size and systemic importance of the insurance sector in comparison with the domestic banking sector is substantially smaller.

At the end of December 2009, the total assets of the domestic insurance sector accounted for about 1,4% of the total assets of the domestic financial system. Nonetheless, the interlinkages between the insurance and banking sectors, its significant participation in the capital markets as well as its role in the wider economy require the systematic monitoring and assessment of the developments in the sector so as to promptly identify potential risks that could threaten the stability of the financial system.

The sector's assessment was based exclusively on the supervisory data provided by the Insurance Companies Control Service (ICCS) of the Ministry of Finance, which is the supervisory authority for insurance undertakings in Cyprus.

2.3.1 Key structural developments in the insurance sector

Domestic insurance market structure

According to data from the ICCS, at the end of 2009, the insurance sector in Cyprus comprised of 34 insurance undertakings incorporated in Cyprus, of which 26 undertakings provide all or most of their services domestically, eight undertakings that conduct all or the largest part of their business outside Cyprus, and two branches/subsidiaries of foreign insurance undertakings that conduct most of their business domestically. There are also four EU/EEA insurance undertakings conducting business under the freedom of establishment regime and 339 under the freedom of services regime (**Table B.3**).

The insurance sector analysis focuses on the 26 domestic insurance undertakings and the two foreign, non-EU based undertakings that conduct all or the majority of their business in Cyprus and are supervised by the ICCS. It must be noted that three domestic and two Greek-based banking groups have significant capital participation (more than 20%) in eight insurance undertakings of the above group.

TABLE B.3 **Insurance sector structure**
(end of December 2009)

	Number of insurance undertakings
Domestic insurance undertakings in Cyprus	26
Life	6
Non-life	17
Composite	3
Branches/subsidiaries of foreign insurance undertakings(1)	2
Life	1
Non-life	1
Insurance undertakings from EU member-states(2)	343
Other insurance undertakings (3)	8
Total	**379**

Source: ICCS.
(1) Outside the EU or EEA area.
(2) Provide insurance services in the Republic of Cyprus under the Directive concerning the freedom of establishment (FOE) or the freedom to provide services of financial institutions (FOS); not supervised by ICCS.
(3) Transact insurance business outside Cyprus; not supervised by ICCS.

2.3.2 Financial condition

Key figures

In view of the adverse economic environment, the insurance sector[52] in 2009

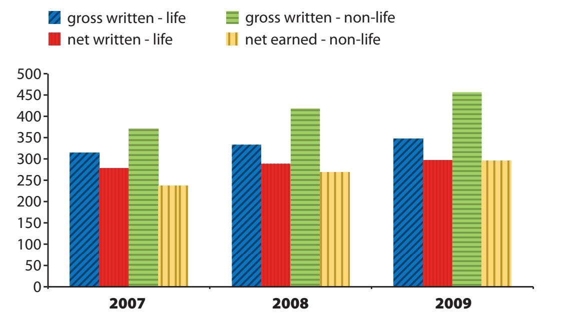
52. Unless otherwise mentioned, data pertaining to composite undertakings are allocated to life and non-life business accordingly.

continued to expand, albeit at a markedly slower rate. Specifically, total gross[53] written premiums in 2009 increased by 6,6% compared with 9,8% in 2008 (**Chart B.74**). The comparatively lower growth rate in 2009 can be largely attributed to the considerable deceleration in new underwriting production in both life and non-life business. In particular, total gross written premiums in non-life business contracted to 8,6% from 13% in 2008, with business lines exhibiting diverse underwriting results. Similarly, the total value of gross written premiums in life business increased by 4% in 2009 in comparison with 6,1% in 2008. Given life business' sensitivity to the prevailing state of the economy, new business, in terms of number of contracts, contracted significantly by 6,6%, driven distinctly by the sharp decrease in new unit-linked insurance business.

As regards the growth of net premiums[54] in 2009, the sector's cumulative total amount registered a notable decline, down to 6,4% from 8,3% in 2008. The comparatively lower growth of net premiums versus gross premiums contributed to the moderate decrease in the premium retention rate[55]. In particular, the retention rate in the life business and non-life business in 2009 was 66,4% and 87,7%, respectively, compared with 67,1% and 88,2% in 2008, respectively.

The domestic insurance market is characterised by a persistently high degree of concentration, with concentration levels being substantially higher in life business. Specifically, the concentration ratio[56] for life

CHART B.74 **Premium production**
(€ million)



Source: ICCS.

53. Including reinsurance ceded and policy fees.
54. Premiums after deduction of reinsurance ceded and policy fees.
55. Net premiums divided by gross premiums.
56. Sum of the market share of the five largest insurance undertakings -per business conducted- based on gross written premiums.

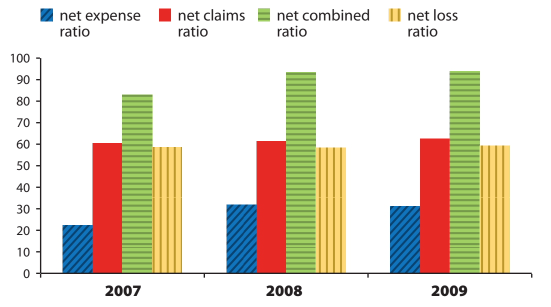
business in 2009 remained marginally above 85%, whereas the respective ratio for non-life business in 2009 was slightly lower than 58%. The high degree of concentration does not show any signs of moderation.

Financial performance and efficiency

Total claims incurred[57], both on a gross and net basis, increased substantially in the year under review. In particular, total gross claims in 2009 increased by 10,8% compared with 5,6% in 2008. Following a similar pattern, net claims incurred in 2009 rose by 9,8% from 7% in 2008. The disproportionately lower increase in net claims incurred indicates, as in the case of premium retention rates, the insurers' propensity to maintain rather stable, prudent levels of reinsurance coverage against the relevant risk.

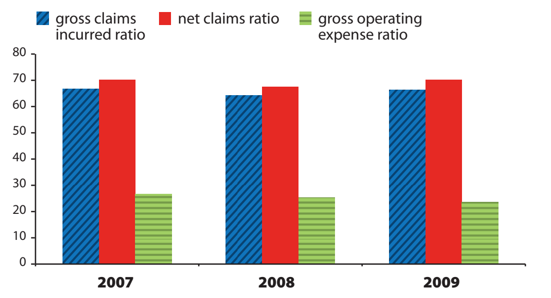
In 2009 life and non-life businesses' claims and expenses ratios, relative to earned premiums, moved into somewhat diverse directions (**Chart B.75** and **Chart B.76**). Specifically, expenses ratios in 2009, and particularly those pertaining to life business, decreased moderately compared with 2008, reflecting insurers' efforts to contain costs and foster operational efficiency. On the other hand, the surge in claims in 2009, particularly in life business, drove claims ratios, both on a gross and net basis, upwards. The higher claims also drove the combined (claims plus expenses) ratio of non-life business slightly higher. Moreover, the adverse macro-economic environment and concomitant

CHART B.75 **Non-life: claims and expenses ratios**
(%)



Source: ICCS.

CHART B.76 **Life: claims and expenses ratios**
(%)



Source: ICCS.

57. Includes claims management costs.

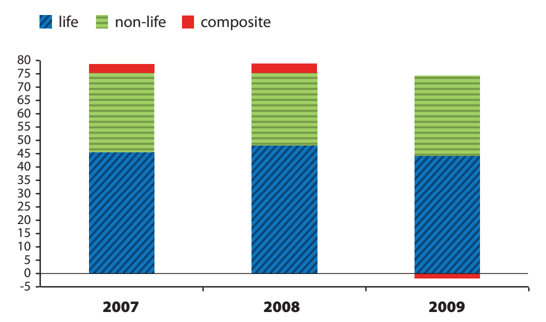
uncertainty contributed to higher lapse rates and, especially, surrender rates.

The total after tax net profit (non-technical account) of the insurance sector for 2009 increased by 2,8%. The improvement in profitability was primarily driven by higher investment income due to the strong recovery of the capital markets in 2009 and, to a lesser extent, to the insurers' cost-cutting efforts. Also, the higher investment income compensated for the higher claims costs. As regards the individual businesses, total net profits for life business in 2009 registered an increase of 53% while cumulative net profit in non-life business shrunk by 33% year-on-year.

Technical (underwriting) profit that, in effect, reflects the sector's efficiency in generating a robust income flow from its core business, premium production, dropped by 8% in 2009. The underwriting performance of the sector in 2009 was encumbered by the lower technical profits of life undertakings, down by 8,1% year-on-year, and the technical losses reported by composite undertakings. In sharp contrast, the technical results of non-life insurers increased by 10,5% in 2009. **Chart B.77** shows the per business allocation of technical profit of the domestic insurance sector. It must be noted that the financial performance across insurers and business lines was quite disperse.

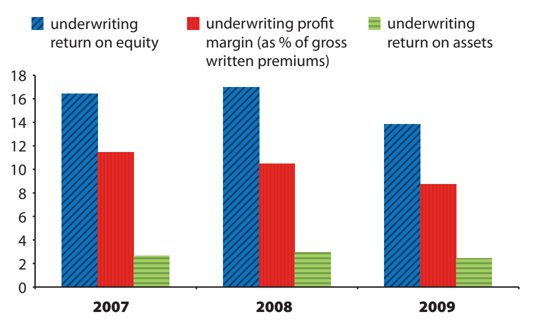
The weaker technical results of the insurance sector as a whole contributed to the deterioration of the sector's major financial performance indicators (**Chart B.78**). In particular, underwriting technical return on

CHART B.77 **Technical result (underwriting profit)**
(€ million)



Source: ICCS.

CHART B.78 **Technical result ratios**
(%)



Source: ICCS.

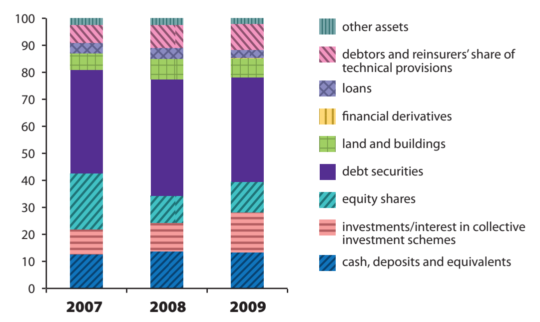
equity and underwriting return on admissible assets in 2009 declined to 13,8% and 2,4%, respectively, compared with 17% and 2,9% in 2008, respectively. In contrast, total non-technical return on equity declined from 17,9% in 2008 to 16,2% in 2009, primarily due to the proportionately higher increase in equity levels in 2009. Also, underwriting (technical) profit margin, as a percentage of gross written premiums, declined from 10,5% in 2008 to 8,8% in 2009. This underlines the sector's deteriorating ability to retain a stable profit share from its underwriting activities and, perhaps, the rather heightened importance of investment income in determining underwriting pricing policies.

Key financial figures

In 2009 the total assets of the domestic insurance sector increased significantly by 11,3%, with the assets of life insurers expanding at the highest rate. The increase in total assets was driven by the higher valuation of particular classes of marketable securities in the insurers' investment portfolios due to the strong rebound of capital markets in 2009. Moreover, driven almost entirely by life insurers, total admissible assets[58] expanded by 10,8% in 2009 in contrast to a decline of 12,3% in 2008.

Specifically, the percentage breakdown of the insurance sector's admissible asset holdings in **Chart B. 79** mirrors the sizeable increase in collective investment schemes and funds vis-a-vis individual share holdings.

CHART B.79 **Breakdown of investment assets that cover technical reserves**
(%)



Source: ICCS.

58. Assets covering technical reserves; net technical reserves for life business and gross technical reserves for non-life business.

Nevertheless, investment allocations in bond securities continue to constitute the single largest investment category[59]. It is noteworthy that the sector's allocations under the category "cash, deposits and equivalents", comprises almost entirely of deposits in approved credit institutions (**Chart B.80**).

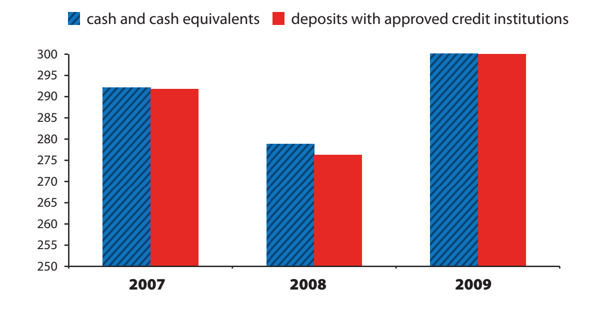
In line with the increase in assets, the insurance sector's total gross liabilities[60], increased substantially in 2009, with non-life business exhibiting the highest percentage increase. Specifically, total gross liabilities rose by 10,9% year-on-year while total gross reserves increased by 11,9% (**Chart B.81**). In part, the significant increase in the overall level of reserves reflects the uncertainty about the future level of liability claims and particularly long-tailed claims, as well as the magnitude of debtors and other receivables.

