



CENTRAL BANK OF CYPRUS
EUROSYSTEM

ECONOMIC BULLETIN

JUNE 2017

NICOSIA - CYPRUS

Published by:
ECONOMIC ANALYSIS AND RESEARCH

Edited by:
Publications Section, General Administration

© **CENTRAL BANK OF CYPRUS, 2017**

Address	80 Kennedy Ave 1076 Nicosia Cyprus
Postal Address	P.O. Box 25529 1395 Nicosia Cyprus
Telephone	+357 22714100
Website	http://www.centralbank.gov.cy

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

*All rights reserved.
Reproduction for educational and non-commercial purposes is permitted
provided that the source is acknowledged.*

ISSN (online) 1986 -1060



CENTRAL BANK OF CYPRUS
EUROSYSTEM

ECONOMIC BULLETIN

JUNE 2017

NICOSIA - CYPRUS



1

Introduction

2

Macroeconomic
Developments
and Projections

CONTENTS

Introduction	8
Macroeconomic Developments and Projections	10
1. International Environment: main developments	11
1.1 External developments	11
1.2 Monetary developments in the euro area	15
2. Domestic developments	18
2.1 Domestic Prices, Monetary Aggregates and MFI Interest Rates	18
2.2 Domestic Competitiveness and the Balance of Payments	26
2.3 Domestic Demand, Production and the Labour Market	31
2.4 Domestic Fiscal Developments	38
3. Macroeconomic Forecasts for the Cyprus Economy	44
Technical Notes	53

Note: The cut-off date for data in this *Bulletin* is 16 May 2017.

TABLES AND CHARTS

TABLES

A.1	Inflation in Cyprus (HICP)	18
A.2	Loans to domestic households	21
A.3	Summary of the April 2016 BLS results	22
A.4	Balance of Payments (main categories)	27
A.5	Tourism	30
A.6	Business and consumer surveys: confidence indicators	33
A.7	Real estate sector	34
A.8	Accounts of general government	44
A.9	HICP projections	45
A.10	National accounts projections in real terms	48

CHARTS

A.1	GDP in selected countries	12
A.2	Inflation in selected countries	13
A.3	Selected exchange rates against the euro	14
A.4	Closing prices of oil (Brent)	14
A.5	Official interest rates	15
A.6	Inflation in the euro area	15
A.7	ECB reference rates and EONIA	16
A.8	Loans to the private sector: euro area	17
A.9	Inflation in Cyprus (HICP)	18
A.10	Deposits of the domestic private sector	20
A.11	Deposits of non-residents: Cyprus	21
A.12	Loans to the domestic private sector	21
A.13	MFI interest rates on euro-denominated housing loans (new business) to euro area households	23
A.14	MFI interest rates on euro-denominated loans (new business) up to €1 million to euro area non-financial corporations	23
A.15	MFI interest rates on euro-denominated deposits (new business) by euro area households	23
A.16	MFI interest rates on euro-denominated deposits (new business) by euro area non-financial corporations	24
A.17	Nominal compensation per employee by sector	24
A.18	Productivity and real compensation per employee	25
A.19	Unit labour costs: Cyprus and the euro area	25

TABLES AND CHARTS

A.20	Real and nominal effective exchange rates (IMF weights)	26
A.21	Tourist arrivals and receipts	30
A.22	(a) Quarterly GDP growth (expenditure categories)	31
	(b) Quarterly GDP growth (expenditure categories)	31
A.23	Retail sales (excluding motor vehicles)	33
A.24	Registration of motor vehicles	33
A.25	Credit card spending	34
A.26	Lending criteria and interest rate on housing loans	35
A.27	House and apartment price indices	35
A.28	Unemployment and employment	36
A.29	Registered unemployment	37
A.30	Unemployment by duration	37
A.31	Budget and primary balances of the general government	38
A.32	Total revenue and expenditure of the general government	38
A.33	General government consolidated gross debt	44
A.34	Real GDP fan chart	51
A.35	HICP fan chart	51
A.36	HICP excluding energy fan chart	51

BOX

Box 1: European Fiscal Governance	39
-----------------------------------	----

ABBREVIATIONS

BLS	Bank Lending Survey	EU	European Union
BoE	Bank of England	Eurostat	Statistical Office of the European Union
BPM	Balance of Payments and International Investment Position Manual	FED	Federal Reserve
CA	Current Account	FOMC	Federal Open Market Committee
CBC	Central Bank of Cyprus	GDP	Gross Domestic Product
CCB	Cooperative Central Bank	HICP	Harmonised Index of Consumer Prices
CPI	Consumer Price Index		
CTO	Cyprus Tourism Organisation	IMF	International Monetary Fund
Cystat	Statistical Service of the Republic of Cyprus	LFS	Labour Force Survey
EBRD	European Bank for Reconstruction and Development	MFIs	Monetary Financial Institutions
ECB	European Central Bank	MoU	Memorandum of Understanding
EER	Effective Exchange Rate	NEER	Nominal Effective Exchange Rate
EIB	European Investment Bank	NFCs	Non-Financial Corporations
EONIA	Euro Overnight Index Average	NPLs	Non-Performing Loans
ESA	European System of Accounts	PNFS	Private Non-Financial Sector
ESI	Economic Sentiment Indicator	REER	Real Effective Exchange Rate
ESM	European Stability Mechanism	SDW	Statistical Data Warehouse
		SPEs	Special Purpose Entities
		UK	United Kingdom
		US	United States of America

Introduction

The economic recovery continued in 2017 at an accelerating and better than expected pace. The recovery is taking place in the context of an international environment that, although relatively positive, is still facing some uncertainty and geopolitical risks

According to provisional Cystat estimates, GDP growth recorded 3,3% in real, seasonally adjusted terms during 2017Q1, compared with the corresponding quarter of 2016. The increase in GDP growth is broadly based and mainly attributed to the hotels and restaurants, retail and wholesale trade, construction, and manufacturing sectors. The financial service activities sector recorded negative growth due to the ongoing delevering.

According to the CBC's revised June 2017 forecasts, real GDP in 2017 is expected to grow by 3,1%. GDP growth is projected to fluctuate around the same levels in 2018 and 2019, mainly reflecting robust private consumption and investment.

The labour market, has been affected positively by the aforementioned developments, albeit with a time lag. More specifically, the unemployment rate declined to 13% in 2016 compared with 14,9% in 2015, while further improvement is expected in 2017.

As regards prices, the harmonised measure of inflation began to reverse its negative path of the previous three years, reaching 2,1% in April 2017. Positive inflation is expected to be recorded in 2017, reaching about 1,2%, mainly due to the continued increase in domestic consumption and GDP, an expected small increase in wages and other external deve-

lopments, such as higher oil prices. Inflation excluding energy is expected to be contained at around 0,5% in 2017.

The significant increase in deposits, particularly from residents of Cyprus and domestic non-financial corporations, highlights the gradual return of depositor confidence in the Cypriot banking system. The annual rate of change in the deposits of the domestic private sector, excluding special purpose entities (SPEs), reached 6,8% in March 2017 compared with 2,8% in March 2016.

At the same time, loan restructurings have intensified, while a continuous reduction in the level of non-performing loans (NPLs) has been recorded since February 2015. Specifically, from February 2015 to January 2017 NPLs decreased by €4,2 billion to €23,7 billion. However, progress can be considered as below expectations given the pace of economic growth.

Another positive development is the gradual increase observed in both the demand for new loans by domestic households and businesses as well as the supply of loans by banks, driven mainly by the improving domestic macroeconomic conditions and historically low lending rates. At the same time, the rapid (is it really "fast" or "rapid?") deleveraging of existing domestic private sector loans continues. As a result, the annual growth rate of domestic private sector loans, excluding SPEs, fell from -0,1% in March 2016 to -0,7% in March 2017.

The overall picture prevailing in the economy up until mid-2017 is more positive compared to previous CBC forecast. The recovery needs to be safeguarded, both by

continuing with structural reforms and improving competitiveness throughout the economy as well as by intensifying the consolidation process in the banking sector. The major challenges facing the economy persist, despite progress in many areas. The high level of public and private debt, the high rate of unemployment and the high level of NPLs leave no room for complacency. Moreover, these problems are the main reason that sovereign bonds are still not rated as investment grade. However, the prospects are positive as long as the country remains committed in its effort without resort to populist policies, which could result in a setback.

Macroeconomic Developments and Projections



1

Introduction

2

Macroeconomic
Developments
and Projections

1. International Environment: main developments

- *Global economic activity continued its recovery in the first months of 2017.*
- *Risks to future global economic activity remain on the downside amid, inter alia, the uncertainty over the post-Brexit economic relations between the UK and the EU.*
- *Global inflation increased mainly due to higher oil prices.*
- *Euro area core inflation remained low with a gradual increase expected over the medium term.*
- *The Federal Reserve adjusted its monetary policy stance due to better macroeconomic conditions, particularly in the labour market. The other major central banks continued their expansionary monetary policy stance.*
- *The euro area continued recording positive credit growth during 2017Q1.*

1.1 External developments

GDP growth¹

Global economic activity has continued to improve steadily since 2016Q4. The main factors that contributed to the pick-up in global economic growth were the higher than expected growth of the US economy, and the improvement in international trade. Nevertheless, the risks to global economic activity over the medium term remain on the downside, mainly reflecting the further insta-

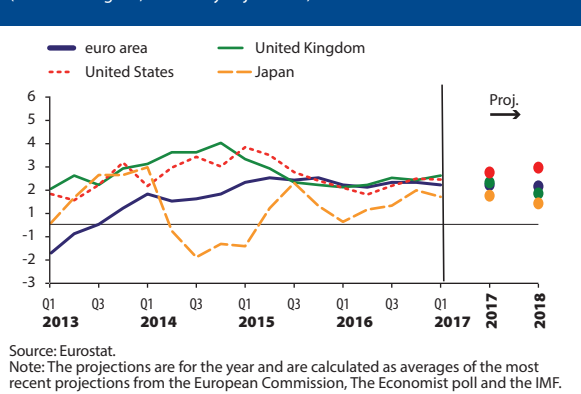
1. GDP projections are estimated as the average of the most recent projections from: The Economist Poll of Forecasters (6 May 2017), the European Commission (European Economic Forecasts, Spring 2017) and the IMF (World Economic Outlook, April 2017).

bility in the international economic and political environment and the possible intensification of terrorist attacks. In particular, the uncertainty surrounding the new US government policies, the gradual rebalancing of China's economy and the unknown future economic relations between the UK and the EU may deter world economic outlook.

In the US, GDP growth reached 1,9% in 2017Q1 compared with 1,6% in 2016Q1. Despite the uncertainty prevailing in the markets owing to recent political events, consumer confidence was positively impacted by the announcement of an upcoming fiscal stimulus, resulting in higher consumer spending and private investment. At the same time, the recovery in macroeconomic conditions, especially in the labour market, in conjunction with the continuous increase in inflation, has led the Federal Reserve to increase the US base rate. In particular, the base rate was increased twice, since December 2015. International organisations and analysts expect GDP growth rate to reach 2,2% in 2017 and 2,4% in 2018. (**Chart A.1**).

In the euro area, annual GDP growth remained unchanged in 2017Q1 stabilising at 1,7%. The main factors constraining the economy's growth dynamics are the increased pressure for further loan deleveraging and the need to reduce the high level of non-performing loans (NPLs). In addition, the recent political uncertainty in the euro area, with the most recent example being the presidential elections in France, increased financial market volatility. Projections by international organisations and analysts for GDP growth currently stand at 1,7% for 2017 and 1,6% for 2018.

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



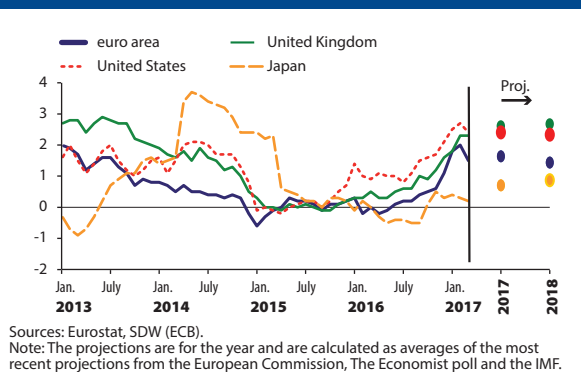
In contrast to the euro area, GDP growth rate in the UK accelerated and reached 2,1% during 2017Q1 compared with 1,6% in 2016Q1. UK economic activity was unexpectedly resilient despite the referendum in favour of the UK's exit from the EU. The main factor underlying the UK's GDP growth performance was private consumption. Looking ahead, the UK and global markets are expected to be negatively affected by the formal initiation of the exit negotiations at end-March 2017 and the uncertainty over the final outcome. As a result, the country's economic activity is expected to be contained to some extent, with projections by international organisations and analysts for GDP growth averaging at 1,8% for 2017 and 1,3% for 2018.