Solvency

Insurance undertakings supervised by the ICCS are required to maintain capital levels at least equal to the regulatory Minimum Solvency Margin (MSM)[61] or the guaranteed amount[62], whichever of the two is higher. According to the data provided by the ICCS, at end of 2009, the aggregate MSM coverage ratio[63] of the insurance undertakings under review climbed to 2,64 from 2,46 and 2,55 in 2008 and 2007, respectively (**Chart B.82**). At the end of 2009, composite insurers' coverage ratio dropped to 1,65 from 1,74 in 2008 largely

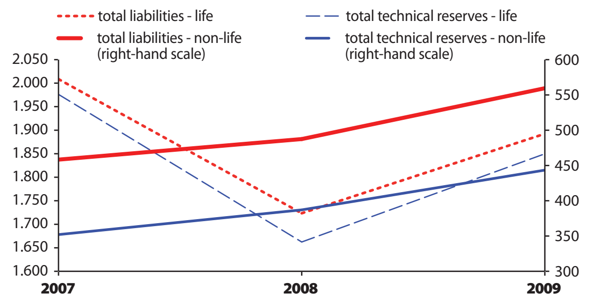
59. No available data exist by geographical breakdown or per issuer allocation of the sector's investments in debt securities.
60. Includes gross technical reserves and surplus carried forward. Technical provisions accounted for about 93% of total industry liabilities in 2009.
61. Calculated for every insurer individually.
62. At the end of December 2009, the guaranteed amount for both life and non-life business increased to €3,5 million from €3,2 million at end-December 2008.
63. Free available assets divided by minimum solvency margin.

CHART B.80 **Cash and cash equivalents and deposits with approved credit institutions**
(€ million)



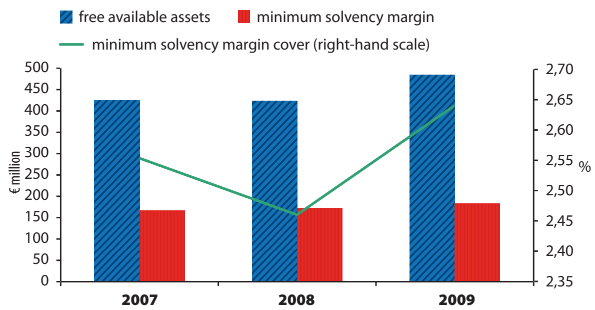
Source: ICCS.

CHART B.81 **Gross technical reserves and gross total liabilities**
(€ million)



Source: ICCS.

CHART B.82 **Free available assets (net) and minimum solvency margin**



Source: ICCS.

due to their negative financial results, while the coverage ratio for non-life insurers increased to 2,65 from 2,63 in 2008. In contrast, the coverage ratio for life insurers rose notably from 2,48 in 2008 to 2,88 in 2009, positively influencing the sector-wide coverage ratio. It should be noted that the dispersion of coverage ratios on the individual insurer level was rather extensive, mirroring the wide discrepancy in the individual capital adequacy levels. On average, though, the insurance sector's shock-absorption capacity remains satisfactory.

Total equity of the insurance sector as a whole rose to 13,1% in 2009 in comparison with a decrease of 3,3% recorded in 2008. It is noteworthy that in 2009 all insurance undertakings (life, non-life and composite) increased their capital base, with the total equity to total assets ratio rising to 17,6% from 17,3% the previous year. All in all, key factors to the sector-wide improvement of the solvency ratio and equity levels were the rise in the value of investment portfolios and the higher profitability of the sector compared with 2008.

A major challenge for the insurance sector is the forthcoming introduction of "Solvency II"[64] in 1 January 2013 and the concomitant changes in the regulatory framework. The new framework aims, *inter alia*, to strengthen capital requirements, risk management practices and internal governance, to streamline supervisory activities and to foster transparency through sufficient public disclosures. One of the fundamental

64. "Solvency II" is based on EC directive 2009/138.

innovations of the framework is the risk-based requirements for calculating the insurer's capital levels. In contrast to the existing regulatory framework, all risks (insurance, financial and operational) must be quantified utilising modern risk-based methodologies while taking into account any risk mitigation techniques. The new, all-encompassing risk-based capital requirements are expected to exert significant pressure on the insurance sector's capital base, primarily on account of the higher levels of required capital.

2.3.3 Risks facing the insurance sector

Notwithstanding the overall improvement in the financial position of the insurance sector in 2009, the outlook of the sector for the remaining of 2010 and 2011 remains fairly uncertain. All in all, the macroeconomic environment risks that inexorably reinforce the inherent risks to insurers, insurance risks and financial risks, remain elevated.

Insurance risks

Given the adverse macroeconomic conditions, demand for insurance products is likely to wane further while the freeble trend of early policy terminations and lapses observed in 2009 is likely to persist. The uncertainty as regards domestic macroeconomic prospects will probably affect life products more, while the general tendency to opt for insurance with lower premium and less coverage is likely to persist and even strengthen. Perhaps the most prominent insurance risk given the uncertainty surrounding the macroeconomic environment, especially at the domestic level, is the adequacy of technical reserves. Sizeable claims and other liabilities, particularly in non-life business, not picked up in the estimation of reserves can ultimately have a significant impact on the sector's capital level and financial performance.

In the event of a further deterioration of the macroeconomic environment, these insurance risks are likely to strengthen. This will exert a significant adverse pressure on the insurance sector's liquidity, profitability and capital adequacy.

Financial risks

Market risk

Market risk continues to be one of the main risks that the insurance sector is exposed to. The prevailing uncertainty in the capital markets renders investment income[65] an unstable source of revenue while asset valuation and corresponding reserving estimations become a highly demanding undertaking. In particular, the volatile conditions in the capital markets have reinforced most investment risks, namely, interest rate risk and spread risk owing to insurers' large debt holdings with a relatively long residual maturity, as well as equity risk, on account of the significant investments in equity shares, outright or through collective investment schemes. In contrast, the insurance sector is not significantly exposed

65. On account of the sector's substantial debt holdings, investment income is also affected by the (prolonged) low interest environment.

to exchange rate risk. Thus, the risk of significant divergence between the projected and actual cash flows from investment assets can have an adverse economic impact on the profitability and solvency of the sector. This eventuality may also induce insurers to adjust their underwriting pricing policies upwards to improve their financial condition.

Credit risk

Overall credit risk has also increased, albeit to a lesser extent compared with market risk. In particular, sovereign credit risk is prevalent through the sector's sizeable investing in euro sovereign bonds. Also, the notable rise in debtor (customers, intermediaries and reinsurers) balances in conjunction with the adverse macroeconomic environment, increased counterparty credit risk in the form of a potential default or downgrade event. Moreover, the potential risk on account of the high concentration of the sector's cash and cash equivalents in bank deposits reinforces the germane risks, namely, concentration risk and counterparty risk.

Contagion risk

Through its investment holdings in bank equity and debt securities, the sector remains, albeit to a limited extent, vulnerable to potential spillover-effects from an adverse development in the banking sector; that is, the contagion event will most likely driven by the banking sector. It must be noted that the participation of domestic banks in the capital of domestic insurance undertakings is extremely low as a percentage of total capital in order to pose any serious threat to the stability of the banking sector.

Liquidity risk

The insurance sector seems to possess appropriate levels of liquidity to meet its foreseen obligations when come due as well as to cope with any emergency liquidity needs with ease. In addition, the largest share of the sector assets is placed in marketable securities that can be liquidated fairly quickly. Notwithstanding the sector's ample liquidity levels, the possibility, albeit low, of a severe liquidity shock due to several large claims cannot be excluded. At any rate, the liquidity demands of insurers are usually less pressing in terms of time and of more predictable nature in comparison with the time-critical liquidity needs that may arise in the banking sector.

2.4 Financial market infrastructures

This section reviews the systemically important financial market infrastructures, (payment, clearing and settlement systems) in Cyprus[66], namely: (a) TARGET2-CY, used for large-value interbank payment and other euro payment transfers, and (b) the Central Depository and Central Registry (CDCR) of Securities, the clearing and securities settlement system of the Cyprus Stock Exchange.

66. The CBC, as the competent authority, can place under its oversight any payment, clearing or settlement system operating in Cyprus. In this regard, the CBC has designated TARGET2-CY and CSE's CDCR as systemically important systems.

The monitoring and assessment of the potential risks that the above systems are exposed to is conducive to the stability of the financial system and the wider economy. A serious disruption in the operations of a systemically important system can trigger further disruptions in other payment systems. The speed at which these problems can propagate and the potential impact on system participants may have systemic implications for the financial system as a whole with effects on the real economy.

During the period under review, the aforementioned systemically important systems exhibited notable efficiency and resiliency, fulfilling the market demand for a smooth, safe and robust payment and settlement infrastructure environment. By extension, this contributed to the stability of the financial sector in Cyprus. The difficult macroeconomic and financial conditions as well as the expected increase in the volume of payment transactions are likely to increase counterparty credit risk as well as the risks emanating from the higher operational needs respectively.

2.4.1 TARGET2-CY (T2-CY)

Key figures and operational performance

T2-CY is the Cypriot component of the pan-European euro payment system TARGET2[67] that began its operations on 19 November 2007. The system is intended for the direct processing and irrevocable settlement of

67. TARGET2 is the euro RTGS system used for the processing and settlement of euro payments in real-time, in central bank money. It commenced its operations in 19 November 2007, gradually replacing the previous TARGET system.

large-value and time-critical euro payment transfers between financial institutions, including central banks, in real-time central bank money. It is also used for the settlement of customer payments, which are generally of much smaller value. During the period January-September 2010, the system's high level of robustness and operational efficiency had a positive contribution to financial stability.

The total value of settled payments via the system in 2009 was €392 billion compared with €251 billion in the previous year, while the total volume of payment instructions processed in 2009 was essentially at the same levels as in 2008 (**Table B.4**). In view of the monthly figures for the period January-September 2010, the number of payment instructions to be settled in 2010 is expected to markedly exceed the respective total figures of 2009 (**Chart B.83**). Furthermore, in terms of value, the share of interbank payments versus customer payments as well as the share of national payments sent by T2-CY participants relative to payments sent by participants in other components of the TARGET2 system, are also expected to increase substantially in 2010. With reference to the volume of payments, customer payments continued to increase their share compared with interbank payments.

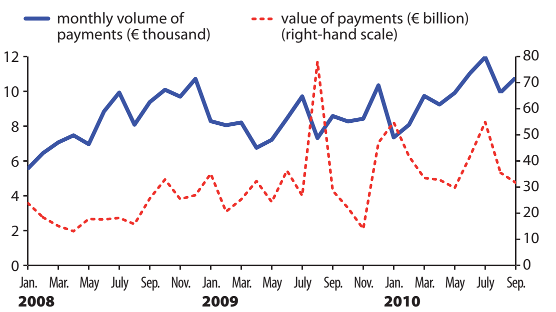
As regards technical availability, T2-CY maintained extremely high levels of availability, ensuring the smooth and operationally reliable processing of payments. During the first six months of 2010, the

TABLE B.4 **TARGET2-CY**

	2009	Jan.-Sep. 2010
Number of participants	20	19
Direct partipants (incl. CBC)	15	14
Indirect participants	5	5
Credit transfers sent within T2-CY (€ billion)	392	356
% of domestic transactions	47,98	57,90
Number of payments processed (thousand)	99,61	88,03
% of domestic transactions	38,02	33,56
Average payment value (€ million)	3,94	4,04
Value of transactions as % of GDP	1.787,16	-

Sources: CBC, ECB.

CHART B.83 **TARGET2-CY: payments**



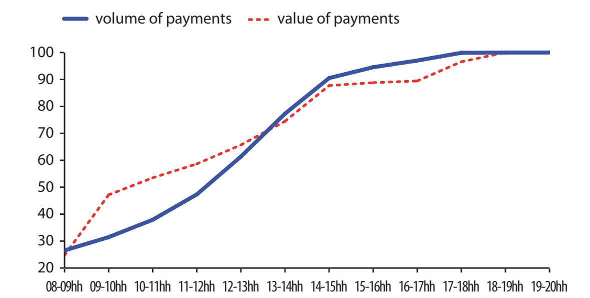
Sources: CBC, ECB.

system's technical availability rate[68] was, on average, 100% compared with 99,99% in 2009 and 99,98% in 2008, with no major operation incidents[69] occurring during the period. This underlines the system's remarkable reliability as well as its capacity for the smooth, uninterrupted settlement of payments even in instances of exceptionally high traffic. It must be noted that in the period January-September 2010, the monthly average ratio of non-settled transactions[70], in terms of value and volume, was 0,6% and 0,1%, respectively. Over the same period, no non-settled transactions were reported due to insufficient funds in a credit institution's settlement account were reported.

Risks

An important factor for the smooth settlement of transactions is the distribution of processed payments during the day. In particular, **Chart B.84**, which portrays the average intra-day time distribution of settled transactions, shows that in the period January-September 2010, 47% of the payments in terms of volume and 59% in terms of value were settled before 12:00 noon compared with 44% and 57%, respectively, in 2009. During the same period in 2010, the percentage of transactions settled before 14:00, in volume and value, was 77% and 74% respectively, compared with 72% and 80% in 2009. It is also worth noting that less than 2% of the submitted payment instructions remained to be settled in the last

CHART B.84 **Hourly settlement of payments (time bands)**
(daily data January-September 2010, %)



Source: CBC.

68. TARGET2 availability rate considers any SSP event during which participants cannot execute payments or a technical slowdown affecting settlement services for more than ten minutes.
69. Major incidents are those that last more than two hours and lead to a delayed system closing or settlement delays of critical payments by more than 30 minutes.
70. Non-settled payments are those that were pending due to lack of funds or for breaching the sender's limit at the time the system closes, and are ultimately rejected.

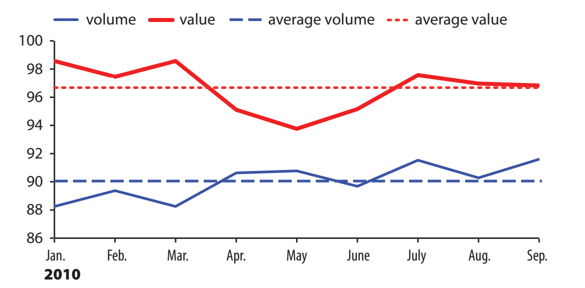
closure of the system.

The initial steepness of intraday time distribution of settled transactions and the close-to-linear pattern that follows show that liquidity circulation across system participants is at a very good level. It also implies the low probability of a gridlock where payments are not settled due to inappropriate (badly-timed) distribution of liquidity among participants. Moreover, the non use of intraday credit facility[71] by the participating credit institutions also an indication of ample liquidity.

During the period January-September 2010, the volume concentration ratio[72] of T2-CY stood at 90%, essentially at the same level as in 2009 and 2008. However, the concentration ratio in terms of value during the above period rose to 96% compared with 92% and 93% in 2009 and 2008, respectively (**Chart B.85**). The high value concentration ratio, which is one of the highest values among all TARGET2 national constituents, shows the high inter-dependency of the five largest participants. In the event of an extreme credit or liquidity shock, this points to a probability, albeit considerably small, of a potential intra-system domino effect. It also highlights, again under a scenario of extreme events, the possibility of spillover-effects to other systems and participants.

Overall, T2-CY's smooth operation, reliability and efficiency remained at extremely high levels contributing to financial stability. Evidently, the system's operational features that are designed to eliminate or

CHART B.85 **TARGET2-CY: concentration ratio**
(%)



Source: CBC.

71. Intraday credit is extended by the CBC and reimbursed within the business day against eligible collateral, in the event of temporarily insufficient covering funds, to ensure the smooth functioning of the system and avoid any potential disruptions.
72. The cumulative share of the five largest participants in the system; it applies for both value and volume payments.

confine some of the inherent risks in payment systems, contribute vastly to this end. In particular, liquidity and counterparty risks are substantially mitigated, since settlement is carried out at the individual (gross) level in real-time with immediate finality, given that the participant's settlement account has sufficient funds available.

Notwithstanding the above safeguards and the system's performance thus far, the uncertain macroeconomic environment coupled with the expected rise in operational requirements are likely to reinforce the materialisation of any of the aforesaid risks.

2.4.2 Central Depository and Central Registry (CDCR) of Securities

Key figures

The CDCR is owned and operated by the CSE. It is the sole central securities depository and securities clearing and settlement system (SSS) in Cyprus for all dematerialised securities listed on the CSE and also one of the eligible SSSs for Eurosystem's credit operations as it is regularly assessed against the corresponding user standards.

The market value of registered outstanding securities in CDCR investor accounts as at 31 December 2009 was €14,17 billion, of which €7,31 billion was in shares, €6,85 billion in bonds and €0,01 billion in other securities. At the end of October 2010, the value of the CDCR registered securities was €14,41 billion (**Table B.5**).

TABLE B.5 **Central Depository and Central Registry (CDCR) of Securities**

	2009	Oct. 2010
Outstanding securities registered (€ million)	14.173	14.411
Equities	7.315	6.252
Bonds	6.852	8.156
of which: Government securites	5.202	6.295
Other	6	3
Number of transactions processed (thousand)	379	-
% of equities	99	-
Value of securities processed (€ billion)	1.973	-
% of equities	95	-
Average value per instruction (€ thousand)	5	-

Sources: CBC, ECB.

In 2009 the value of securities transactions settled in the system amounted to €1,97 billion while the volume of transactions numbered 379 thousands. It is worth noting that securities settlement activity involved almost entirely stock share transactions. These figures were lower by 18,5% and 14,3%, respectively, compare with 2008 (**Table B.5,** p.178). The significant contraction in turnover, which continued over the first half of 2010, was a consequence of the widespread market uncertainty and general economic climate that negatively affected investor sentiment and the propensity to assume risk as well as securities' valuations in the financial markets.

Risks

As regards the major operating risks, the CDCR is a fully automated system integrated with the CSE's trading system, thus minimising the risk of human errors or interventions that may result in unexpected exposures. It should also be noted that in case of extreme emergency events, the CDCR can continue its operations via a back-up facility. Moreover, the system settles transactions by means of a delivery-versus-payment mechanism, which ensures that securities are irrevocably transferred when the appropriate funds are deposited and vice-versa, thus eliminating principal risk.

In the event of a participant's failure due to insufficient funds, the CSE's General Manager has the discretionary power to unwind the failed transaction or use funds from two special purpose funds, the Guarantee Fund and the Joint Compensation Fund, to settle the trade. This, however, does not eliminate counterparty risk particularly in cases of several large failures in the same settlement cycle. Also, the CDCR does not act as a central counterparty, which could reduce credit risk even further.

A significant source of credit risk exists owing to the settlement of the payment, the cash leg of the transaction, in commercial bank money and not in central bank money. Consequently, participants are exposed to the credit risk of the commercial bank. For instance, in the event of (credit) default, the commercial bank will not be in a position to fulfil its obligations as the CDCR's settlement bank.

Overall, the main risks, operational and financial, that the CDCR is exposed to, are considered low and satisfactorily contained, the exception being a potential default of or any other serious event incapacitating the settlement bank to perform its tasks.

SECTION C

Statistical Annex

Explanatory notes for Statistical Annex

The statistical annex contains data on, mostly, the domestic economy and, where possible, longer time series than in the main body of the *Bulletin*. In the notes below, there is aggregate information on the aforementioned data, including explanations for both the subcategories and the sources of the data. The most recent data are, in general, preliminary and thus may need to be revised in future editions of the *Bulletin*.

Table C.1 shows the bilateral exchange rates of selected currencies against the euro. The source of the data is the ECB's Statistical Data Warehouse (SDW).

Tables C.2-C.7 refer to the Consumer Price Index (CPI), which is published on a monthly basis by Cystat with 2005 as the base year. **Table C.2** shows both the national CPI and the HICP. Even though the two indices exhibit similar fluctuations, they differ in two respects. First, the expenditures of charitable institutions (i.e. nursing homes, religious organisations, etc.) and foreign tourists are included in the HICP but not in the national CPI. The second difference concerns imputed rents, which were included in the national CPI until 2005 but not in the HICP. Since January 2006, only part of the imputed rents is included in the national CPI. **Tables C.2 and C.3** show the percentage change in CPI by economic category and the corresponding weighted contribution to the total change in CPI by economic category, respectively. **Tables C.4** and **C.5** present the percentage change in the CPI by category of goods and services and the corresponding weighted contribution to the total change in the CPI by category of goods and services, respectively.

Tables C.6 and **C.7** show the percentage change in the CPI for prices of services and the corresponding weighted contribution to the percentage change in prices of services, respectively.

Table C.8 presents the balance of payments of Cyprus which records the transactions between residents and non-residents. The balance of payments is divided into the current account and the capital and financial account which, because of the double entry principle, must be equal with opposite signs.

Table C.9 shows the trade balance of Cyprus, which records the trade in goods between residents and non-residents of Cyprus.

Tables C.10 and **C.11** present the direct investments by non-residents in Cyprus and Cypriot residents' direct investments abroad, respectively.

Table C.12 shows the international investment position of Cyprus, namely the assets and liabilities of residents over non-residents. The data for **Tables C.8, C.10 - C.12** are collected and compiled by the CBC and are based on the IMF's methodology (BPM5). **Table C.9** is prepared and published by Cystat.

Table C.13 shows tourist arrivals and revenue from tourism as published by Cystat and based on the results of the monthly Passenger Survey.

Table C.14 shows GDP by category of expenditure at constant 2005 market prices calculated using the chain linking method while **Table C.15** shows GDP by category of expenditure at current market prices. The data for GDP are prepared by Cystat and are based on the concepts and methodology of the European System of Accounts (ESA 95). Provisional data are based on the last available indicators, until the results of various economic surveys are finalised.

Table C.16 shows the turnover volume index of retail trade which uses the EU's new version of the statistical classification of economic activities, NACE Rev. 2, as published by Cystat with 2005 as the base year.

Table C.17 shows construction indicators as published by Cystat. Specifically, it shows the total area of building permits authorised by the municipal authorities and the district administration offices as well as the sales of cement in metric tons.

Table C.18 presents the index of industrial production, which shows the monthly change in volume production in the sectors of mining and quarrying, manufacturing industries, electricity, gas and water supply, i.e. sectors B, C, D and E of the EU's new statistical classification of economic activities, NACE Rev. 2. This index is published by Cystat with 2005 as the base year.

Table C.19 shows key indicators of the labour market in Cyprus based on the Labour Force Survey (LFS), which is published by Cystat. The LFS is conducted in all EU member states.

Table C.20 presents gross and net public debt, as compiled by the Ministry of Finance. The table breaks down public debt into its domestic and foreign components as well as distinguishing between long-term and short-term debt.

Table C.21 exhibits a number of key structural indicators of the banking sector. The data is collected by the CBC and the ECB.

Table C.22 shows a number of key aggregate indicators of the banking sector. The data is collected by the CBC.

Table C.23 presents the distribution of bank loans by economic activity based on the EU's NACE Rev.2. The data concerns loans to Cypriot residents including organisations or companies with no physical presence in Cyprus (i.e. "brass plates"). The data is collected by the CBC.

Table C.1 Exchange rates of selected currencies against the euro

	USD/EUR	GBP/EUR	JPY/EUR
Average for January	1,4274	0,8834	130,3282
Average for February	1,3682	0,8758	123,3490
Average for March	1,3574	0,9013	123,1239
Average for April	1,3428	0,8755	125,5327
Average for May	1,2535	0,8553	115,2019
Average for June	1,2225	0,8275	110,8374
Average for July	1,2833	0,8369	112,2827
Average for August	1,2881	0,8239	109,8459
Average for September	1,3137	0,8425	110,7727
Average for October	1,3905	0,8763	113,5519
Average for November (until 13 Nov.)	1,3798	0,8588	113,3714
Average for Jan-November (until 13 Nov.)	1,3274	0,8596	117,2064
Closing rate on 31/12/2009	1,4321	0,8869	133,2000
Closing rate on 19/11/2010	1,3673	0,8556	114,2300
Highest exchange rate vs. the euro	1,4513	0,9118	133,6400
	(11 Jan)	(10 Mar)	(11 Jan)
Lowest exchange rate vs. the euro	1,1923	0,8091	105,9700
	(7 Jun)	(29 Jun)	(24 Aug)
% appreciation (+)/depreciation (-) of the currency vs. the euro from closing rate on 31/12/2009 to closing rate on 19/11/2010	-4,5%	-3,5%	-14,2%

Source: Bloomberg.

Table C.2 Percentage change in CPI by economic category

	2007	2008	2009	Oct. 2009/08	Sep. 2010/09	Oct. 2010/09	Jan.- Oct. 20 09/08	Jan.-Sept. 2010/09	Jan.- Oct. 2010/09	Weights 2005=100 (for 2006)	Weights 2005=100 (for 2007 - 2010)(1)
GENERAL INDEX	**2,38**	**4,67**	**0,33**	**-0,80**	**3,54**	**3,05**	**0,05**	**2,56**	**2,61**	**100,00**	**100,00**
A Domestic products	**3,94**	**7,36**	**0,78**	**-3,69**	**7,50**	**6,09**	**0,85**	**3,22**	**3,51**	**28,60**	**28,98**
A.1 Agricultural	7,83	10,71	3,30	-8,36	15,79	12,75	3,12	0,34	1,52	6,92	6,93
A.2 Industrial	3,02	3,64	2,56	1,46	2,23	1,54	2,88	1,28	1,31	19,24	19,29
A.3 Electricity	-0,33	23,16	-14,84	-19,28	19,91	18,25	-15,61	24,58	23,88	2,44	2,76
B Petroleum products	**2,81**	**10,54**	**-17,19**	**-13,57**	**15,67**	**19,83**	**-20,78**	**18,74**	**18,85**	**6,44**	**6,63**
C Imported products	**-1,92**	**-0,35**	**-0,56**	**-0,55**	**0,11**	**-0,91**	**-0,49**	**-0,91**	**-0,91**	**25,31**	**24,62**
C1 Motor vehicles	-8,50	-1,29	-3,38	-4,72	-3,34	-3,11	-3,01	-4,70	-4,54	6,15	5,41
C2 Other imported products	-0,08	-0,11	0,16	0,48	0,96	-0,40	0,15	0,04	-0,01	19,16	19,21
D Services	**3,58**	**4,48**	**3,69**	**3,65**	**0,51**	**0,36**	**3,71**	**1,48**	**1,37**	**39,65**	**39,77**
HICP	**2,2**	**4,4**	**0,2**	**-1,0**	**3,6**	**3,2**	**0,0**	**2,7**	**2,7**		

Source: Cystat.
(1) The weights were updated as a result of the change in the taxes on motor vehicles.

Table C.3 **Percentage change in CPI by economic category**

	2007	2008	2009	Oct. 2009/08	Sep. 2010/09	Oct. 2010/09	Jan.- Oct. 2009/08	Jan.- Sep. 2010/09	Jan.- Oct. 2010/09	Weights 2005=100 (for 2006)	Weights 2005=100 (for 2007 - 2010)(1)
GENERAL INDEX	**2,38**	**4,67**	**0,33**	**-0,80**	**3,54**	**3,05**	**0,05**	**2,56**	**2,61**	**100,00**	**100,00**
A Domestic products	**1,16**	**2,21**	**0,24**	**-1,16**	**2,28**	**1,86**	**0,26**	**0,99**	**1,04**	**28,60**	**28,98**
A.1 Agricultural	0,56	0,81	0,26	-0,70	1,23	0,98	0,25	0,03	0,13	6,92	6,93
A.2 Industrial	0,58	0,71	0,49	0,28	0,44	0,30	0,55	0,25	0,26	19,24	19,29
A.3 Electricity	-0,01	0,69	-0,52	-0,74	0,62	0,57	-0,54	0,71	0,70	2,44	2,76
B Petroleum products	**0,20**	**0,74**	**-1,28**	**-0,97**	**1,02**	**1,24**	**-1,54**	**1,14**	**1,13**	**6,44**	**6,63**
C Imported products	**-0,46**	**-0,08**	**-0,12**	**-0,12**	**0,02**	**-0,20**	**-0,11**	**-0,19**	**-0,19**	**25,31**	**24,62**
C1 Motor vehicles	-0,44	-0,06	-0,15	-0,20	-0,14	-0,13	-0,13	-0,20	-0,19	6,15	5,41
C2 Other imported products	-0,01	-0,02	0,03	0,08	0,16	-0,07	0,03	0,01	0,00	19,16	19,21
D Services	**1,43**	**1,80**	**1,48**	**1,45**	**0,21**	**0,15**	**1,43**	**0,65**	**0,65**	**39,65**	**39,77**

Source: Cystat.
(1) The weights were updated as a result of the change in the taxes on motor vehicles.