Inflation²

Global inflation continued recording moderate acceleration during the first months of 2017, mainly due to the increase in energy prices as a result of the rebound in oil prices (Chart A.2). On the other hand, core inflation remained at low levels. According to the projections of international organisations and analysts, inflation is expected to follow an upward trend in 2017 and 2018 compared with 2016 across all major economies (the euro area, the UK and the US) on the back of further expected recovery of the global economy as well as the positive momentum in global trade. However, the medium-term risks to inflation are still tilted to the downside in line with the risks to global economic activity.

2. Inflation projections are estimated as the average of the most recent projections from: The Economist Poll of Forecasters (06 May 2017), the European Commission (European Economic Forecast, Spring 2017) and the IMF (World Economic Outlook, April 2017).

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



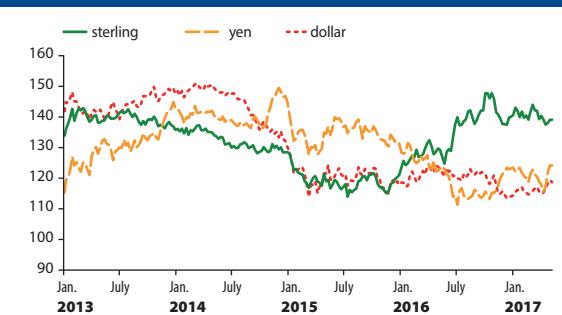
Exchange rates

The euro exchange rate recorded some fluctuations against major currencies during the reference period 30 December 2016 to 12 May 2017 (latest available data) (**Chart A.3**). Following the significant appreciation of the euro against sterling in 2016H2, a moderate slowdown of 0,7% was recorded during the period 30 December 2016 - 12 May 2017. The official initiation of the Brexit negotiations at the end of March 2017 seems to have been discounted by the markets immediately after the referendum result in June 2016. With respect to the dollar and yen, the euro exchange rate appears to have recovered during the reference period of 2017, strengthening by 3,9% and 0,8%, respectively, compared with a depreciation of 3,1% and 6,2% in 2016. In general, the appreciation of the euro against the major currencies largely reflects the decline in financial market fluctuations, especially after the elections in France.

Oil

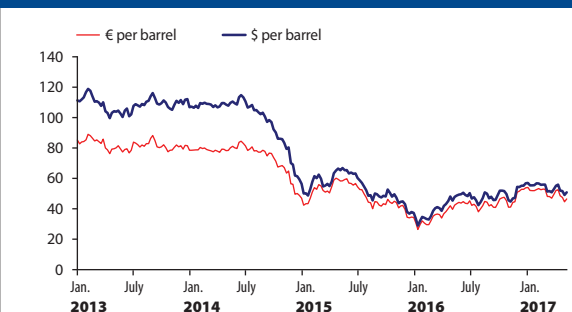
On average, the price of Brent crude oil recorded a moderate increase in early 2017 (**Chart 4**). This was mainly due to the reduction in oil production both by the members of OPEC and 11 non-member countries. However, compared with historical data, oil prices are still considered to be low. Analytically, the oil price increased to \$50,84 per barrel on 12 May 2017 (latest available data) compared with \$47,83 per barrel on 13 May 2016. Based on the oil futures price curve, the markets do not foresee significant changes in

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



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

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



Source: Bloomberg.

oil prices in the near future. As a result, the contribution of energy prices to global inflation is expected to be small.

International official interest rates

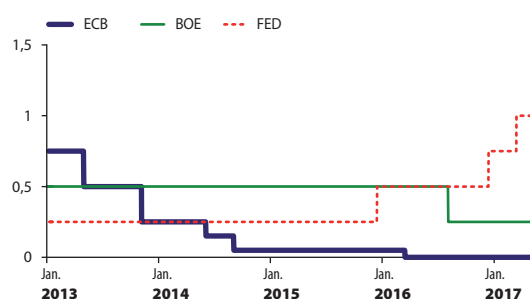
Most major central banks, with the exception of the Fed, continued their expansionary monetary policy in 2017, with the ECB and the Bank of England maintaining their key interest rates at 0% and 0,25%, respectively. In contrast, the Fed has increased its base rate twice since December 2015 by a total of 50 basis points (the upper rate was increased from 0,50% to 0,75% in December 2016 and to 1,00% in March 2017). The Fed's decision was mainly seen as a reaction to the increase of US inflation above the target of 2% (**Chart A.5**). It is worth mentioning that following the onset of the economic crisis in 2008, the US base rate lingered around very low levels, before being increased slightly for the first time at end-2015.

1.2 Monetary developments in the euro area

Inflation

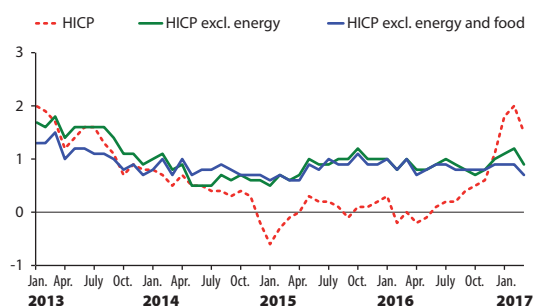
According to the latest available data, headline inflation (HICP) in the euro area stood at 1,5% in March 2017 compared with 2,0% in February 2017 (**Chart A.6**). The deceleration was mainly driven by smaller increases in both energy and unprocessed food prices. In general, the level of economic slack stemming from the current economic activity is

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



Sources: ECB, Fed, BoE.

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



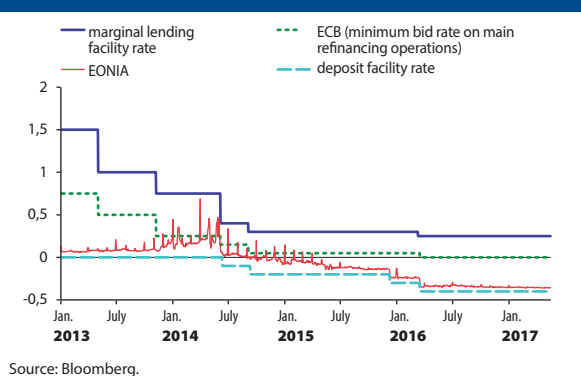
Source: Eurostat.

still hampering domestic wage and price formation. As a result, core inflation remains at low positive levels and it is expected to register a gradual increase only over the medium term, mainly supported by the ECB's expansionary monetary policy measures, the expected ongoing economic growth and the gradual absorption of the slack in the economy. Given the current energy futures price contracts, whereby no substantial change in oil prices is expected over the coming quarters, international organisations and analysts project euro area inflation to stabilise at around 1,6% in 2017. With regard to 2018, euro area inflation is expected to decelerate to 1,4%, mainly due to the elimination of the impact of increased oil prices.

Reference rates and ECB interventions

In 2017Q1 the ECB kept its main refinancing operations rate, marginal lending facility rate and deposit facility rate unchanged at 0,25%, 0% and -0,40%, respectively. The EONIA also remained broadly unchanged since the beginning of December 2016, indicating that markets do not expect further declines in the deposit facility rate (**Chart A.7**). More specifically, the EONIA remained, on average, unchanged in the past year, closing at -0,36% on 16 May 2017. The ECB has continued to support money markets through standard liquidity-providing operations and non-standard measures, in order to support the return of euro area inflation back to the medium-term target of below but close to 2%.

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



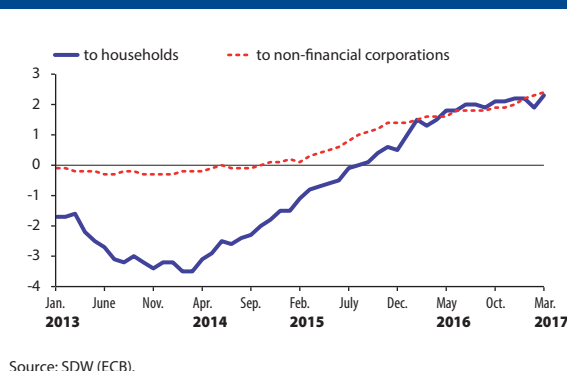
Credit expansion: loans

Loans to the euro area private sector have continued to record positive growth rates during the first months of 2017, attributed to both non-financial corporations (NFCs) and households (2,3% and 2,4% at the end of 2017Q1 respectively) (**Chart A.8**). This positive development mainly reflects the low lending rates prevailing in the euro area as well as the overall improvement in the supply and demand of loans. More specifically, according to the results of the euro area Bank Lending Survey (BLS), net loan demand has been increasing since 2014Q1. At the same time, credit standards for loans to the above mentioned sectors have eased since mid-2014.

Based on the same survey, the participating banks expect credit standards for loans to enterprises to tighten in 2017Q2 compared with 2017Q1, whereas credit standards for loans to households for housing and consumption and other lending purposes are expected to remain unchanged. Net loan demand by households and enterprises is expected to record a further increase in 2017Q2 compared with 2017Q1.

Despite the above positive monetary developments, the high level of NPLs in some member states continues to hinder credit growth dynamics in the euro area, with a subsequent negative impact on the euro area real economy.

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



2. Domestic developments

2.1 Domestic Prices, Monetary Aggregates and MFI Interest Rates

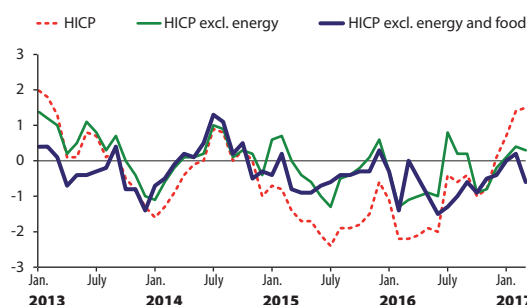
- Domestic headline inflation (HICP) returns to positive levels since December 2016, partly due to higher oil prices.
- Deposit inflows, especially from domestic residents, continue to grow, .
- The continuous deleveraging of existing loans outweigh the growth of new loan contracts.
- Interest rates stabilized at low levels.
- NPLs continue their gradual decrease since February 2015.
- GDP continued to grow on the back of increasing domestic demand and exports.
- Unemployment continued to decline albeit from still high levels.
- Fiscal improvements continued to overshoot targets.

Inflation

As from December 2016, domestic headline inflation (HICP) has been positive. Analytically, HICP inflation increased to 1,2% in 2017Q1 from -1,8% in 2016Q1 (Chart A.9 and Table A.1). Nevertheless, this level still falls short of the ECB's inflation target of below but close to 2%.

Based on the latest data available, HICP was up 2,1% in April 2017, largely due to the different timing of Easter in 2017 compared with 2016. More specifically, significant increases were recorded in the prices of services, particularly in the tourism sector. The increasing trend of headline

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



Source: Eurostat.

TABLE A.1 Inflation in Cyprus (HICP)

	Weights ⁽¹⁾	Annual percentage change				
		Jan.-Mar. 2016	Jan.-Mar. 2017	Mar. 2016	Feb. 2017	Mar. 2017
		2016	2017	2016	2017	2017
HICP	1.000,0	-1,8	1,2	-2,1	1,4	1,5
Unprocessed food	73,0	-4,4	6,2	-8,7	7,3	9,4
Processed food	177,2	-0,7	-0,6	-2,1	-1,8	0,5
Energy	74,3	-12,6	13,3	-14,4	14,9	17,1
Services	462,5	-0,9	0,1	-0,5	0,3	-0,4
Non-energy industrial goods	213,0	0,5	-0,6	1,2	0,1	-1,1
HICP excluding energy	925,7	-0,9	0,3	-1,1	0,4	0,3
HICP excluding energy and food	675,6	-0,5	-0,1	0,0	0,2	-0,6

Source: Cystat.

(1) Based on the weight for 2017.

inflation reflects the continuing robust domestic economic growth and the ongoing significant increases in energy prices. At the same time, it also mirrors the diminishing effect of falling labour costs on domestic prices over the past few years and the implementation of structural changes, such as the liberalisation of air transport. These downward effects continue to contain both headline and core inflation in Cyprus albeit to a lesser degree. During the period under review, positive inflation was recorded in the categories of unprocessed food and energy mainly due to the significant increase in oil prices. Furthermore, there was a reversal in inflation for services, which registered a very small positive year-on-year growth rate, as a result of the ongoing increases in the prices of the major tourism related categories. On the other hand, processed food and non-energy industrial goods prices registered negative growth rates in the period under review.

Inflation excluding energy increased to 0,3% in 2017Q1 from -0,3% in 2016Q1 (**Chart A.9** and **Table A.1, p. 18**). Excluding food and energy, core inflation, with a share of about 68% of the overall HICP, stood at -0,1% in 2017Q1 compared with -0,5% in 2016Q1 (**Chart A.9** and **Table A.1, p. 18**). The lower downward trend in core inflation mainly reflects the positive impact of domestic economic growth. It should be noted that core inflation is important, as it shows the general price trends excluding the impact of exogenous and volatile factors.

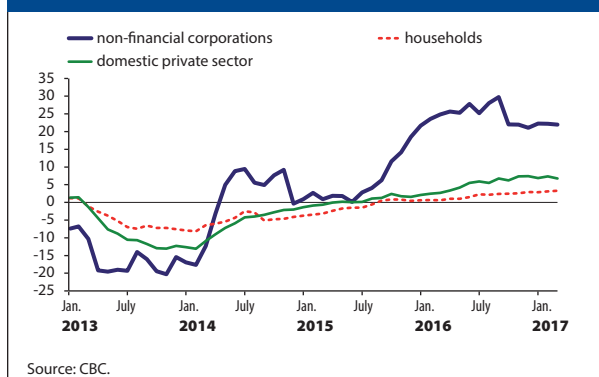
Monetary Aggregates^{3,4}

The gradual improvement in the domestic financial sector aggregates continued in 2017Q1. Despite slight fluctuations, the inflow of deposits underlines the ongoing gradual stabilisation of the domestic banking system and the return of depositors' confidence. At the same time, the gradual increase in new loan contracts to both households and NFCs continued, as historically low interest rates and the growth of the economy have led to an increase in the demand for new loans. The deleveraging process continued in line with the gradual decrease in NPLs, although these remain high compared with other euro area countries. The efficient and timely management of the NPLs is the most important challenge of the banking sector and the domestic economy in general.

The continued inflow of deposits, albeit at a more moderate pace, is consistent with the recovery of depositors' confidence as well as the positive domestic macroeconomic developments. This has stemmed mainly from domestic residents (excluding SPEs). In particular, domestic private sector deposits recorded an annual growth of 6,8% in March 2017 compared with 7,4% in December 2016 and 2,8% in March 2016 (**Chart A.10**).

Non-residents' deposits also recorded a significant improvement returning to positive annual growth rates as from February 2016. Specifically, the annual growth of these deposits stood at 5% in March 2017 compared with

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



3. For a detailed explanation of the methodology and technical analysis of monetary aggregates, see the Technical Notes on p. 53.
4. Monetary aggregates presented in this section of the *Economic Bulletin* refer to domestic residents excluding SPEs. SPEs are included in the non-residents category.

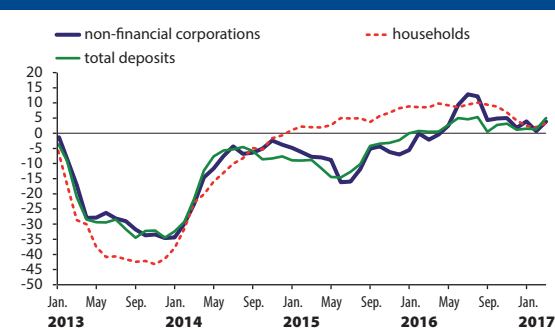
1,1% in December 2016 and 0,4% in March 2016 (Chart A.11).

The annual growth rate of loans to domestic non-financial corporations stood at -1,2% in March 2017 from -2,1% in December 2016 and 0,6% in March 2016 (Chart A.12). As regards the annual growth of loans by domestic households, it was marginally negative at -0,1% at the end of 2017Q1 compared with -1% at end 2016 and -0,9% at the end of 2016Q1 (Chart A.12 and Table A.2).

The negative growth in loans does not seem to be in line with the economy's pace of domestic growth. This can be attributed to the fact that the deleveraging of existing loans is outpacing the increase in new loan contracts, thus incorrectly implying that economic growth is not being supported by private sector financing. In reality, there has been a gradual continuous increase in new loan contracts since December 2014 (first available data), contributing to domestic economic growth. On a similar note, and according to the April 2017 Bank Lending Survey, net demand for housing, consumer credit and other lending as well as enterprise loans have continued increasing since early 2015. As regards credit standards applied by the banks, these remained unchanged in 2017Q1 for all loan categories, thus remaining at the same tightened levels of 2014Q4. According to the BLS, an increase in net demand for all loan categories is expected in 2017Q2, while credit standards are expected to remain unchanged (Table A.3, p. 22).

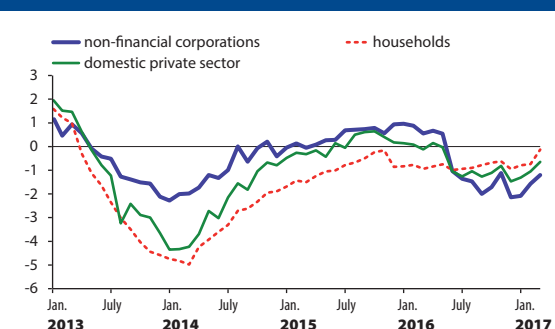
The tighter credit standards implemented following the crisis are largely a consequence of the high level of NPLs which weigh on the

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



Source: CBC.

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



Source: CBC.

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

	Outstanding balance as % of total ⁽³⁾	Annual percentage change					
		2015 Dec.	2016 Mar.	2016 June	2016 Sep.	2016 Dec.	2017 Mar.
Domestic households	100,0	-0,9	-0,9	-1,0	-0,8	-1,0	-0,1
1. Consumer credit	12,4	-0,8	-0,5	-0,8	-0,5	-1,2	-0,5
2. Lending for house purchase	55,3	-1,9	-1,7	-1,2	-0,9	-1,1	-0,7
3. Other lending	32,3	0,7	0,0	-0,7	-0,7	-0,7	1,0

Source: CBC.

(1) Sectoral classification is based on ESA 2010.

(2) Including non-profit institutions serving households.

(3) As at the end of the last month available. Figures may not add up due to rounding.

financial sector. High levels of NPLs interrupt not only the orderly functioning of the financial system but also general economic activity. However, it should be noted that NPLs have been declining since their peak at the beginning of 2015. Restructuring efforts are continuing intensively in cases where viable settlements are possible, with the support of the overall policy and legal framework in place. Analytically, NPLs fell by € 4,2 billion between February 2015 and January 2017 (latest available data). The downward trend in NPLs relates to increased repayments, successful loan restructurings reclassified as performing, loan write-offs and settlement of debt through swaps with immovable property. Despite the above, it should be noted that the decrease recorded thus far is below expectations given the current pace of economic growth.

In summary, the continuous efforts of the domestic banking sector to clean-up its balance sheet after the 2013 crisis seems to have had positive results. Improved monetary aggregates and the restoration of investors' confidence support both current economic growth as well as the growth prospects of the domestic economy. Having said that, significant challenges in the banking sector remain and pose a real risk to the future prospects of the economy. This underlines the need for more intensive efforts to address the challenge of high NPLs.

Interest rates

The interest rate environment in Cyprus recorded further mild reductions in 2017Q1. In

TABLE A.3 Summary of the April 2016 BLS results

Summary of results	Cyprus		Euro area	
	2017 Q1	2017 Q2 (expectations)	2017 Q1	2017 Q2 (expectations)
Credit standards for loans				
Enterprises	Unchanged	Unchanged	Easing	Easing
Households				
- Housing loans	Unchanged	Unchanged	Tightening	Tightening
- Consumer credit and other lending	Unchanged	Unchanged	Easing	Easing
Demand for loans				
Enterprises	Increase	Increase	Increase	Increase
Households				
- Housing loans	Increase	Increase	Increase	Increase
- Consumer credit and other lending	Increase	Increase	Increase	Increase

Sources: CBC, SDW.

Note: The above results list the changes that occurred in the last three months (in this case 2016Q1), and the changes that are expected for the next three months (i.e. 2016Q2). Recall that the measure used for the statistical analysis of this survey is the diffusion index.

general, the historically low domestic interest rates, coupled with favourable macroeconomic conditions, are supportive of the ongoing deleveraging efforts of the private sector as well as of the banks' efforts to clean-up their balance sheets. At the same time, they are conducive to the restructuring efforts of existing loans, both performing and non-performing.

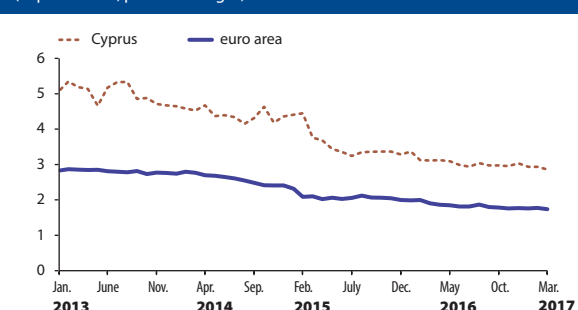
Breaking this down, the average interest rate on new euro-denominated loans⁵ from Cyprus MFIs to both households and NFCs, with an initial rate fixation of up to one year, recorded a marginally downward trend. Indicatively, the average interest rate for housing loans dropped to 2,86% in 2017Q1 from 3,11% in 2016Q1 (**Chart A.13**). Over the same period, the cost of new lending to NFCs for amounts up to €1 million decreased to 3,94% from 4,39% (**Chart A.14**).

Deposit rates recorded a similar trend. The average interest rate on new deposits for households with an agreed maturity of up to one year declined to 1,33% in 2017Q1 from 1,52% in 2016Q1 (**Chart A.15**). The corresponding interest rate for NFCs stabilised around 1,34% over the last year (**Chart A.16**, p. 24).

Despite the decline in domestic interest rates over recent years, Cyprus continues to maintain relatively higher interest rates than the rest of the euro area. Indicatively, the spread between the corresponding lending rates in 2017Q1 was 112 and 169 basis points for housing loans and NFC loans, respectively (**Charts A.13 and A.14**). The spread has remained around these levels since last year, as euro area interest rates followed a similar downward trend due to the continuation of the

CHART A.13 MFI interest rates on euro-denominated housing loans (new business) to euro area households⁽¹⁾

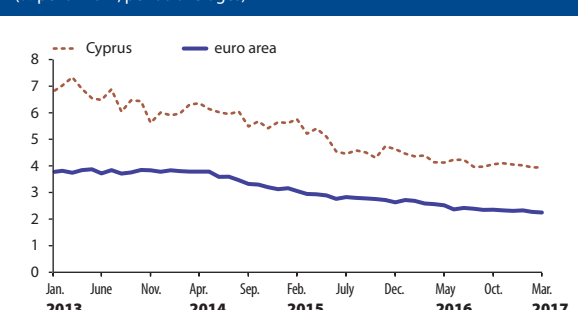
(% per annum, period averages)



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

CHART A.14 MFI interest rates on euro-denominated loans (new business) up to €1 million to euro area non-financial corporations⁽¹⁾

(% per annum, period averages)



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

CHART A.15 MFI interest rates on euro-denominated deposits (new business) by euro area households⁽¹⁾

(% per annum, period averages)



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

5. The interest rate level on new loans includes the interest rates applicable to loans that were performing but have been restructured.

ECB's expansionary monetary policy. As regards the deposit rate spreads between domestic and euro area rates in 2017Q1, these stood at 91 and 128 basis points for households and NFCs respectively (Charts A.15, p. 23 and A.16). Cyprus's higher deposit rates compared with the corresponding rates in the euro area, have helped to attract foreign deposit inflows to the domestic banking sector.

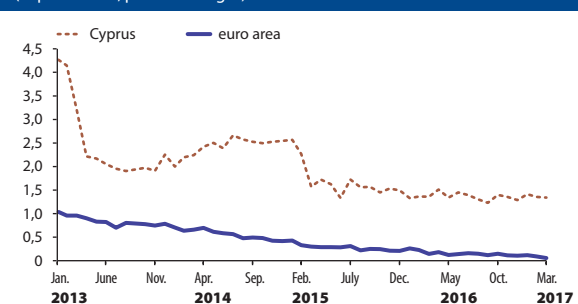
Looking ahead, domestic interest rates are not expected to record significant changes in the short term. This is in line with euro area developments and in accordance with the ECB's intention to continue its expansionary monetary policy for a long time, as announced at its Governing Council meeting on 27 April.