Table C.4 **Percentage change in the CPI by category of goods and services**

	2007	2008	2009	Oct. 2009/08	Sep. 2010/09	Oct. 2010/09	Jan.- Oct. 2009/08	Jan.- Sep. 2010/09	Jan.- Oct. 2010/09
GENERAL INDEX	**2,38**	**4,67**	**0,33**	**-0,80**	**3,54**	**3,05**	**0,05**	**2,56**	**2,61**
Food and non-alcoholic beverages	5,56	7,59	3,69	-3,00	7,15	5,95	4,08	0,23	0,79
Alcoholic beverages and tobacco	1,34	0,23	3,10	3,77	0,25	0,24	3,16	1,21	1,11
Clothing and footwear	0,29	-1,32	-4,06	-2,28	2,98	-1,35	-4,62	-0,56	-0,64
Housing, water, electricity and gas	2,07	7,01	-2,49	-3,77	6,14	5,94	-2,92	8,04	7,83
Furnishings, household equipment and supplies	0,27	2,15	1,47	2,12	0,01	-0,46	1,42	0,73	0,62
Health	6,22	4,93	6,49	7,29	2,00	2,07	6,27	3,25	3,13
Transport	-0,48	4,47	-6,97	-5,68	2,76	4,07	-8,53	3,45	3,52
Communications	1,30	0,16	0,01	0,01	-0,04	-0,03	0,01	-0,05	-0,04
Recreation and culture	0,59	3,65	1,92	2,02	-0,74	-0,67	2,05	0,22	0,12
Education	4,88	5,05	5,29	5,07	4,02	3,95	5,33	4,95	4,85
Restaurants and hotels	4,20	7,65	5,60	4,67	1,83	1,66	5,83	2,16	2,11
Miscellaneous goods and services	2,48	2,50	2,99	3,17	2,54	2,41	2,98	2,11	2,14

Source: Cystat.

Table C.5 **Weighted contribution to the total change in the CPI by category of goods and services**
(%)

	2007	2008	2009	Oct. 2009/08	Sep. 2010/09	Oct. 2010/09	Jan.-Oct. 2009/08	Jan.-Sep. 2010/09	Jan.-Oct. 2010/09
GENERAL INDEX	**2,38**	**4,67**	**0,33**	**-0,80**	**3,54**	**3,05**	**0,05**	**2,56**	**2,61**
Food and non-alcoholic beverages	0,98	1,36	0,70	-0,58	1,37	1,13	0,75	0,05	0,15
Alcoholic beverages and tobacco	0,03	0,00	0,06	0,08	0,01	0,00	0,06	0,03	0,02
Clothing and footwear	0,03	-0,11	-0,32	-0,19	0,21	-0,11	-0,35	-0,04	-0,05
Housing, water, electricity and gas	0,34	1,13	-0,42	-0,65	1,03	0,99	-0,48	1,31	1,27
Furnishings, household equipment and supplies	0,02	0,14	0,09	0,13	0,00	-0,03	0,09	0,05	0,04
Health	0,31	0,25	0,34	0,37	0,11	0,11	0,32	0,18	0,17
Transport	-0,07	0,65	-1,04	-0,82	0,39	0,56	-1,26	0,48	0,48
Communications	0,05	0,01	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Recreation and culture	0,04	0,22	0,12	0,12	-0,05	-0,04	0,12	0,01	0,01
Education	0,14	0,15	0,16	0,15	0,13	0,13	0,16	0,15	0,15
Restaurants and hotels	0,31	0,57	0,44	0,37	0,15	0,14	0,45	0,18	0,17
Miscellaneous goods and services	0,17	0,17	0,20	0,21	0,18	0,17	0,20	0,15	0,15

Source: Cystat.

Table C.6 **Percentage change in prices of services**

	Sep. 2010/09	Oct. 2009/08	Oct. 2010/09	Jan.-Sep. 2010/09	Jan.- Oct. 2009/08	Jan.- Oct. 2010/09
GENERAL INDEX	**3,54**	**-0,80**	**3,05**	**2,56**	**0,05**	**2,61**
Rents	-0,12	2,89	-0,25	1,50	2,97	1,32
Maintenance of houses	0,61	0,57	0,61	0,84	1,05	0,81
Transport	-11,58	1,26	-13,23	-8,34	1,43	-8,84
Communications	0,00	0,06	0,00	0,01	0,05	0,01
Insurance	0,05	4,00	0,05	0,91	2,94	0,82
Public services	1,34	1,07	1,15	1,31	2,00	1,29
Education	4,02	5,07	3,95	4,94	5,33	4,84
Medical care	2,69	9,62	2,76	4,30	8,30	4,14
Restaurants	1,50	5,25	1,51	2,23	5,96	2,15
Personal and household services	1,49	2,82	1,44	2,04	2,88	1,99
Total services	**0,51**	**3,65**	**0,36**	**1,48**	**3,71**	**1,37**

Source: Cystat.

Table C.7 **Weighted contribution to the percentage change in prices of services**
(%)

	Sep. 2010/09	Oct. 2009/08	Oct. 2010/09	Jan.-Sep. 2010/09	Jan.- Oct. 2009/08	Jan.- Oct. 2010/09
GENERAL INDEX	**3,54**	**-0,80**	**3,05**	**2,56**	**0,05**	**2,61**
Rents	-0,01	0,19	-0,02	0,10	0,20	0,09
Maintenance of houses	0,01	0,01	0,01	0,02	0,02	0,02
Transport	-0,30	0,03	-0,34	-0,22	0,04	-0,23
Communications	0,00	0,00	0,00	0,00	0,00	0,00
Insurance	0,00	0,07	0,00	0,02	0,05	0,01
Public services	0,02	0,01	0,02	0,02	0,03	0,02
Education	0,13	0,15	0,13	0,16	0,16	0,15
Medical care	0,11	0,36	0,11	0,18	0,31	0,17
Restaurants	0,12	0,39	0,12	0,18	0,45	0,17
Personal and household services	0,12	0,22	0,12	0,17	0,23	0,16
Total services	**0,21**	**1,45**	**0,15**	**0,65**	**1,43**	**0,65**

Source: Cystat.

Table C.8 **Balance of payments**
(€ million)

	2008			2009 (prov.)		
	Credit	Debit	Net	Credit	Debit	Net
CURRENT ACCOUNT	**10.920,6**	**13.828,0**	**-2.907,4**	**9.639,2**	**10.958,0**	**-1.318,8**
GOODS, SERVICES AND INCOME	**10.267,9**	**13.132,0**	**-2.864,2**	**9.167,4**	**10.302,0**	**-1.134,6**
GOODS AND SERVICES	**7.720,6**	**9.623,7**	**-1.903,2**	**6.721,3**	**7.591,3**	**-870,0**
GOODS	**1.194,8**	**6.714,0**	**-5.519,2**	**995,2**	**5.226,7**	**-4.231,5**
SERVICES	**6.525,8**	**2.909,7**	**3.616,0**	**5.726,1**	**2.364,6**	**3.361,5**
Transport	1.768,9	1.100,4	668,5	1.544,9	900,0	644,9
Travel	1.861,8	1.051,4	810,4	1.550,4	906,1	644,3
Communications services	70,5	100,7	-30,1	78,4	69,1	9,2
Construction services	103,6	15,0	88,6	39,1	9,3	29,8
Insurance services	122,8	45,4	77,4	71,4	33,5	37,9
Financial services	836,7	148,9	687,8	800,2	77,8	722,4
Computer and information services	144,6	19,5	125,0	70,7	17,7	53,0
Royalties and licence fees	8,2	31,9	-23,7	8,6	29,2	-20,5
Other business services	1.400,2	268,2	1.132,0	1.388,0	235,1	1.152,9
Personal, cultural and recreational services	35,7	51,0	-15,3	26,1	31,9	-5,8
Government services, n.i.e.	173,0	77,4	95,6	148,4	54,9	93,4
Services not allocated	0,0	0,0	0,0	0,0	0,0	0,0
INCOME	**2.547,4**	**3.508,4**	**-961,0**	**2.446,1**	**2.710,7**	**-264,7**
Compensation of employees	59,7	260,9	-201,2	28,7	163,0	-134,3
Investment income	2.487,7	3.247,5	-759,8	2.417,4	2.547,8	-130,3
Direct investment income	486,7	1.685,5	-1.198,8	460,2	1.264,3	-804,1
Portfolio investment income	865,4	704,0	161,4	836,2	593,5	242,7
Other investment income	1.135,6	858,0	277,6	1.121,0	690,0	431,0
CURRENT TRANSFERS	**652,7**	**695,9**	**-43,2**	**471,8**	**656,0**	**-184,2**
General government	124,6	208,4	-83,8	131,1	224,2	-93,1
Other sectors	528,1	487,5	40,6	340,7	431,8	-91,1
CAPITAL AND FINANCIAL ACCOUNT			**2.843,6**			**1.413,8**
Capital account	54,4	48,6	5,8	102,6	41,8	60,8
Financial account			2.837,8			1.353,0
Direct investment			-228,9			998,1
Abroad			-2.034,2			-1.874,7
In Cyprus			1.805,3			2.872,8
Portfolio investment			-12.483,4			-11.393,2
Assets			-11.836,8			-1.348,7
Liabilities			-646,6			-44,5
Financial derivatives			-94,7			302,2
Other investment			15.353,8			11.353,5
Assets			-7.230,7			-6.177,7
Liabilities			22.584,5			17.531,2
Official reserve assets			291,1			92,3
Net errors and omissions			**63,8**			**-94,9**

Source: CBC.

Table C.9 **Trade account**

(€ million unless otherwise indicated)

	2008	2009	% change	2009 Jan.-Aug.	2010 Jan.-Aug.	% change
Imports	7.366,7	5.654,4	-23,2	3.728,7	4.135,3	10,9
Consumer goods	2.047,5	1.927,6	-5,9	1.257,3	1.269,1	0,9
Intermediate inputs	2.129,9	1.563,5	-26,6	1.017,0	1.126,1	10,7
Capital goods	664,6	597,7	-10,1	440,3	387,7	-12,0
Transport equipment	1.047,8	0,561	-99,9	364,4	534,1	46,5
Fuels and lubricants	1.450,0	0,996	-99,9	644,0	807,2	25,3
Exports	1.190,4	963,2	-19,1	578,5	709,0	22,6
Trade deficit	6.176,3	4.691,2	-24,0	3.150,2	3.426,3	8,8

Source: Cystat.

Table C.10 **Direct investment in Cyprus by non-residents**

(€ million)

NACE Code	Economic activity	Net capital flows 1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008**	2009**
595	AGRICULTURE AND FISHING	-0,3	0,3	*	0,2	0,2	0,0	0,0	0,0	0,0	-0,1	-0,1	0,0	0,0
1495	MINING AND QUARRYING	0,1	4,1	8,9	2,8	2,1	2,1	4,7	50,3	19,9	0,4	2,1	1,0	0,0
3995	MANUFACTURING	7,5	-5,2	6,0	14,3	5,6	37,8	-9,2	53,2	30,4	79,6	15,4	9,9	3,1
4195	ELECTRICITY, GAS AND WATER	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	2,0	0,5
4500	CONSTRUCTION	3,2	3,7	*	6,6	-6,3	13,6	29,8	58,9	68,3	47,9	52,2	40,6	14,5
5295	TRADE AND REPAIRS	125,1	130,2	132,4	210,7	256,1	217,8	101,1	277,3	177,2	262,5	371,3	401,1	976,1
5500	HOTELS AND RESTAURANTS	1,3	-0,6	0,4	2,3	21,3	8,3	1,9	*	*	5,7	10,6	9,1	5,8
6495	TRANSPORT AND COMMUNICATION	0,7	2,4	7,2	9,6	-0,2	44,6	119,1	*	*	-21,6	55,6	164,5	53,6
6895	FINANCIAL INTERMEDIATION	184,5	42,0	394,5	431,8	444,3	173,6	140,0	122,1	0,8	279,8	316,5	1.331,2	2.395,7
7395	REAL ESTATE AND BUSINESS ACTIVITIES	140,0	108,6	172,6	218,3	278,9	523,3	338,1	205,8	356,0	485,2	801,6	802,6	648,3
9995	OTHER SERVICES	17,9	20,1	30,9	12,6	35,8	67,8	40,0	75,8	269,6	322,4	1,1	3,1	24,8
9996	NOT ALLOCATED	0,0	0,0	0,0	0,0	0,0	14,7	24,4	15,3	0,0	0,0	0,0	-0,6	-0,8
9999	**TOTAL**	**479,9**	**305,6**	**754,3**	**909,1**	**1.037,8**	**1.103,6**	**789,8**	**873,0**	**940,5**	**1.461,9**	**1.626,4**	**2.764,8**	**4.121,5**

Geographical / economic zone		Net capital flows 1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008**	2009**
E1	EUROPEAN COUNTRIES	397,2	252,5	637,0	771,4	873,3	955,1	667,5	764,5	909,4	861,0	1.553,1	2.354,1	3.743,7
D2	EU-16	195,4	*	209,1	392,9	414,0	418,1	511,7	477,4	501,3	443,1	945,0	541,2	1.607,9
D3	EU-27	231,6	223,2	219,1	458,4	455,2	444,1	588,4	604,3	534,0	492,2	972,1	1.185,4	1.970,7
E4	AFRICA	15,3	19,0	19,1	16,2	20,8	25,3	25,9	*	*	*	-0,9	59,3	19,6
E7	AMERICA	33,1	*	75,2	82,6	82,3	*	30,3	*	-9,4	192,4	5,0	199,0	219,4
F2	ASIA	34,7	31,1	24,7	39,7	63,0	86,6	*	14,8	34,2	413,3	69,2	152,4	138,1
F7	OCEANIA	-0,4	*	-1,7	-0,8	-1,7	*	*	-1,2	*	*	0,0	0,1	0,8
Z8	Extra EU-16 not allocated	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	-0,1	0,0	0,0	0,0
A1	**WORLD (ALL ENTITIES)**	**479,9**	**305,6**	**754,3**	**909,1**	**1.037,8**	**1.103,6**	**789,8**	**873,0**	**940,5**	**1.461,9**	**1.626,4**	**2.764,8**	**4.121,5**

Source: CBC.