Labour costs

In 2016 labour costs continued to register declines for the fourth consecutive year (cumulative decrease of 10,5% for the period 2013-2016). Specifically, total nominal wages and social contributions per employee (compensation per employee) registered a drop of 0,6% in 2016, compared with a decrease of 1,1% in the previous year (Chart A.17). This development was due to the annual reduction of 1,6% recorded in compensation per employee in the public sector, which was partly offset by the annual growth of 0,1% recorded in the compensation per employee in specific subsectors of the private sector⁶. The reduction in the public sector was due to the drop in gratuity payments, despite the increase in average gratuity because of higher wage benefits in

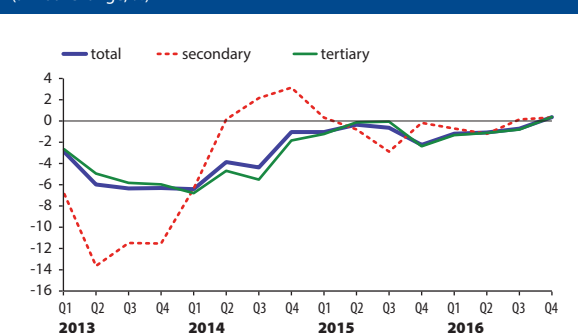
6. These sectors are those of financial and insurance activities and information and communication.

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



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

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



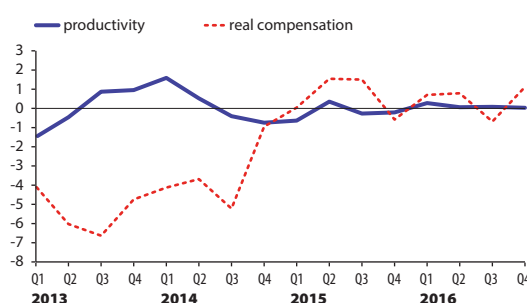
Sources: SDW (ECB), Cystat, CBC.

relation to 2015, as well as the continued freeze of wage and cost of living adjustments until the end of 2016. As regards the sectoral breakdown, the decline in nominal compensation per employee is mostly explained by developments in the tertiary sector. This sector accounts for about 82% of total employment, with the relevant compensation per employee registering a decline of 0,7% in 2016. An annual fall of 0,8% and 0,3% was observed in nominal compensation per employee in the primary and secondary sectors, respectively.

Despite the decline registered in nominal compensation per employees in 2016, due to the reduction in the general level of prices, real compensation per employee recorded an increase of 0,5%, similar to that recorded in 2015. Productivity, measured as the change in real GDP per person employed, registered an annual increase of 0,1% in 2016, compared with a 0,2% decrease in the previous year (**Chart A.18**).

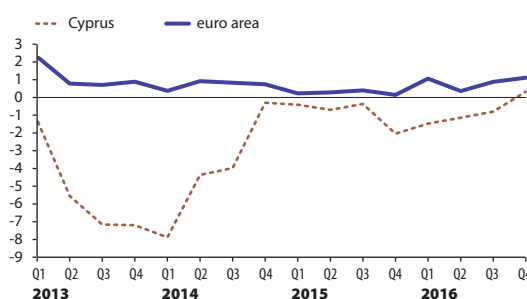
Unit labour costs, determined by the reduction in nominal compensation per employee and productivity change, recorded an annual decrease of 0,7% in 2016, compared with a decrease of 0,9% in 2015 (**Chart A.19**). In contrast, unit labour costs in the euro area recorded an increase of 0,9% in 2016, compared with an increase of 0,3% in 2015. Unit labour costs is an important indicator of competitiveness for an economy and reflects labour costs per unit of output. An examination of the unit labour costs index over time shows that it has been lower compared with the euro area since 2013, highlighting the improvement of the economy's competitive-

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



Sources: SDW (ECB), Cystat, CBC.

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



Source: SDW (ECB).

ness due to the significant reduction in nominal compensation per employee, with a consequent reduction in the prices of goods and services. In 2016 the index fluctuated considerably below that of the euro area.

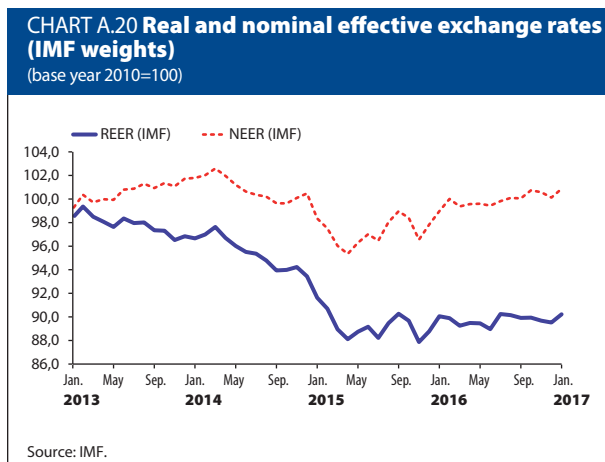
2.2 Domestic Competitiveness and the Balance of Payments

Effective exchange rate

Chart A.20 shows the effective exchange rate (EER) of the euro in Cyprus, in nominal (NEER) and real (REER⁷) terms, as calculated by the IMF. In 2016, the NEER index strengthened slightly, while the REER index stabilised at around the 2015 levels. Since the peak of the crisis in 2013, the REER index registered a remarkable improvement. Overall, in 2016 the trend of the REER index as well as the widening gap between the NEER and REER indexes was influenced by developments in the nominal value of the euro and by domestic developments, specifically the lower inflation recorded in Cyprus compared with its trading partners.

The REER index, the inflation rate and unit labour costs are important measures of the competitiveness of an economy. Lower unit labour costs and a lower REER in Cyprus compared with competing countries, suggest that domestic exports tend to be more price competitive. In general, inflation is related to both variables mentioned above and therefore also reflects the degree of competitiveness of the Cyprus economy. The adoption of measures affecting salaries and other benefits

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



both in the public and private sectors have reduced unit labour costs for the whole economy, thus improving competitiveness and supporting the recovery of the Cyprus economy in the medium term.

Balance of payments

The reporting of external trade statistics has been substantially altered in light of new methodological and statistical changes⁸. These statistics, especially for exports and imports of goods, are affected by the inclusion of the economic transfer of mobile transport equipment by Ship Owning Special Purpose Entities (SOSPE) registered in Cyprus. These transactions do not affect nor are affected by domestic developments.

The current account balance deteriorated in 2016, recording a deficit of €941,8 million (5,3% of GDP) compared with a deficit of €514 million (or 2,9% of GDP) in 2015 (Table A.4). However, excluding the transactions of SOSPE, the current account deficit recorded a significant improvement.

More analytically, the trade deficit of goods worsened, reaching €3.846,3 million in 2016 compared with a deficit of €3.167,2 million in the previous year (Table A.4). The widening of the trade deficit of goods is mainly due to the increase in imports of goods and to a lesser extent to the decrease in exports of goods. Excluding the transactions of SOSPE, the trade deficit of goods worsened marginally compared with the deficit recorded in 2015.

The surplus of the services account increased significantly and reached €3.846,7 million in 2016, compared with €3.226,2

TABLE A.4 Balance of Payments (main categories)
(€ million)

	2015	2016	Change
Current account balance	-514,0	-941,8	-427,8
Goods and services balance	59,0	0,4	-58,6
Trade balance	-3.167,2	-3.846,3	-679,1
Exports of goods	2.481,5	2.440,0	-41,5
Imports of goods	5.648,7	6.286,3	637,6
Services balance	3.226,2	3.846,7	620,5
Exports of services	8.315,6	8.867,5	551,9
of which:			
Transport	2.371,6	2.419,8	48,2
Travel	2.241,9	2.495,1	253,2
Insurance and pension services	23,9	67,0	43,1
Financial services	2.240,9	2.183,9	-57,0
Other business services	243,0	178,4	-64,6
Imports of services	5.089,4	5.020,8	-68,6
of which:			
Transport	1.382,7	1.458,0	75,3
Travel	960,2	1.073,1	112,9
Insurance and pension services	103,1	123,5	20,4
Financial services	785,7	784,1	-1,6
Other business services	657,7	408,3	-249,4
Primary income (net)	-62,5	-482,6	-420,1
Secondary income (net)	-510,6	-459,6	51,0

Source: CBC.

8. More information regarding the introduction of the ESA 2010 and BPM 6 statistical methods is provided in Box 1, p. 50 of the December 2014 *Economic Bulletin*.

million in 2015, mostly due to the increase in exports of services.

Exports of services increased by 6,6% (or €551,9 million) in 2016, mainly reflecting developments in telecommunications, computer and information services as well as travel. Revenues from tourism, which are included in the travel category, recorded a significant increase of 11,9% (or €251,3 million) in 2016. The positive trend in the tourism sector has continued in 2017. On the basis of available data for the first two months of 2017, revenues from tourism continue to record increases (see Tourism, p. 30). In contrast, decreases were recorded in the categories of financial and other business services in 2016.

Imports of services decreased by 1,3% (or €68,6 million), mainly driven by the decreases recorded in the category of other business services (37,9% or €249,4 million) and the charges for the use of intellectual property (58,7% or €86,7 million). Increases were recorded in the categories of transport, travel as well as telecommunications, computer and information services.

The primary income account (which mainly includes income from employment and investment) recorded a larger deficit, of the order of €482,6 million compared with €62,5 million in 2015. This development was mainly driven by the category of other investments, as the amount of interest received decreased more than the amount of interest paid. The deficit in the secondary income account (which mainly includes current transfers) improved, mostly due to the decrease in the government contribution to European Funds. The current account deficit in 2016

was financed mainly by borrowing, through the issuance of domestic debt securities by the private sector and to a lesser extent by the government.

The net international investment position (IIP) of Cyprus has been negatively affected by the implementation of the new statistical standards, i.e. the European System of Accounts, 2010 (ESA 2010) and the IMF's Balance of Payments and International Investment Position Manual, sixth edition (BPM6). More specifically, the deterioration in the IIP was triggered by the adoption of the methodological changes and the implementation of the new statistical standards as well as the inclusion of the economic transfer of mobile transport equipment of SOSPE. These companies, have significant financial liabilities and in particular loans which are mainly used for the purchase of ships. While these loans have a direct impact on net IIP, the respective real assets (ships) do not, thus creating an imbalance in the figures reported. Most importantly, as SOSPE are not financed by domestic banks they do not present an immediate risk to the Cyprus banking system and to the domestic economy in general.

The net IIP in 2016 was negative at €22,5 billion or 125,4% of GDP compared with -€23 billion or -130,3% of GDP in 2015. Excluding the transactions of SOSPE, the net IIP in 2016 registered an improvement of 79,2 percentage points amounting to -€8,3 billion or -46,2% of GDP, while for 2015 the improvement was 75,1 percentage points and the IIP amounted to -€9,7 billion or -55,2% of GDP.

Tourism

The tourism sector constitutes one of the most important pillars of the Cyprus economy. In 2016 a record number of tourist arrivals and revenues was recorded. The conditions prevailing in the external environment contributed positively, as they adversely affected neighbouring competitor countries. Additionally, domestic economic conditions helped in preserving the competitiveness of the tourist. Furthermore, the efforts to diversify the tourism market base and increase the shares from other European countries, the Middle East and Asia have been successful.

More specifically, in 2016, tourist arrivals increased by 19,8% and reached 3,2 million tourists. Arrivals from the United Kingdom increased by 11,2%, despite exchange rate developments, while arrivals from Russia increased by 48,9%. It should be noted that arrivals from the UK continue to register increases. At the same time, increases in arrivals were recorded from other markets, such as Germany, Israel and Lebanon. As a direct consequence, revenues from tourism increased significantly by 11,9% in 2016. However, per capita tourist expenditure decreased by 6,6% (Table A.5 and Chart A.21), attributed to the decrease of 2,2% in daily per capita expenditure and the reduction in the average length of stay from 9,9 to 9,5 days.

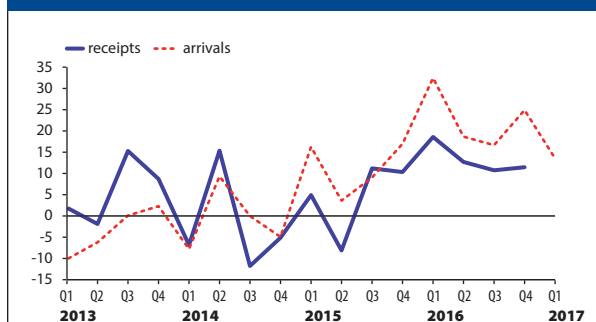
The positive trend in the tourism sector continues in 2017 as well. Available data on tourist arrivals for 2017Q1 show an increase of 13,5% compared with the corresponding period of 2016. Also, revenues from tourism increased by 22,9% in the first two months of

TABLE A.5 Tourism

	Tourist arrivals (thous.)	Tourist receipts (€ million)	Expenditure per person (€)
2015	2.659,4	2.112,1	794,2
2016	3.186,5	2.363,2	741,6
annual % change	19,8	11,9	-6,6
2016 Jan. - Feb.	114,6	66,7	582,0
2017 Jan. - Feb.	144,8	82,0	566,3
annual % change	26,4	22,9	-2,7
2016 Jan. - Mar.	251,6	-	-
2017 Jan. - Mar.	285,7	-	-
annual % change	13,5	-	-

Source: Cystat.

CHART A.21 Tourist arrivals and receipts
(annual change, %)



Source: Cystat.

2017. This seems to suggest that the efforts made to mitigate the issue of seasonality have been successful. Moreover, due to increased reservations during the summer season and in order to meet increased demand, hoteliers proceeded with hotel extensions and renovations as well as the construction of new tourist units.

Based on pre-bookings to date, and given the geopolitical conditions prevailing in the external environment, arrivals in the current year are expected to exceed last year's historically high level, *ceteris paribus*.

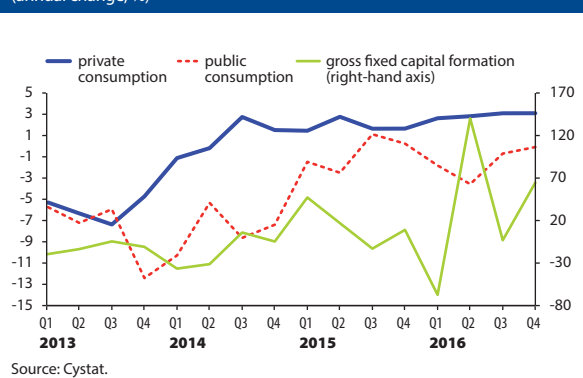
2.3 Domestic Demand, Production and the Labour Market

Quarterly national accounts⁹

The Cyprus economy recorded a positive growth rate of 2,8% in 2016, compared with 1,7% in the previous year. More specifically, GDP growth is attributable to an improvement in the sub-categories of private consumption and gross fixed capital formation, while net exports and government consumption have declined. (Chart A.22 (a) and A.22 (b)). It should be noted that the increase in private consumption by 2,9% was mainly due to the stabilisation of the domestic economic environment and the restoration of consumer confidence in the Cypriot economy.

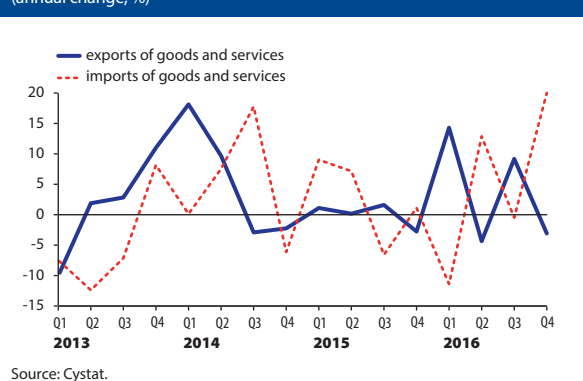
Gross fixed capital formation recorded an

CHART A.22(a) Quarterly GDP growth (expenditure categories)
(annual change, %)



Source: Cystat.

CHART A.22(b) Quarterly GDP growth (expenditure categories)
(annual change, %)



Source: Cystat.

9. With the introduction of the ESA 2010 and BPM 6 statistical methods, total exports and imports of Cyprus as well as gross fixed capital formation include, among other things, the economic transfer of mobile transport equipment and activities of SOSPEs which affect the GDP expenditure sub-categories but due to the statistical recording do not affect the GDP growth rate.

increase of 25,9%, partly due to purchases of mobile transport equipment (mainly ships acquired by SOSPE). There was also a significant increase in exports of goods and services by 3,6%, with tourism registering historically high levels (see Tourism, p. 30). The increase in exports was offset by an even higher increase in imports of goods and services, resulting in a decline in net exports, as mentioned above. Specifically, imports recorded an increase of 5,3% during the year, reflecting the increase in imports of mobile transport equipment.

As mentioned above, the figures above are affected by the inclusion of the economic transfer of mobile transport equipment (mainly ships) of SOSPEs. Excluding these ship transactions, both exports and imports continue to record a significant increase in 2016. Excluding ship transactions and other one-off factors, gross fixed capital formation continues to register a significant increase compared to 2015.

Growth in the economy is broad-based, with most sectors of production contributing positively. The sectors with the most important contribution to GDP growth in 2016 were accommodation and food services (0,7 percentage points), professional, scientific and technical activities (0,5 percentage points), construction (0,4 percentage points) wholesale and retail trade (0,4 percentage points), and manufacturing (0,3 percentage points). A negative contribution was recorded by the financial and insurance activities sector (0.5 percentage points) attributable to loan deleveraging within the context of the ongoing restructuring of the banking

sector and the adjustment of private sector balance sheets.

In light of more recent preliminary data, GDP grew further by 3,3% (seasonally adjusted data) in 2017Q1, owing to the same contributing sectors as in 2016.

Recent economic indicators reflect the ongoing recovery in domestic demand. In particular, the Economic Sentiment Indicator (**Table A.6**) increased from 113,3 in December 2016 to 115,5 in April 2017, reaching a level comparable to that observed in August 2007. The turnover index of retail trade (**Chart A.23**) continued its ongoing improvement growing by 3,2% in the first two months of the year. A significant increase was also observed in the sub-indices of consulting and professional services. Also, registrations of motor vehicles (**Chart A.24**) continued their positive trend, recording an increase of 35% in the first four months of 2017 compared with the corresponding period of the previous year. As regards credit card payments, spending by Cypriot cardholders in Cyprus increased by 9,7% in the first four months of 2017, compared to the corresponding period in 2016. Spending of foreign credit card holders in Cyprus recorded an increase of 22,4% in the first four months of 2017 (**Chart A.25, p. 34**), reflecting the positive developments in the tourism sector (**Chart A.21, p. 30**).

It is noteworthy that the confidence index of the construction sector is improving. The production index in the construction sector, although still fluctuating at very low levels, is showing the first signs of recovery, registering positive growth rates since 2015Q3 (see Real Estate Market, p. 34).

TABLE A.6 Business and consumer surveys: confidence indicators

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

	2016 June	2016 Sep.	2016 Dec.	2017 Mar.	2017 Apr.
ESI	108,5	108,8	113,3	115,8	115,5
Industry	2	-2	0	10	7
Services	10	20	28	26	31
Consumer	-7	-6	-1	-2	-3
Retail trade	-6	0	9	5	6
Construction	-28	-24	-27	-29	-24

Source: European Commission.

Note: Seasonally adjusted data.

CHART A.23 Retail sales (excluding motor vehicles)

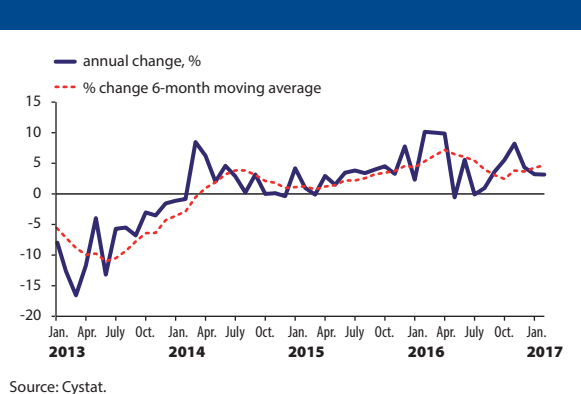
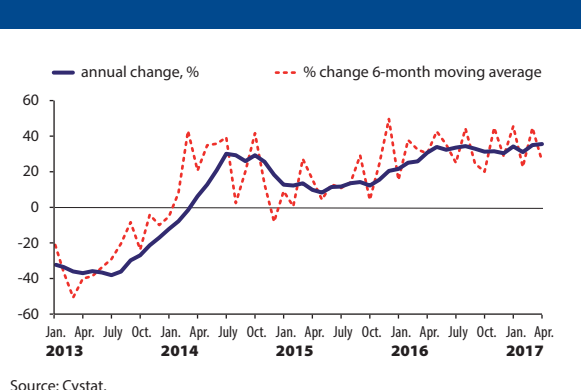


CHART A.24 Registration of motor vehicles



At the same time, data until March 2017 show that new lending by the banking sector to the domestic private sector recorded a significant increase. Nevertheless, the growth rate of total loans remains negative, mainly reflecting the continuous efforts of both the private and the banking sector to deleverage and correct their balance sheets (see Monetary Aggregates, p. 20).

As mentioned earlier, there has been a significant recovery in the tourism sector, with significant increases in both arrivals and revenue from tourism (see Tourism, p. 30). Regarding the professional services sector, the available data for the listing of new companies in Cyprus in 2017 (increase of 2,1% in 2017Q1) show the comparative advantage that Cyprus has in providing the relevant services.

Real estate market

The real estate sector in Cyprus continues to stabilise amid signs of gradual recovery. Demand for properties continues to increase. Residential property prices recorded a marginal quarterly increase in 2016Q3 for the first time since 2009 and construction activity continues to recover. Should the recovery persist in the future, it will also support the efforts to address the high levels of NPEs.

Demand for properties continue to increase, reaching the respective level of 2012. Specifically, according to data from the Department of Lands and Surveys, sales contracts recorded an annual increase of 6,9% during the period January – April 2017 (Table A.7), attributed to increases in demand from both

CHART A.25 Credit card spending
(cumulative annual % change from January)

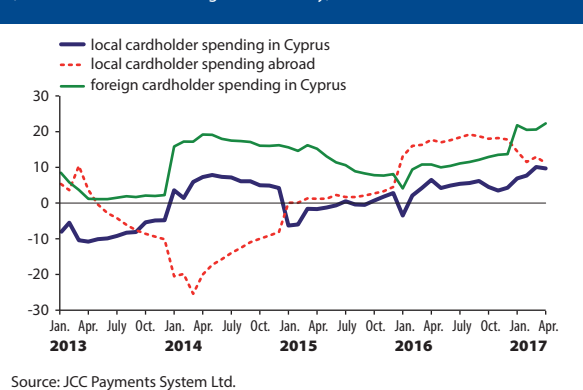


TABLE A.7 Real estate sector
(annual change, %, unless otherwise stated)

	Jan.-Apr. 2016	Jan.-Apr. 2017	Apr. 2016	Mar. 2017	Apr. 2017
Local sales of cement	37,9	36,5	39,7	37,4	n/a
Sales contracts (total)	27,2	6,9	34,9	16,1	-1,6
Sales contracts (locals)	28,0	2,8	33,8	14,7	-0,3
Sales contracts (foreigners)	24,5	20,6	38,1	19,7	-5,2
Building sentiment indicator (average of index)	-27,2	-25,3	-24,6	-29,4	-23,8
Property price expectations for the next 3 months (average of index)	-7,1	2,1	-4,3	4,0	3,8
Price index of construction materials (Period: Jan. - Sep. 2015 and 2016)	-3,2	0,8	-2,2	1,1	0,6

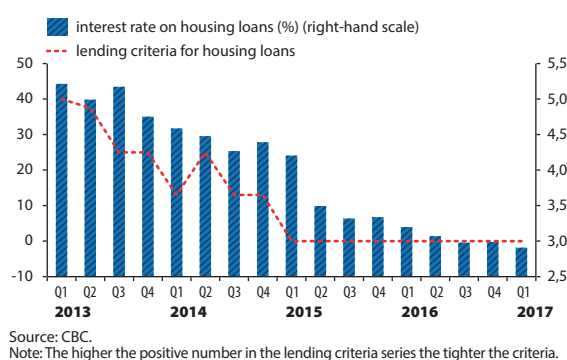
Sources: Cystat, Dept of Lands & Surveys, European Commission.

local and foreigners (2,8% and 20,6%, respectively). The aforementioned increases are in line with the available data for new housing loans, which stood at €144,4 million in 2017Q1 compared with €91,2 million in 2016Q1. The low interest rates for housing loans to households (2,86% in March 2017 – **Chart A.26**) also support the increased demand for properties, as confirmed by the BLS.