* In order that the confidentiality of the data is ensured, amounts which relate to a small number of transactions are not presented on their own but are included at a higher level of aggregation.

** 2008 data include brass plates (any legal form which has been incorporated or registered in Cyprus, but without physical presence in Cyprus.

For the conversion of Cyprus pounds into euro, the irrevocable exchange rate of €1 = £0,585274 was used.

Table C.11 **Direct investment abroad**

(€ million)

NACE Code	Economic activity	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008**	2009**
		Net capital flows												
595	AGRICULTURE AND FISHING	0,0	*	*	-2,6	*	-0,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0
1495	MINING AND QUARRYING	0,0	0,0	0,0	0,0	-0,9	0,0	0,0	0,0	0,1	0,0	0,0	0,0	0,0
3995	MANUFACTURING	0,6	-2,6	-3,8	-7,1	-7,1	-4,6	-15,5	-58,9	-39,5	41,3	-2,1	-0,6	-2,5
4195	ELECTRICITY, GAS AND WATER	*	0,0	0,0	*	*	-1,4	0,0	-0,1	0,0	0,0	0,0	0,4	-1,2
4500	CONSTRUCTION	-1,0	-1,2	-1,2	-4,2	*	-69,5	-75,0	*	-196,8	*	-49,4	-100,0	-31,2
5295	TRADE AND REPAIRS	-1,8	-0,6	-2,7	-9,1	-7,9	-5,3	-32,6	-37,3	176,9	-30,2	-22,9	-88,0	-271,8
5500	HOTELS AND RESTAURANTS	*	*	-2,3	-18,2	-62,9	-16,3	-88,1	*	*	*	-22,4	-18,7	-9,0
6495	TRANSPORT AND COMMUNICATION	0,0	-8,7	-39,6	-22,2	-13,5	-21,3	-18,4	-12,0	3,8	-10,0	-54,5	-0,4	-46,9
6895	FINANCIAL INTERMEDIATION	-18,8	-47,5	-116,2	-98,4	-160,9	-112,1	-94,6	-122,4	42,5	-430,9	-348,1	-2.239,1	-2.980,8
7395	REAL ESTATE AND BUSINESS ACTIVITIES	-4,3	-1,5	-2,5	-18,1	-12,7	-299,6	-132,4	-137,4	-415,8	-180,3	-406,8	-379,6	-285,2
9995	OTHER SERVICES	*	*	*	*	-3,9	-0,8	-10,7	-0,7	*	114,2	-0,1	-1,8	-7,8
9996	NOT ALLOCATED	0,0	0,0	0,0	0,0	0,0	-9,3	-39,5	-8,9	0,0	0,0	0,0	0,0	0,0
9999	**TOTAL**	**-24,5**	**-62,6**	**-169,4**	**-183,0**	**-274,3**	**-540,6**	**-506,8**	**-555,4**	**-442,4**	**-707,2**	**-906,3**	**-2.827,7**	**-3.636,4**

Geographical / economic zone		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008**	2009**
		Net capital flows												
E1	EUROPEAN COUNTRIES	-20,6	-44,6	-115,0	-139,2	-234,8	-441,4	-412,0	-475,6	-301,9	-375,8	-842,1	-1.781,5	-2.231,4
D2	EU-16	-19,8	-36,2	-104,4	-114,4	-221,9	-188,0	-319,4	-319,7	-127,1	-68,8	-494,5	72,0	-363,2
D3	EU-27	-20,0	-36,0	-104,6	-116,1	-223,6	-429,0	-339,0	-359,2	-138,7	-34,7	-516,3	-8,9	-1.771,7
E4	AFRICA	*	-0,6	-30,0	-7,6	*	-26,4	-35,4	*	*	-213,4	-0,8	-77,8	-148,3
E7	AMERICA	-1,1	*	*	-2,4	*	*	-16,9	-6,5	*	*	-5,4	-563,0	-949,1
F2	ASIA	-1,2	-16,0	-21,4	-0,6	-3,9	*	-41,1	*	*	*	-51,8	-193,8	-273,7
F7	OCEANIA	*	*	*	-33,2	-32,9	-3,4	-1,4	-11,2	-4,8	-8,6	-5,8	-41,1	-33,9
Z8	Extra EU-16 not allocated	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	-0,4	-0,1	0,0
A1	**WORLD (ALL ENTITIES)**	**-24,5**	**-62,6**	**-169,4**	**-183,0**	**-274,3**	**-540,6**	**-506,8**	**-555,4**	**-442,4**	**-707,2**	**-906,3**	**-2.657,4**	**-3.636,4**

Source: CBC.

* In order to ensure confidentiality of the data, amounts which relate to a small number of transactions are not presented on their own but are included at a higher level of aggregation.

** 2008 data include brass plates (any legal form which has been incorporated or registered in Cyprus, but without a physical presence in Cyprus. For the conversion of Cyprus pounds into euro, the irrevocable exchange rate of €1 = £0,585274 was used.

Table C.12 **Annual international investment position including brass plates: 2009 (provisional)**
(€ million)

	ASSETS	LIABILITIES	BALANCE
FINANCIAL ACCOUNT			**3.446,3**
Direct Investment			**-5.287,4**
Abroad			**11.559,4**
Equity capital and reinvested earnings			6.766,2
MFIs (excluding central banks)			700,7
Other sectors			6.065,5
Other Capital			4.793,2
MFIs (excluding central banks)			0,5
Other sectors			4.792,7
In the reporting country			**16.846,8**
Equity capital and reinvested earnings			13.169,8
MFIs (excluding central banks)			1.927,4
Other sectors			11.242,5
Other capital			3.677,0
MFIs (excluding central banks)			13,8
Other sectors			3.663,2
Portfolio Investment	**39.752,6**	**9.667,6**	**30.085,0**
Equity securities	**2.241,7**	**1.369,7**	
Monetary authorities	0,0		
General government	0,0		
MFIs (excluding central banks)	1,6	233,0	
Other sectors	2.240,1	1.136,7	
Debt securities	37.510,9	8.297,9	
Bonds and notes	**37.377,7**	**7.491,4**	
Monetary authorities	2.743,2	0,0	
General government	0,0	2.550,0	
MFIs (excluding central banks)	33.184,2	4.525,8	
Other sectors	1.450,4	415,6	
Money market instruments	**133,2**	**806,5**	
Monetary authorities	0,0	0,0	
General government	0,0	625,6	
MFIs (excluding central banks)	99,4	135,9	
Other sectors	33,8	45,0	
Financial Derivatives	**356,8**	**740,4**	**-383,6**
Monetary authorities	0,0	0,0	0,0
General government	0,0	0,0	0,0
MFIs (excluding central banks)	352,8	738,4	-385,6
Other sectors	4,0	2,0	2,0
Other Investment	**47.249,1**	**69.112,3**	**-21.863,1**
Monetary authorities	**245,3**	**344,1**	
Loans/currency and deposits	245,3	344,1	
Other assets/liabilities	0,0	0,0	
General government	**130,0**	**807,6**	
Trade credits	124,0	0,0	
Loans/currency and deposits	0,0	807,6	
Other assets/liabilities	6,0	0,0	
MFIs (excluding central banks)	**40.644,7**	**66.750,1**	
Loans/currency and deposits	40.644,7	66.750,1	
Other assets/liabilities	0,0	0,0	
Other sectors	**6.229,1**	**1.210,5**	
Trade credits	99,6	31,9	
Loans/currency and deposits	6.129,5	1.178,6	
Other assets/liabilities	0,0	0,0	
Reserve assets	**895,4**		

Source: CBC.
2008 data include brass plates (any legal form which has been incorporated or registered in Cyprus, but without a physical presence in Cyprus),
For the conversion of Cyprus pounds into euro, the irrevocable exchange rate of €1 = £0,585274 was used.

Table C.13 **Tourist arrivals and receipts from tourism**

		Tourist arrivals			Receipts from tourism		
		Number of	% change			% change	
Year	Month	tourists	Previous year	Cumulative period	€ (million)	Previous year	Cumulative period
2006	January	54.875	-6,8	-6,8	36,2	2,4	2,4
	February	66.151	-8,9	-8,0	39,4	-1,7	0,2
	March	107.071	-21,9	-15,1	66,5	-18,3	-9,4
	April	206.548	12,5	-3,9	127,2	20,2	2,5
	May	283.513	-0,2	-2,5	191,1	6,1	4,0
	June	280.164	-0,9	-2,0	201,1	3,8	3,9
	July	341.443	0,7	-1,3	264,9	10,6	5,8
	August	314.872	-6,5	-2,4	264,8	-3,9	3,5
	September	296.532	-2,1	-2,3	240,8	2,2	3,2
	October	283.046	-3,2	-2,4	209,9	2,0	3,1
	November	95.682	-8,7	-2,7	64,3	-12,7	2,4
	December	71.022	-6,1	-2,8	49,1	-5,2	2,2
2007	January	51.848	-5,5	-5,5	33,6	-7,1	-7,1
	February	63.098	-4,6	-5,0	38,5	-2,2	-4,6
	March	104.316	-2,6	-3,9	68,5	3,1	-1,0
	April	189.310	-8,3	-6,0	123,7	-2,8	-1,8
	May	273.058	-3,7	-5,1	204,6	7,1	1,9
	June	282.465	0,8	-3,4	207,4	3,2	2,3
	July	352.423	3,2	-1,7	287,3	8,5	4,0
	August	340.534	8,1	0,1	306,0	15,5	6,6
	September	315.437	6,4	1,1	263,0	9,3	7,0
	October	275.103	-2,8	0,6	206,3	-1,7	5,9
	November	94.741	-1,0	0,5	67,8	5,5	5,9
	December	73.742	3,8	0,6	51,4	4,5	5,9
2008	January	50.658	-2,3	-2,3	35,3	4,9	4,9
	February	70.140	11,2	5,1	40,6	5,5	5,2
	March	108.164	3,7	4,4	67,3	-1,7	1,8
	April	182.091	-3,8	0,6	107,8	-12,8	-5,0
	May	271.599	-0,5	0,1	191,3	-6,5	-5,7
	June	307.237	8,8	2,7	229,6	10,7	-0,7
	July	342.554	-2,8	1,2	272,9	-5,0	-2,0
	August	328.100	-3,7	0,2	278,0	-9,1	-3,7
	September	305.348	-3,2	-0,3	247,4	-5,9	-4,1
	October	267.866	-2,6	-0,6	198,6	-3,7	-4,0
	November	97.900	3,3	-0,5	72,4	6,8	-3,6
	December	72.127	-2,2	-0,5	51,6	0,5	-3,5
2009	January	47.066	-7,1	-7,1	31,2	-11,6	-11,6
	February	56.626	-19,3	-14,2	36,3	-10,7	-11,1
	March	90.434	-16,4	-15,2	57,4	-14,7	-12,8
	April	181.395	-0,4	-8,6	107,4	-0,3	-7,5
	May	246.546	-9,2	-8,9	158,1	-17,4	-11,7
	June	260.931	-15,1	-10,8	175,4	-23,6	-15,8
	July	304.126	-11,2	-10,9	232,5	-14,8	-15,5
	August	291.583	-11,1	-11,0	234,8	-15,5	-15,5
	September	276.178	-9,6	-10,7	200,2	-19,1	-16,1
	October	230.431	-14,0	-11,1	156,3	-21,3	-16,7
	November	89.670	-8,4	-11,0	61,0	-15,7	-16,7
	December	66.201	-8,2	-10,9	42,7	-17,2	-16,7
2010	January	45.952	-2,4	-2,4	29,7	-4,8	-4,8
	February	55.250	-2,4	-2,4	33,9	-6,6	-5,8
	March	103.803	14,8	5,6	65,6	14,3	3,4
	April	139.658	-23,0	-8,2	89,0	-17,1	-6,1
	May	258.014	4,7	-3,1	164,8	4,2	-1,9
	June	275.280	5,5	-0,6	195,3	11,3	2,2
	July	306.106	0,7	-0,3	231,1	-0,6	1,4
	August	304.264	4,3	0,7	241,1	2,7	1,7
	September	289.126	4,7	1,3	220,5	10,1	3,1
	October	241.698	4,9	1,7	n/a	n/a	n/a

Source: Cystat.