The gradual increase of construction activity shows that the real estate market has now started to experience a moderate recovery. Specifically, the index of production in construction, which is published by Cystat, recorded an annual increase of 17,9% in 2016Q4. On the positive side, it also noted that this indicator has been recording annual increases since 2015Q3. Sales of cement (**Table A.7, p. 34**) recorded an annual increase of 36,5% in 2017Q1. In addition, the index of building activity, which is published in the *Business and Consumer Surveys* (BCS) of the European Commission, was on average 2,3 (seasonally adjusted data) during the period January – April 2017, compared with -0,9 during the respective period in 2016.

Residential property prices, as recorded by the CBC residential property price index (RPPI), recorded a quarterly increase of 0,1% in 2016Q3, the first since 2009. This increase reflects increases of 0,1% in both house and apartment prices. On an annual basis, the RPPI recorded a decrease of 1,3% in 2016Q3 (**Chart A.27**). It is worth noting that the index of property price expectations over the next three months, which is published in the BCS, was on average 2,1 during the period January

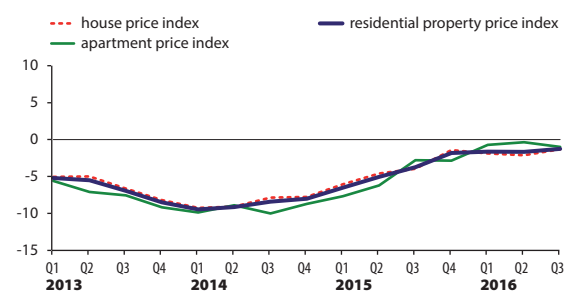
CHART A.26 Lending criteria and interest rate on housing loans



Source: CBC.

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

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



Source: CBC.

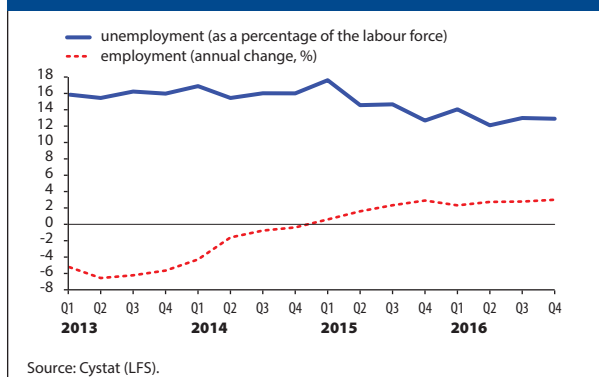
– April 2017, compared with -7,1 and -16,3 during the same period in 2016 and 2015, respectively. This was the first positive figure of the index of property price expectations since September 2008.

As regards the outlook for the construction sector, it is considered to be moderately positive. Specifically, the number of authorised building permits, which is considered to be a leading indicator of construction activity, recorded an annual increase of 6,8% in 2016. There were also increases in the number of authorised building permits for dwellings (14,1%), for offices (25,4%) and for division of plots (7,8%) during the same period. These rising trends continued in the early months of 2017, as the total number of building permits recorded an annual increase of 14,5% during the period January – February 2017. Furthermore, the building sentiment indicator, which is published in the BCS, was on average -25,3 during the period January – April 2017, compared with -27,2 during the respective period in 2016 (**Table A.7, p. 34**). The index of employment expectations in the construction sector over the next three months, which is published in the BCS, was on average 5,0 during the period January – April 2017, compared with -0,4 during the respective period in 2016.

Labour market

In line with the growth of the economy, employment increased further by 2,7% in 2016, compared to an increase of 1,9% in 2015 (**Chart A.28**). Albeit to a lesser extent, total hours worked also recorded an

CHART A.28 Unemployment and employment

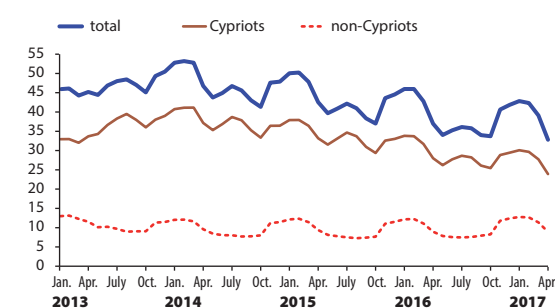


increase of 2,3% in 2016 compared with 1,7% in the previous year. Consequently, hours worked per employee decreased by 0,4% in 2016 compared with a marginal decrease of 0,1% in 2015. Unemployment as a percentage of the labour force (as recorded by the Labour Force Survey (LFS)), also showed signs of improvement, falling to 13% in 2016 compared with 14,9% in the previous year. In 2016Q4, the unemployment rate increased slightly to 12,9%, compared with 12,7% in the corresponding quarter of 2015 (**Chart A.28, p. 36**). According to LFS data, youth unemployment fell to 29,1% in 2016 compared with 32,6% in 2015.

The general reduction in unemployment is also confirmed by the number of registered unemployed (**Chart A.29**), which in April 2017 decreased by 11,3% compared with the corresponding month of 2016 (from 37.000 to 32.800 registered unemployed).

In times of economic crisis with prolonged high levels of unemployment, it is very important to monitor the duration of unemployment as the long-term unemployed are harder to reintegrate into the labour market (**Chart A.30**). According to LFS data, the unemployment rate with a maturity equal to or greater than six months decreased to 7,8% in 2016Q4, compared with a rate 8,6% in 2015Q4. According to the latest registered unemployment figures from Cystat, the number of registered unemployed for six months and over decreased by 1.585 persons in April 2017, compared with the same month of the previous year, which is in line with LFS data.

CHART A.29 Registered unemployment
(number of unemployed, thousands)



Source: Cystat.

CHART A.30 Unemployment by duration
(% of the labour force)



Source: Cystat (LFS).

2.4 Domestic Fiscal Developments

The general government fiscal accounts recorded a surplus of 0,4% of GDP in 2016, with the primary balance reaching 3% of GDP (Chart A.31). According to preliminary data by Cystat, the positive fiscal developments are continuing in 2017Q1 with a headline surplus of 1,1% of GDP, compared with a surplus of 0,8% in the corresponding period of 2016. At the same time, the primary balance recorded a surplus of the order of 1,6% in 2017Q1 compared with 1,3% in 2016Q1.

Public revenues grew by 4,9% in 2017Q1 (Chart A.32 and Table A.8, p. 44), mostly due to a 12,6% increase in taxes on production and imports. This was the result of an 18,3% increase in VAT receipts, reflecting the improved economic climate. Similarly, social contributions increased by 9,1%, due to improvements in the labour market.

Public expenditure (Chart A.32 and Table A.8, p. 44) recorded an annual increase of 1,7% in 2017Q1, driven mainly by a growth of 44% in gross fixed capital formation as a result of the increased implementation of development projects, as well as a 7,8% increase in intermediate consumption. There was a 77,5% reduction in subsidies due to delays in some payments within the aforementioned expenditure category. Upon their materialisation in the coming months public expenditure for subsidies will return to normal levels.

The general government consolidated gross debt to GDP ratio reached 107,8% in 2016. According to the latest available data, at the end of 2017Q1 the debt declined to 104,1% (Chart A.33, p. 44). This

CHART A.31 Budget and primary balances of the general government
(cumulative for the period as from Q1, as a percentage of GDP)

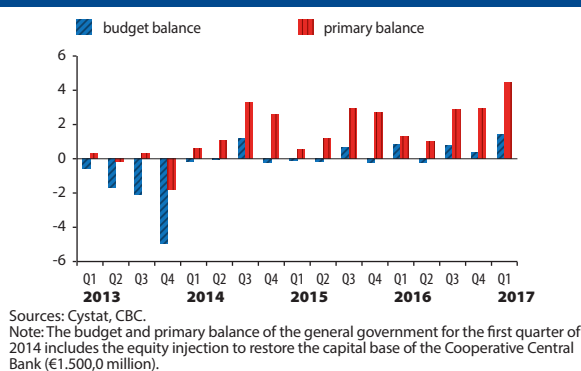
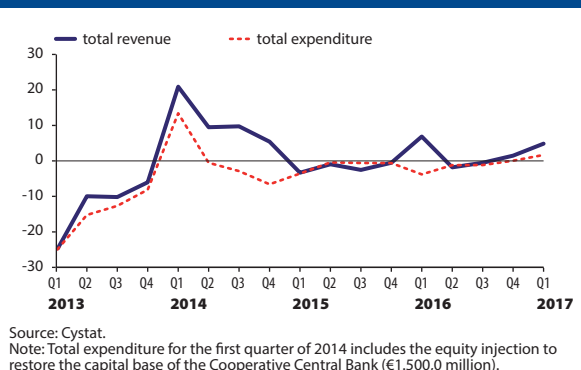


CHART A.32 Total revenue and expenditure of the general government
(cumulative for the period as from Q1, annual change, %)



Box 1: European Fiscal Governance

Following the conclusion of Cyprus's economic adjustment programme at the end of March 2016, the country embarked on its Post-Programme Surveillance (PPS) period¹. In addition, Cyprus has returned to the normal cycle of annual evaluations through the European Commission's Macroeconomic Imbalance Procedure (MIP)². Following the inception of Cyprus' economic adjustment programme in March 2013, the surveillance of imbalances had taken place in the context of the programme, and the country was therefore temporarily exempted from the MIP. This box outlines the procedures which will be applied systematically in the context of the monitoring of the Cypriot economy since exiting the programme, mainly within the framework of the European fiscal governance.

Post-Programme Surveillance (PPS)

The PPS started automatically after the conclusion of the Cypriot economic adjustment programme and aims to broadly monitor and evaluate the capacity of the country to repay the financial assistance received in the context of the programme. PPS missions from international lenders, as well as the resulting progress reports, are biannual and will last until at least 75% of the financial assistance received has been repaid. Unless there is early repayment of the received loan, 75% of the assistance provided to

Cyprus by international lenders is expected to be paid by the end of 2029.

In the context of the PPS, the European Commission, in cooperation with the ECB, will undertake regular review missions to Cyprus to analyse economic, fiscal and financial developments. While there are no policy conditionalities under the PPS, the European Council can issue recommendations for corrective actions if deemed necessary.

Macroeconomic Imbalance Procedure (MIP)

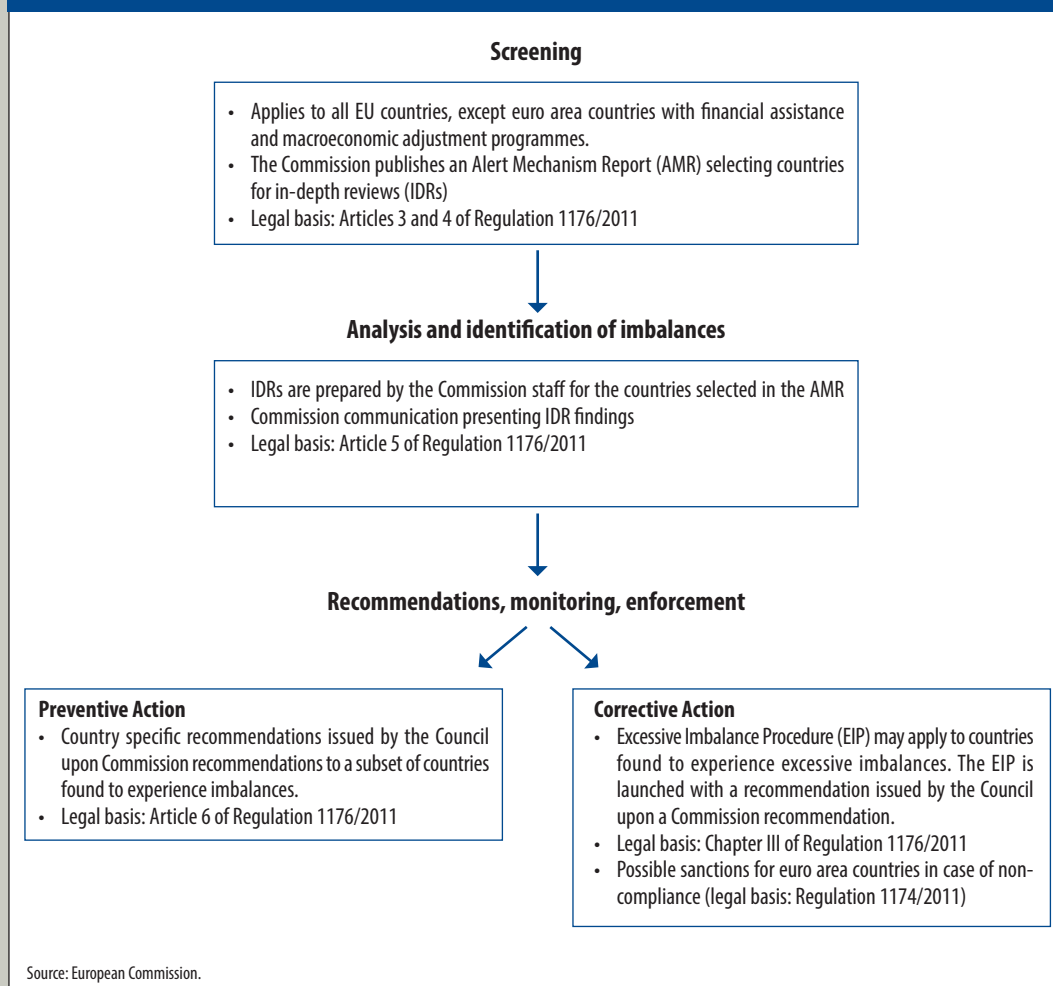
The MIP (**Figure 1, p. 40**) is a surveillance process of the European Commission aiming to detect and address macroeconomic imbalances that may adversely affect the smooth functioning of member state economies or of the EU as a whole.