Table C.14 **Gross domestic product by category of expenditure at constant 2005 prices: chain linking method**
(€ million)

Year / Q		Gross domestic product	General govenment consumption	Private consumption	Gross capital formation	Exports of goods and services	Imports of goods and services
1996	Q1	2.299,3	313,9	1.591,4	719,2	828,2	1.153,4
	Q2	2.530,7	371,7	1.461,5	709,8	1.210,5	1.222,9
	Q3	2.454,4	399,8	1.419,1	384,5	1.409,9	1.158,9
	Q4	2.424,7	605,6	1.648,1	251,5	1.165,7	1.246,2
1997	Q1	2.340,5	373,1	1.631,7	577,2	841,2	1.082,7
	Q2	2.521,4	422,9	1.513,6	648,8	1.219,8	1.283,8
	Q3	2.562,4	435,0	1.415,4	434,9	1.541,0	1.263,9
	Q4	2.508,1	610,6	1.695,9	220,2	1.174,6	1.193,2
1998	Q1	2.420,7	436,1	1.751,7	511,0	889,9	1.168,0
	Q2	2.683,9	423,2	1.553,6	648,5	1.265,4	1.206,8
	Q3	2.698,2	462,9	1.490,9	467,5	1.542,0	1.265,0
	Q4	2.626,9	593,5	1.817,5	324,3	1.167,5	1.275,9
1999	Q1	2.529,6	461,0	1.829,9	446,9	893,9	1.102,0
	Q2	2.815,6	476,1	1.604,6	684,1	1.358,2	1.307,4
	Q3	2.816,9	480,5	1.509,8	374,1	1.740,1	1.287,5
	Q4	2.771,5	665,2	1.862,8	317,7	1.307,2	1.381,5
2000	Q1	2.678,8	421,4	1.937,8	526,3	1.030,5	1.237,2
	Q2	2.978,6	429,0	1.709,1	792,8	1.517,4	1.469,7
	Q3	2.953,3	482,0	1.609,1	418,3	1.890,1	1.446,2
	Q4	2.871,9	645,4	2.000,7	372,9	1.415,3	1.562,4
2001	Q1	2.773,6	460,6	2.145,7	437,8	1.090,5	1.360,9
	Q2	3.083,3	494,7	1.817,9	698,8	1.682,6	1.610,6
	Q3	3.109,4	527,9	1.526,5	655,1	2.005,3	1.605,3
	Q4	2.978,0	708,2	2.092,0	184,5	1.433,5	1.440,2
2002	Q1	2.840,0	516,0	2.096,5	590,4	998,5	1.361,3
	Q2	3.164,6	537,6	1.846,3	766,5	1.589,8	1.575,7
	Q3	3.124,7	569,7	1.666,0	546,5	1.886,2	1.543,7
	Q4	3.065,8	719,2	2.069,2	370,5	1.433,7	1.526,8
2003	Q1	2.886,2	542,9	2.092,0	705,1	911,6	1.365,4
	Q2	3.203,9	553,7	1.931,8	782,9	1.401,5	1.466,0
	Q3	3.189,1	565,1	1.691,3	525,9	1.979,2	1.572,4
	Q4	3.150,6	822,4	2.127,2	200,9	1.588,3	1.588,1
2004	Q1	2.994,0	507,3	2.187,3	572,1	1.207,8	1.480,5
	Q2	3.347,4	560,3	1.994,2	839,4	1.612,6	1.659,1
	Q3	3.324,3	572,1	1.890,2	592,4	1.930,3	1.660,6
	Q4	3.289,6	708,1	2.279,4	656,7	1.452,0	1.806,6
2005	Q1	3.127,9	509,5	2.308,9	673,4	1.238,1	1.602,0
	Q2	3.463,9	560,1	2.119,4	679,4	1.708,6	1.603,5
	Q3	3.451,6	522,3	1.921,4	677,8	2.058,9	1.728,8
	Q4	3.418,8	835,2	2.349,2	651,3	1.499,2	1.916,2
2006	Q1	3.246,3	570,0	2.401,2	674,2	1.353,9	1.753,1
	Q2	3.624,1	624,9	2.204,9	804,8	1.804,1	1.814,6
	Q3	3.592,3	599,4	2.034,3	590,3	2.214,3	1.846,0
	Q4	3.554,6	811,0	2.463,1	816,8	1.362,2	1.898,5
2007	Q1	3.414,2	576,2	2.569,0	788,4	1.337,2	1.856,5
	Q2	3.797,7	568,7	2.375,4	1.125,9	1.740,7	2.013,0
	Q3	3.774,7	615,3	2.206,9	720,7	2.394,0	2.162,3
	Q4	3.750,1	853,6	2.804,6	671,3	1.672,8	2.252,2
2008	Q1	3.580,7	574,6	2.812,9	966,6	1.361,1	2.134,5
	Q2	3.955,5	596,2	2.609,7	1.173,2	1.792,3	2.215,9
	Q3	3.899,8	754,3	2.503,7	952,0	2.222,7	2.532,9
	Q4	3.834,0	850,2	2.867,6	554,4	1.622,0	2.060,1
2009	Q1	3.602,4	635,4	2.822,4	547,7	1.345,6	1.748,7
	Q2	3.885,5	640,1	2.634,0	871,1	1.506,5	1.766,2
	Q3	3.793,3	767,3	2.396,9	667,1	1.850,4	1.888,4
	Q4	3.723,0	892,4	2.615,3	519,9	1.467,3	1.771,9
2010	Q1	3.555,4	622,9	2.699,7	627,5	1.312,0	1.706,7
	Q2	3.905,0	620,6	2.652,7	912,2	1.478,7	1.759,1

Source: Cystat.

Table C.15 **Gross domestic product by category of expenditure at current prices**
(€ million)

Year / Q		Gross domestic product	General govenment consumption	Private consumption	Gross capital formation	Exports of goods and services	Imports of goods and services
1996	Q1	1.708,4	208,4	1.222,3	545,8	680,0	948,1
	Q2	1.955,6	248,8	1.194,4	539,7	989,6	1.017,0
	Q3	1.899,6	271,7	1.177,6	276,9	1.148,6	975,2
	Q4	1.885,5	414,7	1.318,0	246,8	963,8	1.057,8
1997	Q1	1.779,7	262,3	1.279,2	461,2	707,5	930,5
	Q2	1.991,7	299,4	1.254,7	521,5	1.027,9	1.111,8
	Q3	2.032,9	313,1	1.200,1	313,3	1.308,4	1.102,0
	Q4	2.006,2	440,6	1.384,2	216,4	1.004,3	1.039,3
1998	Q1	1.895,5	317,0	1.400,0	417,9	772,4	1.011,8
	Q2	2.185,0	308,6	1.315,1	525,6	1.091,5	1.055,9
	Q3	2.210,4	338,6	1.284,3	360,4	1.331,0	1.103,9
	Q4	2.154,3	435,2	1.506,2	316,2	1.010,0	1.113,4
1999	Q1	2.037,2	343,5	1.493,6	384,5	780,1	964,6
	Q2	2.341,6	358,6	1.376,4	569,0	1.195,1	1.157,5
	Q3	2.354,2	362,1	1.319,4	286,0	1.541,3	1.154,6
	Q4	2.329,5	510,3	1.597,3	303,7	1.173,4	1.255,2
2000	Q1	2.232,4	328,9	1.639,4	463,2	946,5	1.145,5
	Q2	2.569,1	338,7	1.532,9	665,8	1.413,7	1.382,0
	Q3	2.558,4	389,9	1.463,8	308,4	1.768,2	1.371,8
	Q4	2.523,4	525,8	1.769,3	374,1	1.342,8	1.488,5
2001	Q1	2.395,2	382,4	1.859,7	396,2	1.048,0	1.291,1
	Q2	2.776,4	411,7	1.659,8	621,1	1.618,0	1.534,1
	Q3	2.781,4	438,1	1.420,5	539,2	1.913,7	1.530,1
	Q4	2.674,8	586,6	1.902,8	189,8	1.370,4	1.374,8
2002	Q1	2.490,6	434,0	1.858,7	541,4	956,2	1.299,6
	Q2	2.830,0	452,5	1.712,6	671,3	1.504,5	1.511,0
	Q3	2.828,0	486,5	1.586,0	462,9	1.771,7	1.479,1
	Q4	2.830,7	623,8	1.936,8	384,2	1.340,0	1.454,0
2003	Q1	2.658,1	493,8	1.954,8	648,5	854,0	1.293,0
	Q2	3.046,3	511,4	1.867,3	744,3	1.307,2	1.383,9
	Q3	3.036,2	533,9	1.646,4	484,2	1.857,5	1.485,8
	Q4	3.020,4	783,4	2.069,8	168,9	1.505,3	1.507,0
2004	Q1	2.858,7	483,2	2.082,5	538,6	1.158,4	1.403,9
	Q2	3.257,0	535,4	1.948,9	792,7	1.564,6	1.584,6
	Q3	3.269,4	549,4	1.856,9	575,4	1.891,6	1.603,9
	Q4	3.268,7	687,2	2.268,4	646,0	1.431,8	1.764,6
2005	Q1	3.073,6	506,9	2.257,8	653,5	1.229,4	1.573,9
	Q2	3.451,5	559,6	2.121,6	666,9	1.702,8	1.599,4
	Q3	3.464,9	522,0	1.937,1	681,4	2.057,6	1.733,2
	Q4	3.472,4	838,7	2.382,4	680,2	1.515,0	1.943,9
2006	Q1	3.277,2	586,2	2.397,8	689,2	1.382,9	1.778,9
	Q2	3.718,8	641,2	2.252,8	834,7	1.846,9	1.856,8
	Q3	3.718,8	618,4	2.099,5	609,4	2.278,8	1.887,2
	Q4	3.720,3	836,9	2.547,7	862,8	1.421,0	1.948,1
2007	Q1	3.577,4	606,1	2.632,8	832,5	1.405,1	1.899,1
	Q2	4.070,9	600,6	2.510,3	1.199,0	1.841,7	2.080,7
	Q3	4.116,7	652,3	2.375,2	777,7	2.555,8	2.244,2
	Q4	4.114,3	905,6	3.027,9	752,2	1.810,0	2.381,5
2008	Q1	3.967,1	634,4	3.029,2	1.092,7	1.498,0	2.287,1
	Q2	4.458,4	658,4	2.910,9	1.323,0	1.979,6	2.413,5
	Q3	4.454,7	845,7	2.833,8	1.080,2	2.456,0	2.761,0
	Q4	4.367,4	953,4	3.207,5	659,8	1.786,8	2.240,1
2009	Q1	4.011,8	734,3	3.085,2	599,4	1.465,9	1.872,9
	Q2	4.392,1	744,8	2.948,9	952,3	1.634,0	1.887,9
	Q3	4.282,0	877,0	2.673,1	747,3	1.991,1	2.006,4
	Q4	4.260,3	1.008,3	2.942,6	617,8	1.578,9	1.887,3
2010	Q1	3.983,1	725,6	3.004,0	692,1	1.435,4	1.873,9
	Q2	4.428,8	719,5	3.010,3	1.027,3	1.637,1	1.965,4

Source: Cystat.

Table C.16 Turnover volume index of retail trade

Year /	Month	Volume	6-month moving average	% Change: Previous year	% Change: 6-month moving average
2007	January	100,7	111,9	4,9	7,2
	February	95,1	109,9	7,6	7,3
	March	108,4	109,8	11,6	7,8
	April	106,9	109,6	5,1	7,3
	May	111,8	110,4	6,9	7,3
	June	118,4	106,9	9,9	7,7
	July	124,9	110,9	7,4	8,1
	August	118,3	114,8	10,1	8,5
	September	115,6	116,0	6,0	7,6
	October	117,5	117,8	8,8	8,2
	November	119,8	119,1	12,3	9,1
	December	154,8	125,2	10,8	9,3
2008	January	108,3	122,4	7,8	9,4
	February	108,5	120,9	14,7	10,0
	March	109,8	120,0	1,7	9,3
	April	118,3	120,2	10,9	9,7
	May	122,8	120,8	10,2	9,3
	June	121,2	115,2	2,4	7,7
	July	136,2	119,8	9,0	8,0
	August	120,8	121,7	1,9	6,0
	September	124,4	124,1	7,7	7,0
	October	120,7	124,5	3,0	5,7
	November	112,8	122,8	-5,5	3,1
	December	153,6	128,3	-0,3	2,5
2009	January	111,2	124,1	2,2	1,4
	February	102,9	121,1	-6,0	0,2
	March	103,4	117,5	-6,4	-2,1
	April	115,8	116,6	-2,6	-3,0
	May	114,2	116,8	-7,4	-3,3
	June	117,7	110,7	-2,9	-3,9
	July	132,7	114,2	-2,8	-4,6
	August	116,6	116,5	-3,6	-4,2
	September	116,7	118,8	-6,4	-4,3
	October	116,4	118,9	-3,8	-4,5
	November	108,3	118,0	-4,2	-3,9
	December	148,7	123,2	-3,6	-4,0
2010	January**	104,1	118,5	-6,4	-4,4
	February**	98,3	115,4	-4,5	-4,6
	March **	115,2	115,2	11,4	-1,9
	April**	107,9	113,8	-6,8	-2,5
	May**	113,7	114,7	-0,4	-1,9
	June**	119,1	109,7	1,2	-1,0
	July**	135,6	115,0	2,2	0,5
	August*	118,5	118,3	1,6	1,4

Percentage change by category	August 2009/2008	August * 2010/2009	Jan.-Aug. 2009/2008	Jan.-Aug.* 2010/2009
General index	**-3,5**	**1,6**	**-3,3**	**-0,2**
General index excluding automotive fuel	**-4,4**	**1,5**	**-4,0**	**-0,2**
Non-specialised stores with food, beverages or tobacco predominating	0,7	3,0	-0,8	5,9
Other retail sale in non-specialised stores	-2,6	-7,5	0,6	-3,1
Food, beverages and tobacco in specialised stores	0,8	-9,4	-6,7	2,3
Food products	0,8	1,1	-1,7	5,3
Non food products (except automotive fuel)	-6,9	1,6	-5,1	-3,0
Textiles, clothing and footwear	11,6	-3,6	4,5	0,3
Electrical goods and furniture	-8,1	7,6	-11,9	-4,3
Computer equipment, books and other	-15,4	9,6	-9,0	-3,0
Automotive fuel in specialised stores	4,6	3,2	2,1	-0,5

Source: Cystat.
* Provisional.
** Revised data.

Table C.17 **Construction indicators**

		Sales of cement (volume)			Building permits authorised (volume)		
			% change			% change	
		Total	Previous	6-month	Area	Previous	6-month
Year /	Month	(m. ton)	year	moving average	(sq.m.)	year	moving average
2006	January	112.257	-7,20	0,40	280.754	4,75	12,25
	February	127.234	0,52	-0,67	265.808	-6,97	4,73
	March	149.825	-0,58	-0,06	331.444	0,19	8,07
	April	118.938	-19,04	-3,30	251.063	-0,38	4,54
	May	154.815	15,80	-1,44	380.135	31,46	6,05
	June	146.826	2,13	-1,55	309.252	4,11	5,55
	July	157.298	16,03	2,12	296.102	15,97	7,23
	August	73.669	-3,15	1,87	199.623	-9,79	7,41
	September	145.224	3,67	2,67	253.311	-4,23	6,97
	October	150.045	10,09	8,16	331.638	0,79	6,86
	November	156.958	7,34	6,69	333.853	-0,85	1,17
	December	134.066	1,69	6,68	274.504	-4,46	-0,30
2007	January	132.561	18,09	6,70	263.912	-6,00	-3,65
	February	130.638	2,68	7,00	299.455	12,66	-0,42
	March	174.292	16,33	9,32	388.979	17,36	3,35
	April	137.205	15,36	10,10	324.503	29,25	7,54
	May	160.929	3,95	9,41	333.002	-12,40	4,89
	June	165.444	12,68	11,26	304.133	-1,66	5,25
	July	174.989	11,25	10,36	339.730	14,73	8,51
	August	78.961	7,18	11,29	192.004	-3,82	6,49
	September	148.393	2,18	8,68	288.517	13,90	5,47
	October	176.722	17,78	9,37	318.083	-4,09	0,31
	November	177.170	12,88	11,04	275.785	-17,39	-0,32
	December	133.152	-0,68	8,83	284.703	3,72	0,58
2008	January	156.587	18,12	9,90	249.822	-5,34	-2,89
	February	173.499	32,81	13,66	299.159	-0,10	-2,31
	March	175.963	0,96	13,04	295.942	-23,92	-8,92
	April	164.519	19,91	13,30	296.211	-8,72	-9,74
	May	179.007	11,23	13,00	293.231	-11,94	-8,77
	June	172.650	4,36	13,45	312.757	2,84	-8,72
	July	200.922	14,82	13,04	329.337	-3,06	-8,20
	August	69.945	-11,42	7,98	188.451	-1,85	-8,84
	September	168.055	13,25	10,30	339.160	17,55	-1,28
	October	178.855	1,21	7,07	374.647	17,78	3,50
	November	164.606	-7,09	3,62	382.457	38,68	12,14
	December	135.678	1,90	3,22	327.935	15,18	14,31
2009	January	120.871	-22,81	-3,79	278.876	11,63	17,57
	February	122.367	-29,47	-7,78	273.892	-8,45	15,20
	March	123.823	-29,63	-14,79	255.578	-13,64	9,86
	April	117.392	-28,65	-20,00	234.397	-20,87	3,03
	May	132.204	-26,15	-23,44	254.844	-13,09	-5,44
	June	137.449	-20,39	-26,23	359.744	15,02	-5,14
	July	151.742	-24,48	-26,40	295.814	-10,18	-8,35
	August	48.329	-30,90	-26,18	176.594	-6,29	-7,55
	September	126.657	-24,63	-25,27	276.027	-18,61	-9,71
	October	128.881	-27,94	-25,19	203.278	-45,74	-16,01
	November	122.260	-25,73	-25,10	263.849	-31,01	-18,59
	December	107.190	-21,00	-25,38	263.566	-19,63	-18,84
2010	January	84.111	-30,41	-26,32	228.827	-17,95	-22,60
	February	99.354	-18,81	-24,93	335.783	22,60	-24,22
	March	135.848	9,71	-19,92	317.003	24,03	-14,51
	April	99.749	-15,03	-17,36	244.383	4,26	-9,22
	May	120.199	-9,08	-14,07	270.480	6,14	1,45
	June	130.944	-4,73	-11,13	254.982	-29,12	-0,96
	July	139.952	-7,77	-7,51	241.035	-18,52	-3,11
	August	49.809	3,06	-4,84	145.686	-17,50	-2,24
	September	118.607	-6,36	-7,64	n/a	n/a	n/a

Source: Cystat.

Table C.18 **Volume index of manufacturing production**

Year /	Month	Index Monthly	Index Cumulative	% Change Previous Year	% Change 6-month moving average	% Change Cumulative period
2008	January	97,10	97,10	7,29	5,24	7,29
	February	100,90	99,00	11,49	7,24	9,39
	March	106,70	101,57	0,00	6,94	5,91
	April	107,80	103,13	12,29	7,95	7,51
	May	118,80	106,26	5,51	7,17	7,05
	June	117,20	108,08	3,17	6,33	6,33
	July	127,80	110,90	6,95	6,31	6,43
	August	71,20	105,94	-4,43	4,27	5,42
	September	114,80	106,92	6,10	5,32	5,50
	October	114,60	107,69	2,50	3,78	5,18
	November	111,70	108,05	-0,98	2,64	4,57
	December	113,10	108,48	2,63	2,54	4,39
2009	January	113,10	108,48	2,63	2,54	4,39
	February	88,10	87,60	-9,27	-0,18	-9,78
	March	91,70	89,90	-9,12	-1,09	-9,19
	April	94,90	91,57	-11,06	-3,97	-9,85
	May	93,90	92,15	-12,89	-6,62	-10,64
	June	101,30	93,98	-14,73	-9,12	-11,56
	July	105,20	95,85	-10,24	-11,32	-11,32
	August	115,20	98,61	-9,86	-11,34	-11,08
	September	62,90	94,15	-11,66	-11,72	-11,13
	October	102,10	95,03	-11,06	-11,71	-11,12
	November	99,20	95,45	-13,44	-11,82	-11,37
	December	100,20	95,88	-10,30	-11,03	-11,27
2010	January *	81,10	81,10	-7,95	-11,28	-7,95
	February *	83,90	82,50	-8,51	-10,84	-8,23
	March *	100,50	88,50	5,90	-8,21	-3,35
	April*	87,90	88,35	-6,39	-6,91	-4,12
	May*	99,30	90,54	-1,97	-5,40	-3,66
	June*	104,10	92,80	-1,05	-3,18	-3,18
	July*	107,70	94,93	-6,51	-3,12	-3,74
	August*	63,40	90,99	0,79	-1,83	-3,36

Percentage change by category	August 2009/2008	August 2010/2009	Jan.-Aug. 2009/2008	Jan.-Aug. 2010/2009
General index	**-11,7**	**0,8**	**-11,1**	**-3,4**
Manufacture of food products, beverages and tobacco products	-4,9	0,4	-5,1	-0,7
Manufacture of textiles, wearing apparel and leather products	-13,2	-13,4	-15,5	-20,6
Manufacture of wood and products of wood and cork, except furniture	-4,5	-29,0	-6,2	-17,3
Manufacture of paper products and printing	-26,7	41,8	-16,3	26,7
Manufacture of refined petroleum products, chemicals and chemical products and pharmaceutical products and preparations	0,8	26,0	1,9	12,5
Manufacture of rubber and plastic products	-18,8	-0,8	-11,0	-6,3
Manufacture of other non-metallic mineral products	-28,0	-5,4	-22,7	-12,4
Manufacture of basic metals and facricated metal products	-18,2	-15,1	-14,6	-8,0
Manufacture of electronic and optical products and electrical equipment	-20,4	26,0	-7,0	31,3
Manufacture of machinery	-17,0	-16,0	-11,0	-22,9
Manufacture of motor vehicle and other transport equipment	-5,2	-0,8	-11,2	-9,4
Manufacture of furniture, other manufacturing and repair and installation of machinery and equipment	-23,8	-15,3	-20,6	-15,4

Source: Cystat.
* Revised data.

Table C.19 **Labour market indicators based on the Labour Force Survey (LFS)**

	2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2
Labour force	**394.996**	**403.780**	**404.040**	**407.542**	**409.499**	**414.288**
Employed	**376.807**	**382.899**	**382.085**	**383.268**	**379.881**	**387.909**
By type of employment:						
Full time	345.388	350.613	350.202	350.240	344.315	352.515
Part time	31.420	32.287	31.883	33.028	35.566	35.394
By sector of employment:						
Primary sector	14.805	14.719	15.368	15.186	13.773	14.858
Secondary sector	86.660	82.963	84.446	83.661	78.787	79.043
Tertiary sector	276.342	285.217	282.271	284.421	287.321	294.008
Employees	301.420	306.243	305.369	306.834	306.192	314.416
Unemployed	**18.189**	**20.881**	**21.956**	**24.273**	**29.618**	**26.379**
By unemployment duration:						
Less than 12 months	15.916	19.067	20.185	21.285	24.629	21.557
12 months and above	2.274	1.814	1.769	2.987	4.989	4.823
Activity rate (%)	**63,6**	**64,4**	**64,5**	**64,9**	**64,8**	**65,0**
Male	71,7	72,8	73,1	73,1	72,2	72,7
Female	55,8	56,4	56,4	57,1	57,7	57,8
Employment rate (%)	**60,6**	**61,1**	**61,0**	**61,1**	**60,1**	**60,9**
Male	68,7	69,2	69,2	68,7	67,0	68,3
Female	53,0	53,4	53,3	53,8	53,5	53,9
Unemployment rate (%)	**4,6**	**5,2**	**5,4**	**6,0**	**7,2**	**6,4**
Male	4,1	4,9	5,4	6,1	7,2	6,1
Female	5,2	5,5	5,5	5,7	7,3	6,7

Source: Cystat.

Table C.20 **Public debt**

(€ million)

	2007	2008				2009				2010		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
A. Domestic debt	12.945,12	12.905,66	12.508,01	12.434,67	12.595,05	14.191,93	15.054,87	15.123,64	12.922,91	13.173,94	13.214,60	12.946,18
Long-term debt	6.928,11	6.723,41	6.280,79	6.020,29	5.992,60	5.964,87	5.673,27	5.605,03	5.542,69	5.291,75	5.183,55	10.831,87
Short-term debt	6.017,01	6.182,25	6.227,21	6.414,38	6.602,46	8.227,06	9.381,60	9.518,61	7.380,22	7.882,19	8.031,05	2.114,31
B. Foreign debt	2.132,33	2.131,90	2.117,67	2.209,10	2.354,17	1.992,07	3.785,41	3.633,46	3.984,47	4.619,71	4.863,95	4.811,18
Short-term liabilities of the CBC to the IMF	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Long-term loans	732,33	731,90	717,67	714,95	827,74	827,29	803,28	800,54	808,88	808,52	782,73	794,64
Medium-term loans (EMTN)	1.400,00	1.400,00	1.400,00	1.050,00	1.050,00	1.050,00	2.550,00	2.550,00	2.550,00	3.550,00	3.550,00	3.550,00
Short-term loans (ECP)	0,00	0,00	0,00	444,15	476,43	114,79	432,13	282,92	625,59	261,19	531,22	466,54
C. Total public debt	15.077,45	15.037,56	14.625,68	14.643,77	14.949,22	16.184,00	18.840,28	18.757,10	16.907,38	17.793,65	18.078,55	17.757,36
D. Net total debt (excl. intragovermental borrowing & short-term liabilities of the CBC to the IMF)	9.261,52	8.854,49	8.397,65	8.228,57	8.345,95	9.356,12	11.857,86	11.637,67	9.819,85	10.701,03	10.839,71	10.449,06

Source: Ministry of Finance.