The publication of the Alert Mechanism Report (AMR) in late November/early December is the start of the annual cycle of the MIP. The AMR uses a scoreboard of economic activity indicators, plus a wider set of auxiliary indicators, to screen for potential macroeconomic imbalances that policymakers should address. Based on a non-mechanical economic reading of the scoreboard, a country-specific analysis and the findings from previous investigations, countries in need for further In-Depth Reviews (IDRs) are identified. Based on the economic reading of the 2017 AMR scoreboard, 13 out of 28 member states were selected for IDRs in order to further examine the accumulation and unwinding of their imbalances.

1. Article 14 of Regulation (EU) N°472/2013

2. Regulation (EU) 1176/2011 and Regulation (EU) 1174/2011

CHART 1 **Macroeconomic Imbalance Procedure**



The IDR allows for a more thorough, qualitative economic analysis of the state of the economy. Furthermore, this analysis is utilised by the European Commission to assess whether macroeconomic risks in member states are accumulating or winding down, and to conclude on the existence of either imbalances or excessive imbalances. The magnitude of potential imbalances is influenced significantly by the judgement of the European Commission's

experts. Drawing from the scoreboard published in the 2017 AMR, Cyprus presented persistent imbalances for 9 out of the 14 indicators in 2015, more than any other EU member state. This led to the classification of the country as one with "excessive imbalances" in the publication of the Cyprus Country Report. It should be noted that the economic picture presented by these indicators does not adequately capture the significant progress made so far

TABLE 1 **Scoreboard of indicators for Cyprus, 2015**

		Thresholds	Value, Cyprus 2015
External imbalances and competitiveness			
Current account balance - % of GDP	3 year average	-4 / 6 %	-4,1
Net international investment position	% of GDP	-35%	-130,3
Real effective exchange rate – 42 trading partners, HICP deflator	3 year % change	± 5%	-6,2
Export market share - % of exports	3 year % change	-6%	-16,8
Nominal unit labour cost index (2010 = 100)	3 year % change	9%	-10,5
Internal imbalances			
House price index (2010 = 100), deflated	1 year % change	6%	2,9
Private sector credit flow, consolidated	% of GDP	14%	4,4
Private sector debt, consolidated	% of GDP	133%	353,7
General government gross debt	% of GDP	60%	107,5
Unemployment rate	3 year average	10%	15,7
Total financial sector liabilities, non-consolidated	1 year % change	16,5%	2,8
Employment indicators			
Activity rate - % of total population aged 15-64	3 year change in pp	-0,2 pp	0,4
Long term unemployment rate - % of active population aged 15-74	3 year change in pp	0,5 pp	3,2
Youth unemployment rate - % of active population aged 15-24	3 year change in pp	2,0 pp	5,1

Source: European Commission.

in restoring the soundness of the banking sector, the correction of public finances and the implementation of important growth-enhancing reforms. This is partly due to the fact that the indicators are calculated as averages of the last three years.

After taking into account discussions with the European Parliament, the European Council and the Eurogroup, the Commission will employ the findings from the IDRs to prepare country-specific recommendations (CSRs) under the 'European Semester'³ of economic policy coordination. CSRs are used by the Commission for the prevention and correction of macroeconomic imbalances, and usually consist of policy guidance for a relatively broad range of issues that are likely to help address the imbalances that

have been identified. Article 6.2 of Regulation 1176/2011 requires the Council to “inform the European Parliament of the recommendations and make them public”. CSRs are discussed among member state governments in the Council in mid-May, approved by EU leaders at a summit in June and formally adopted by finance ministers in July.

On 22 May 2017, the European Commission issued five CSRs to Cyprus for the correction of its excessive macroeconomic imbalances. In summary, the main imbalances focused on issues related to fiscal policy and sustainability of public debt, the efficiency of the judicial system, the level of non-performing loans, acceleration of labour market and national health system reforms, and, finally, the

3. The European Semester provides the Commission with a framework for economic policy coordination across the EU. It allows EU countries to assess their economic and fiscal plans and monitor progress at specific times throughout the year.

support and unfreezing of the privatization programme.

In cases of serious imbalances, the Excessive Imbalance Procedure (EIP) can be launched. Under the EIP, a member state is required to submit a corrective action plan with a clear roadmap and deadlines for its implementation. In parallel, surveillance by the Commission is stepped up in the form of published regular progress reports that are submitted by the member state. In addition, the Commission has the option to carry out enhanced surveillance missions. Despite the availability of the necessary legislation and cases that could fall under the EIP, the Commission has not yet launched an EIP for countries found with excessive imbalances. Instead, an enhanced “specific monitoring” process has been put in place for these countries.

In the case where member states fail to comply with the CSRs, the Commission can impose an interest-bearing deposit of 0,1% of GDP, which is converted into a fine after a second compliance failure. For member states under the EIP, the same sanctions can be imposed if a country fails twice to submit a comprehensive corrective action plan. Again, these sanctions are bound by law, but have yet to be exercised by the Commission.

In its recent Country Report for Cyprus, the Commission outlines some important imbalances and potential risks for Cyprus, which are summarised below. It should be noted that the figures in the scoreboard are for 2015, while analysis on more recent data is also presented in the paragraphs below.

Private Debt

The high level of private debt (households and non-financial corporations, NFCs) in Cyprus is one of the highest in the EU. It should be stressed that the debt of NFCs can be partly attributed to the debt of special purpose entities (SPEs) (around 75 percentage points-you mean 75% of GDP). These SPEs are mostly ship owning companies. These companies are financed almost entirely by non-domestic sources and therefore do not pose a substantial risk to the Cypriot banking system and the domestic economy in general. Net household private debt is at negative levels, if financial assets (deposits) are also taken into account. This indicates that, overall, households have liquid assets that on average exceed their borrowing levels.

Balance of Payments

The current account deficit remains high, although it recorded a significant improvement in 2016, reaching -5,3% of GDP, significantly lower than the historically high deficit of -15,5% of GDP in 2008. This occurred mainly through the shrinking of imports. At the same time, Cyprus’s net international investment position (NIIP) stood at -130,3% of GDP in 2015, while the latest figure for 2016 is -125,4% of GDP. It is difficult for Cyprus’s NIIP to improve significantly through a current account surplus because the economy is small and very open, reliant on imported raw materials such as oil. At the same time, the aforementioned data were negatively affected by a) the methodological changes adopted with

the introduction of new statistical standards and b) the inclusion of the economic transfer of mobile transport equipment by the ship owning SPEs registered in Cyprus. Excluding the impact of the SPEs, NIIP in 2015 showed an improvement of 75,1 percentage points, reaching -55,2% of GDP, while in 2016 it improved by 79,2 percentage points reaching -46,2% of GDP.

Public Debt

General government gross debt as a percentage of GDP rose marginally to 107,8% in 2016 from 107,5% in 2015. This was due to the accumulation of cash reserves, partly as a result of the issuance of a bond by the Republic in 2016. In particular, from the €1 billion issuance in July 2016, only €550 million was used to repurchase bonds during the year, with the remainder being available to the government as liquid reserves for strategic reasons (e.g. for further debt management operations or for meeting potential needs). Government reserves now account for around 8% of GDP, which are sufficient to cover financing needs until the end of 2018.

Labour market

Labour market conditions are continuing to improve, reflecting developments in economic activity. In particular, employment has been showing positive growth

rates since 2015Q1, while data from the Labour Force Survey indicate that that unemployment as a percentage of the labour force declined to 13% in 2016 compared with 14,9% in 2015. However, overall unemployment still remains at a high level. In addition, youth unemployment (15-24 years old) and long-term unemployment (duration of 12 months and over) remain very high, which may have a negative impact on the quality of human capital, with consequent repercussions on growth and public finances. In particular, youth unemployment in 2016 stood at 29,1% and long-term unemployment at 5,7% of the workforce.

To conclude, although the European Commission stresses the existence of imbalances in its Cyprus Country Report, it also highlights the great effort and progress that has been made in recent years to phase them out. Public finances have been put on the right track through the authorities' fiscal policy, the financial system has entered a period of stability and consolidation, and a large number of structural reforms has been implemented. However, significant challenges remain, such as the high levels of non-performing loans as well as public and private debt. The slowdown in the implementation of the remaining reforms due to fiscal fatigue, especially in view of the forthcoming presidential elections, needs to be reversed and greater effort applied to correcting the imbalances.

development reflects the 1,6% primary surplus (Chart A.31, p. 38) as well as the rise in nominal GDP. The accumulation of significant cash reserves, which cover the government's financing needs until the end of 2018, also play an important role.

3. Macroeconomic Forecasts for the Cyprus Economy

- Healthy growth rates for the Cypriot economy are expected to continue.
- Growth is expected to be driven by domestic demand and exports.
- Gradual increases in prices expected in the coming years, with inflation returning to positive levels.
- Risks for GDP and HICP are viewed as balanced.

The Cypriot economy continues to record growth in GDP, stemming mainly from domestic demand and exports. GDP growth in 2016 was broad-based with almost all sectors of production contributing positively to growth. On the basis of the latest data, the CBC estimates that the Cyprus economy will continue to record healthy growth rates in the coming years.

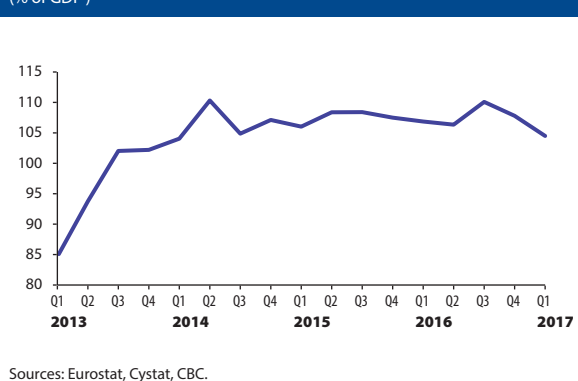
This section analyses the updated forecasts of the CBC as produced within the context of the Eurosystem projections. It is noted that the GDP growth forecast for 2017 has been revised marginally upwards compared with the projection published in the December 2016 *Economic Bulletin*. In the baseline scenario, growth is expected to be marginally

TABLE A.8 Accounts of general government

	Jan.-Mar. 2016 (€ million)	Jan.-Mar. 2017 (€ million)	Change %
EXPENDITURE			
Intermediate consumption	118,7	128	7,8
Compensation of employees	512,1	520,1	1,6
Social transfers	587,4	593,5	1,0
Interest	91,0	94,5	3,8
Subsidies	35,6	8	-77,5
Other current expenditure	99,3	110,3	11,1
Gross fixed capital formation	35,7	51,4	44,0
Other capital expenditure	10,5	9,4	-10,5
Total expenditure	1.490,3	1.515,2	1,7
Total expenditure as a % of GDP	8,3	8,1	
REVENUE			
Taxes on production and imports	604,2	680,5	12,6
Current taxes on income, wealth, etc	398,8	402,4	0,9
Social contributions	384,8	419,7	9,1
Other current resources	33,6	40,3	19,9
Sales	106,8	101,1	-5,3
Capital transfers received	9,8	7,5	-23,5
Property income	98,6	64,6	-34,5
Total revenue	1.636,6	1.716,1	4,9
Total revenue as a % of GDP	9,1	9,2	
Surplus (+) / Deficit (-)	146,3	200,9	
Surplus (+) / Deficit (-) % of GDP	0,8	1,1	

Sources: Cystat, CBC.