Table C.21 **Structural indicators of the Cyprus banking sector[1]**
(end of year, non-consolidated data)

	2006			2007			2008			2009		
	CY	**MU13**	**EU27**	**CY**	**MU13**	**EU27**	**CY**	**MU15**	**EU27**	**CY**	**MU16**	**EU27**
Number of credit institutions	336	6.157	8.507	215	6.128	8.354	163	6.569	8.090	155	6.458	8.358
Number of local units (branches)	941	181.499	228.648	921	183.981	233.800	923	186.363	238.021	930	179.916	229.532
Number of employees of CIs	10.845	2.250.316	3.257.921	11.286	2.276.562	3.315.549	12.554	2.305.578	3.331.329	12.513	1.041.856	2.007.336
Total assets of CIs (€ million)	76.623	24.962.298	34.291.278	92.897	28.312.864	41.123.104	118.142	30.566.597	42.217.558	139.372	29.921.272	42.143.710
Herfindahl index for CIs	1.056	630	592	1.089	654	596	1.019	687	665	1.086	663	632
Share of the 5 largest CIs in total assets	63.9	42.8	41.5	64.9	44.1	42.5	63.9	44.7	45.2	65	44.6	44.3
Loans of CIs to non-financial corporations (€ million)	12.349	3.857.454	4.893.314	16.046	4.388.718	5.582.082	22.058	4.826.951	5.960.945	23.338	4.692.298	5.786.003
Loans of CIs for housing purchase (€ million)	5.450	3.214.028	4.774.062	6.989	3.436.867	5.006.323	8.584	3.484.830	4.780.815	10.492	3.550.837	5.083.829
Loans of CIs for consumer credit (€ million)	2.848	588.802	877.477	3.118	617.856	914.629	4.261	632.850	883.593	4.770	632.338	889.898
Other household lending from CIs (€ million)	5.676	739.568	901.683	6.111	753.384	931.463	6.366	770.476	931.043	5.645	771.580	943.906
Total loans of CIs to non-CIs (€ million)	31.417	10.853.959	17.116.095	41.021	12.069.220	19.283.779	54.442	12.697.835	19.279.722	57.847	12.686.427	19.135.788
Total deposits of CIs from non-CIs (€ million)	43.099	8.978.515	12.007.694	52.516	9.969.039	16.672.571	56.008	10.799.707	16.742.519	58.154	11.000.234	16.887.947
Total assets under management by investment funds € million)	1.005	5.549.891	6.480.943	1.190	5.778.955	6.818.705	1.272	4.231.724	5.125.478	1.422	5.370.574	6.291.915
Number of branches of CIs from EU countries	4	473	654	9	501	709	8	559	767	9	568	766
Number of branches of CIs from third countries	17	88	204	16	95	216	15	114	215	16	109	206
Total assets of branches of CIs from EU countries (€ million)	733	963.127	3.128.295	5.088	1.248.250	3.812.300	4.135	1.274.081	3.318.795	1.122	1.211.278	3.237.410
Total assets of branches of CIs from third countries (€ million)	3.284	99.251	1.722.482	5.632	126.152	2.011.810	5.529	207.692	1.849.925	5.271	173.960	1.825.679
Number of subsidiaries of CIs from EU countries	8	351	538	7	346	529	8	351	515	8	351	495
Number of subsidiaries of CIs from third countries	1	159	260	1	169	278	1	174	289	1	177	284
Total assets of subsidiaries of CIs from EU countries (€ million)	18.533	3.026.041	4.097.662	18.562	3.675.067	4.732.306	35.362	3.602.783	4.711.594	45.522	3.752.643	5.060.437
Total assets of subsidiaries of CIs from third countries (€ million)	[2]	258.292	1.264.843	[2]	468.508	1.335.583	[2]	640.736	1.156.013	[2]	418.183	1.037.842
Population (thousand, end of period)	773	317.473	494.090	784	319.259	496.379	792	322.463	498.700	798	329.103	500.316
Gross domestic product at market price (€ million)	14.673	8.473.617	11.696.576	15.667	8.889.919	12.387.162	16.948	9.210.090	12.509.708	16.946	8.968.600	11.796.430

Sources: CBC, ECB.
(1) Includes the co-operative credit institutions.
(2) Where the number of subsidiaries is less than three, the underlying data is not disclosed for confidentiality reasons.

Table C.22 **Key aggregate indicators of the Cyprus banking sector**(1)
(aggregate cross-border and cross-sector consolidated data)

			Dec. 08	June 09	Dec. 09	June 10
1. Efficiency (%)	1.1	Cost-to-income ratio	48,69	48,36	51,52	50,85
2. Expenditure (% of total assets)	2.1	Staff expenses	0,80	0,74	0,75	0,76
	2.2	Other administrative expenses	0,44	0,35	0,39	0,38
	2.3	Depreciation	0,09	0,08	0,09	0,09
	2.4	Total operating expenses	1,33	1,18	1,23	1,22
3. Expenditure (% of total operating expenses)	3.1	Staff expenses	60,58	63,04	60,77	61,84
	3.2	Other administrative expenses	32,91	29,86	32,07	31,21
	3.3	Depreciation	6,51	7,10	7,16	6,95
4. Income (% of total assets)	4.1	Net interest income	1,90	1,65	1,68	1,80
	4.2	Net non-interest income	0,83	0,79	0,71	0,61
	4.3	Dividend income	0,03	0,01	0,01	0,02
	4.4	Net fees and commissions income	0,55	0,40	0,43	0,38
	4.5	Trading and foreign exchange results	0,18	0,32	0,23	0,19
	4.6	Realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss	0,02	0,15	0,12	0,12
	4.7	Gains (losses) on financial assets and liabilities held for trading, net	-0,03	0,03	0,03	0,01
	4.8	Gains (losses) on financial assets and liabilities designated at fair value through profit or loss (net)	-0,05	0,00	0,01	0,01
	4.9	Other net operating income	0,07	0,05	0,04	0,02
	4.10	Total operating income	2,73	2,44	2,39	2,40
5. Income (% of total income)	5.1	Net interest income	69,58	67,56	70,30	74,80
	5.2	Net non-interest income	30,42	32,44	29,70	25,20
	5.3	Dividend income	0,95	0,45	0,40	0,71
	5.4	Net fees and commissions income	20,25	16,55	17,99	15,78
	5.5	Trading and foreign exchange results	6,45	13,26	9,70	7,93
	5.6	Realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss (net)	0,82	6,21	4,90	4,92
	5.7	Gains (losses) on financial assets and liabilities held for trading, net	-1,14	1,27	1,26	0,22
	5.8	Gains (losses) on financial assets and liabilities designated at fair value through profit or loss (net)	-1,77	0,10	0,22	0,53
	5.9	Other net operating income	2,63	2,18	1,58	0,85
6. Profitability (%)	6.1	Operating profits per total assets	1,40	1,26	1,16	1,18
	6.2	Provisions per total assets	0,00	0,02	0,02	0,00
	6.3	Impairment per total assets	0,30	0,42	0,46	0,48
	6.4	Impairment on financial assets not measured at fair value through profit or loss per total assets	0,30	0,42	0,45	0,48
	6.5	Total profit (loss) before tax from continuing operations per total assets	1,10	0,83	0,70	0,71
	6.6	Total profit (loss) after tax and discontinued operations per total assets	0,96	0,74	0,59	0,62
	6.7	Total profit (loss) after tax and discontinued operations per total assets (ROA)	0,96	0,74	0,59	0,62
	6.8	Total profit (loss) after tax and discontinued operations per total equity (ROE)	14,99	13,39	10,46	10,69
	6.9	Net interest margin	1,83	1,74	1,76	1,84
7. Assets (% of total assets)	7.1	Financial assets held for trading	0,64	0,36	0,32	0,28
	7.2	Financial assets designated at fair value through profit or loss	0,68	0,66	0,74	0,61
	7.3	Available-for-sale financial assets	8,13	10,65	7,98	4,15
	7.4	Loans and receivables (including finance leases)	76,75	74,32	74,34	78,55
	7.5	Held-to-maturity investments	2,43	4,54	5,32	5,94
	7.6	Derivatives-hedge accounting	0,03	0,03	0,02	0,01
	7.7	Tangible and intangible assets	2,41	2,05	2,12	1,94
	7.8	Investments in associates, subsidiaries and joint ventures	0,25	0,25	0,27	0,53
	7.9	Total loans and advances	74,59	72,50	70,35	64,13
	7.10	Debt instruments	13,38	17,55	17,83	24,82
	7.11	Total equity instruments	0,41	0,35	0,42	0,39
8. Liabilities (% of total assets)	8.1	Deposits from central banks	4,22	7,61	7,24	7,38
	8.2	Financial liabilities held for trading	1,15	0,87	0,78	0,88
	8.3	Financial liabilities designated at fair value through profit and loss	2,79	2,32	2,25	1,83
	8.4	Financial liabilities measured at amortised cost	83,82	81,82	81,96	82,15
	8.5	Financial liabilities associated with transferred financial assets	0,00	0,00	0,00	0,00
	8.6	Derivatives-hedge accounting	0,20	0,24	0,25	0,39
	8.7	Provisions	0,46	0,42	0,44	0,41
	8.8	Total deposits from credit institutions	26,12	31,71	30,68	32,19
	8.9	Total deposits (other than from credit institutions)	57,81	50,19	50,86	49,96
	8.10	Total debt certificates (including bonds)	1,67	1,08	1,34	0,60

Table C.22 **Key aggregate indicators of the Cyprus banking sector[1] (continued)**
(aggregate cross-border and cross-sector consolidated data)

			Dec. 08	June 09	Dec. 09	June 10
9.	Value of equity (%)	9.1 Issued capital per total equity	23,88	22,36	22,28	21,07
		9.2 Revaluation reserves and other valuation differences per total equity	-6,85	-4,12	-4,05	-7,48
		9.3 Reserves (including retained earnings) per total equity	21,77	29,82	29,23	40,98
		9.4 Income from current year per total equity	14,46	6,32	8,92	4,99
		9.5 Minority interest per total equity	1,95	2,10	1,51	1,24
		9.6 Tangible equity per tangible total assets	4,36	4,09	4,42	4,34
10.	Off-balance-sheet items (% of total assets)	10.1 Loan commitments given	1,54	1,17	1,87	1,85
		10.2 Financial guarantees and other commitments given	2,61	2,05	2,03	1,88
		10.3 Financial guarantees and credit derivatives received	0,73	0,55	0,62	0,45
11.	Liquidity (% of total assets)	11.1 Cash and trading assets ratio	7,36	6,41	8,18	7,14
		11.2 Cash, trading and available-for-sale assets ratio	15,50	17,06	16,16	11,28
		11.3 Interbank market dependence ratio	26,12	31,71	30,68	32,19
		11.4 Funding base stability ratio (denominator other than total assets)	67,54	60,48	61,37	60,38
12.	Asset quality and provisioning (%)	12.1 Non-performing loans per total loans	4,55	5,49	5,94	6,59
		12.2 Loan loss provisions per total non-performing loans	70,68	62,23	60,98	58,48
13.	Capital adequacy (%)	13.1 Overall solvency ratio	10,99	12,41	12,11	11,98
		13.2 Tier 1 capital ratio	8,33	9,62	9,52	10,30
		13.3 Capital buffer	2,99	4,41	4,11	3,98

Source: CBC.
(1) Includes all domestically-controlled and foreign-controlled banks but excludes the co-operative credit institutions.

Table C.23 **Distribution of bank loans to Cyprus residents by economic activity based on the EU's NACE Rev.2 classification**
(monthly data, %)

		Outstanding amount as a % of total	
		June 2010	Sep. 2010
A	Agriculture, forestry and fishing	0,80	0,84
B	Mining and quarrying	1,62	1,53
C	Manufacturing	3,66	3,69
	of which: construction-related activities (16.1 to 16.2 and 23.3 to 23.7)	0,58	0,60
D	Electricity, gas, steam and air conditioning supply	0,46	0,50
E	Water supply, sewerage, waste management and remediation activities	0,43	0,38
F	Construction	10,67	10,99
G	Wholesale and retail trade; repair of motor vehicles and motorcycles	9,31	9,09
H	Transportation and storage	1,73	1,75
I	Accommodation and food service activities	4,41	4,33
J	Information and communication	0,74	0,69
K	Financial and insurance activities (excluding monetary intermediation)	7,01	6,73
L	Real estate activities	8,85	9,00
M	Professional, scientific and technical activities	3,25	3,20
N	Administrative and support service activities	0,58	0,65
O	Public administration and defence; compulsory social security	2,25	1,93
P	Education	0,30	0,31
Q	Human health and social work activities	0,54	0,55
R	Arts, entertainment and recreation	0,33	0,32
S	Other service activities	1,57	1,52
T	Private individuals	41,49	42,01
Total		**100,00**	**100,00**

Source: CBC.

Technical Notes

Section A

(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 of 2008). As a result, MFIs reclassified a large number of organisations or customers' businesses without a physical presence in Cyprus, known as "brass plates", from non-residents to residents. The effect of this change is excluded from the monetary and financial statistics series presented in Section A of this publication, which reports local data or residents excluding organisations and businesses without a physical presence in Cyprus. For purposes of normalisation and comparability of monetary time series, data have been further processed by the ERD of the CBC. 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 changes adjusted for reclassifications and revaluations, 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.

Monetary data are not adjusted for exchange rate fluctuations.

(B) Balance of Payments

The current statistical data collection and compilation system is based on the IMF methodology ("BPM5"), which has been adopted by the EU, and complies with additional requirements and level of detail specified by both Eurostat and the ECB.

As in the case of monetary data, the new residency definition was adopted on 1 July 2008 (definition of the term "resident of Cyprus" used in the Statistical Purposes Directive of 2008). As a result, a number of organisations and enterprises of any legal form incorporated or registered in Cyprus without maintaining a physical presence, are now considered as "residents of Cyprus".

The Statistics Department of the CBC also publishes data adjusted for transactions of entities without a physical presence in Cyprus (i.e. these entities are not considered "residents of Cyprus" in these figures). These data are used in the *Economic Bulletin* for the analysis of balance of payments.

More details on the data collection of compilation system of balance of payments data are available on the CBC website.

Section B

The monthly balance sheet submitted by the MFIs to the CBC covers the aggregated, non-consolidated figures of all credit institutions operating in Cyprus, including the co-operative credit institutions.

With respect to data derived from the monthly balance sheet submitted by the MFIs to the CBC, the calculation of annual percentage changes is based on the ECB methodology. Specifically, the growth of monetary aggregates is calculated based on monthly changes adjusted for reclassifications and revaluations to reflect changes due to net transactions. The above methodology has been adopted since the December 2009 *Bulletin*.

As a result of the change in the residency definition for statistical purposes in July 2008, MFI loans to NFCs without a physical presence Cyprus (known as "brass plates") are included in MFI loans to domestic NFCs.

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