CHART A.33 General government consolidated gross debt (% of GDP)



Sources: Eurostat, Cystat, CBC.

above 3% between 2017 and 2019. Recent economic indicators, especially in relation to tourism, as well as recent preliminary GDP data, exhibit a more positive trend compared with previous projections. As far as inflation is concerned, gradual price increases are expected in the coming years on the basis of the ongoing recovery of the Cyprus economy, the increase in the international price of oil until 2017 as well as on the projected gradual dissipation of the external impact which had contributed to the lower prices in 2016.

Prices: HICP

In 2017 inflation in Cyprus is expected to return to positive levels, reaching 1,2% compared with -1,2% in 2016 (**Table A.9**), mainly as a result of rising prices from all categories of goods and services and, to a lesser extent, increases in oil prices. HICP excluding energy is also expected to record positive growth rates, reaching 0,5% in 2017 from -0,5% in 2016. Prices excluding energy and food, which better reflect domestic price pressures, are expected to increase, reflecting increased costs in terms of wages and rents as well as rising profitability.

In 2018 and 2019 inflation is expected to reach 1,3% and 1,5%, respectively, mainly due to the projected continuation of domestic economic recovery and the rise in the prices of goods and services. Excluding energy, inflation is projected to be around 1,3% and 1,6% in the years 2018 and 2019, respectively. Prices excluding energy and food are also expected to record further increases in the years under review.

TABLE A.9 HICP projections
(annual change, %)

	2016	2017f	2018f	2019f
HICP	-1,2	1,2	1,3	1,5
HICP excluding energy	-0,5	0,5	1,3	1,6

Sources: Cystat, CBC.

Compensation, productivity and the labour market

Reflecting the positive trend of GDP, the labour market is expected to improve between 2017 and 2019. In particular, employment is expected to continue to grow recording a positive rate of change of 2,7% in 2017 (following the positive growth rates observed since 2015Q1). The expected further improvement in the economic climate and the growth of companies' turnover, will also positively affect employment. In the years 2018 and 2019, employment is expected to further increase by 2,7% per year.

In line with the above, the unemployment rate, as defined by the LFS, is expected to fall further in 2017, reaching 10,8% from 13% in 2016. Further improvement is expected to be recorded in 2018 and 2019, reaching 8,9%, and 7%, respectively. Developments in unemployment are expected to be more positive than the projections provided by Cyprus's international lenders over recent years, mainly due to the significant decline in the presence of foreign workers in Cyprus, the continuing recovery in employment and the flexibility exhibited by the Cypriot labour market in relation to wages. However, until 2019 unemployment is expected to remain higher than the average rate recorded in the period prior to the crisis.

Nominal compensation per employee, in line with the GDP recovery, is expected to record an increase of 1,4% in 2017, compared with a 0,6% decrease in 2016, reflecting increases in the public sector as well as in specific segments of the private sector. Compensation

per public sector employee is expected to register a small increase in 2017, due to the wage increases that took place as of January 2017. This increase is, however, partly offset by the recruitment of professional soldiers in the National Guard whose wages are lower than the average wage of existing civil servants. For the years 2018 and 2019, nominal compensation per employee is expected to further increase by 1,9% and 2,7%, respectively. This development is mainly attributed to the improvement in the domestic economy and the consequent improvement in the labour market, resulting in higher private sector wages. It also reflects increases in compensation per employee in the public sector, due to the granting of general and indexed wage increases in view of the termination of the wage and pension freeze period. This increase in wages is expected to have a positive impact on both private consumption and household savings which have been used to smooth out consumption during the economic crisis.

Following developments in compensation per employee, unit labour costs are expected to increase by 1% in 2017 following four consecutive years of decreases (a cumulative decrease of 10,7%). Further increases of 1,4% and 2,2% are projected for 2018 and 2019, respectively.

National accounts

According to the latest preliminary figures for 2017Q1, GDP registered a year-on-year increase of 3,3% (seasonally adjusted). The better than expected path of the Cyprus economy reflects developments across

almost all sectors of production. On the basis of available data and in conjunction with leading economic indicators, the economy is projected to record growth of 3,1% in 2017 (Table A.10).

Specifically, real private consumption is expected to increase further by 2,3% in 2017, following an increase of 2,9% in 2016, mainly reflecting the increase in disposable income lower interest rates, tax deductions (such as the reduction in immovable property tax) increased employment and wage increases. Public consumption is projected to increase by 2,8% in 2017 relative to a decrease of 1,4% in 2016, partly due to the increase in wages as a result of the recruitment of professional soldiers in the National Guard and the termination of the wage and pension freeze period. Gross fixed capital formation, which has reached historical low levels, is expected to record a decrease of 15,4% in 2017 despite the implementation of specific development projects from both the public and the private sector. This drop is mainly attributed to a base effect and one-off transactions in mobile transport equipment (ships). Excluding the impact of transport equipment (ships), gross fixed capital formation is expected to increase in 2017. It should be noted that gross fixed capital formation in the public sector for 2017 includes the purchase of ships for the purpose of enhancing the capacity of the coastguard. Exports of goods and services are expected to further increase by 3% in 2017, compared with an increase of 3,6% in 2016, mainly driven by tourism, telecommunications, computer and information services, as well as transportation.

TABLE A.10 National accounts projections in real terms
(annual change, %)

	2016	2017f	2018f	2019f
GDP	2,8	3,1	3,2	3,2
Private consumption	2,9	2,3	2,2	2,2
Public consumption	-1,4	2,8	1,2	2,3
Gross fixed capital formation	25,9	-15,4	10,2	9,0
Exports of goods and services	3,6	3,0	3,2	3,1
Imports of goods and services	5,3	-2,2	3,2	3,2

Sources: Cystat, CBC.

The improvement in competitiveness, reflected by the significant drop in wages, production costs and overall costs of companies in recent years, has contributed to the strong export performance. Based on the most recent data available, as well as on pre-bookings, tourism receipts and arrivals are expected to be exceptionally high in the coming years. At the same time, the extension of the tourism season, which has been the primary objective of the authorities in recent years, is expected to materialise in due course largely as the result of the construction of a casino. At the same time, imports of goods and services are expected to register a decrease of 2,2% in 2017, compared with an increase of 5,3% in 2016 due to the base effect resulting from the import of mobile transport equipment (ships) and despite the increase in the volume of petroleum products.

The increase in new lending is expected to support the recovery of the economy, while the successful completion of the Cyprus Republic's economic adjustment programme in March 2016 has strengthened the confidence of the markets to some extent. Also, the recent sovereign upgrades by various credit rating agencies have helped Cyprus to return to the markets gradually, despite the fact that Cyprus government bonds are still classified as non-investment grade. It should be emphasised that the ongoing consolidation of the financial sector, with the latest available data on NPLs recording a significant decline, will help to further stimulate the economy.

Given the positive dynamics of the domestic economy, it is expected that GDP will grow by a further 3,2% in 2018 and 2019. In

particular, private consumption is expected to record a steady annual increase of 2,2% over the two years, partly due to the recovery in disposable income. An increase of 10,2% is projected to be recorded in gross fixed capital formation in 2018, with a further increase of 9% in 2019. These expected increases reflect the large private investments that have already begun and will be completed in the coming years, including the two marinas in Larnaca and Ayia Napa, the expansion of the oil mining and storage terminal at Vasiliko, the construction, renovation and extension of hotels and, in particular, the casino. The latter, officially licensed on 18 May 2017, is a major project that will enrich the tourist product, extend the tourism season and create new jobs. An increase of 1,2% and 2,3% is also expected to be recorded in public consumption for the years 2018 and 2019, respectively, due to the termination of the wage and pension freeze, the introduction of COLA indexation, the increase in public sector employment as well as the increase in intermediate consumption.

Exports are also expected to register an increase of 3,2% and 3,1% in 2018 and 2019, respectively. Total imports, which are significantly affected by the increase in the volume of imports of petroleum products, are expected to increase by 3,2% per year in 2018 and 2019.

Risk assessment of macroeconomic forecasts¹⁰

The forecasts for the course of GDP (Table A.10, p. 48) and HICP (Table A.9, p. 45) are considered to form the baseline scenario. The

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

confidence intervals associated with the baseline scenario forecasts are outlined in **Charts A.34** and **A.35**, respectively. The confidence interval related to the baseline forecast for HICP excluding energy is shown in **Chart A.36**. As analysed in more detail below, risks to the GDP and HICP forecasts are considered to be balanced.

Regarding GDP, downside risks are associated with a possible worsening of external demand for services, such as the possible unfavourable economic conditions prevailing in the UK post-Brexit. Downside risks may also arise from geopolitical developments in the Mediterranean region. If these developments materialise, they could adversely affect the prospects of the tourism and professional services sectors, even though recent geopolitical developments have positively affected the Cyprus economy. In addition, downside risks relate to a possible deterioration in domestic credit conditions. A slower than expected progress in reducing the high level of NPLs could also negatively affect economic activity.

In relation to upside risks, an increase in net new loans beyond what is expected, could contribute further to the economic recovery and especially private investment. Among these projects, the construction of the casino stands out (this investment is not included in the baseline scenario) and its operation by 2017 is expected to contribute to the diversification of the tourism product.

Finally, exploration of new fields in the Cyprus Exclusive Economic Zone related to the discovery of gas fields could lead to higher revenues both directly and indirectly

CHART A.34 Real GDP fan chart
(annual change, %)

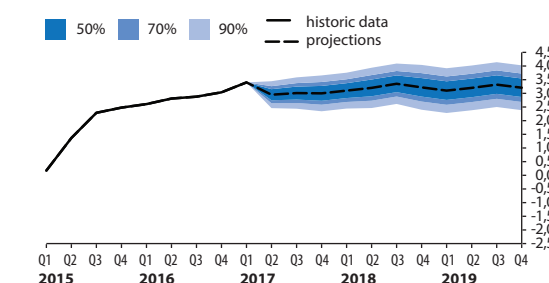


CHART A.35 HICP fan chart
(annual change, %)

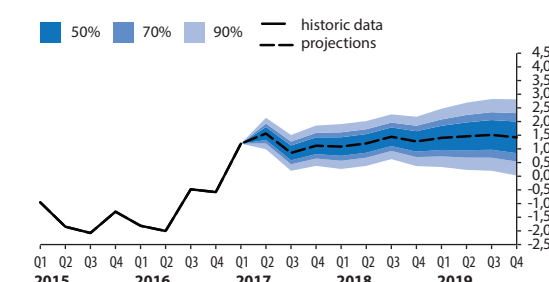
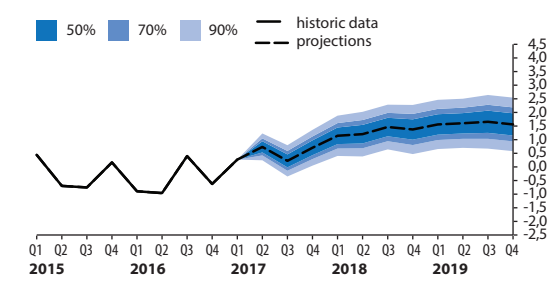


CHART A.36 HICP excluding energy fan chart
(annual change, %)



through increased economic activity. Overall, the sectors that are likely to be positively affected are those associated with energy and related services, tourism (benefiting from the construction of the casino and the entry of new air passenger carriers) as well as professional services.

With respect to inflation, the main downside risks relate to a possible deterioration in the external demand for services. Specifically, the impact of the UK leaving the EU as well as the fragile balance in the Mediterranean region, with all the possible consequential effects on exports, could potentially exert downward pressure on prices of goods and services. In addition, downside risks relate to a deterioration in domestic credit conditions.

The main upside risks relate to the better than expected improvement in the domestic economic outlook, the realisation of higher oil prices and the possible depreciation of the euro against the dollar.

Technical Notes



1

Introduction

2

Macroeconomic
Developments
and Projections

(A) Domestic monetary aggregates

All monetary aggregates' data exclude the CBC.

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

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

The above methodology has been adopted since the December 2009 edition of the *Economic Bulletin*. In previous editions of the *Bulletin*, the growth rate of monetary variables was calculated as the annual percentage change of outstanding balances

at the end of the period. Details of the methodology can be found in the *Monetary and Financial Statistics*, published by the Statistics Department of the CBC, which is available on the CBC website.

(B) Balance of Payments

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

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

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

(C) National Accounts

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

More details on the methodology of compiling the balance of payments and the national accounts are available in the Box1 p.51 of the December 2014 *Economic Bulletin* and on the website of the CBC.