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1. Trip notes - fact findings from our recent trip to Nicosia (June 20th-21st)

In late June, we traveled to Nicosia where we met with high-level officials from the Central Bank, the Finance Ministry, as well as market participants from the domestic financial sector and the real estate market. Our visit took place in the aftermath of the European Parliament elections and the successful tapping of international bond markets by the Republic of Cyprus for 15-yr & 30-yr tenors for the first time in the history of the Republic. Below we provide a summary of our findings regarding the recent economic developments and the outlook for 2019-2020, the thorny issue of NPEs and their remedial, a number of short & medium term unaddressed challenges and, finally, the recent upgrades by rating agencies.

- **The Cypriot economy confronted with new challenges**: According to our discussants, Cyprus has entered a new phase in the post-economic adjustment programme era. After the original post-program success in a number of areas (public finances, banking sector etc.), Cyprus is increasingly confronted with a new set of challenges both internal and external that need to be addressed for the economy not to backtrack.

- **Cyprus has entered a lower, yet more sustainable growth path:** Having expanded buoyantly by 4% on average in 2016-2018, which followed an earlier three-year recession in 2012-2015, now Cyprus follows a lower but sustainable growth path of approximately 2.5%-3% on average over 2019-2021. More specifically,
  - The external environment is less friendly than in the previous period, thus putting downward pressure on some of the country's key industries, namely tourism, logistics, shipping and professional services.
  - The growth outperformance of the Cypriot economy in the past three years was underpinned by the strong rebound of the construction sector. The program of granting citizenship through inward investment[1] has attracted foreign investment in the real estate sector in the form of high-rise residential towers, which are located in the areas of Limassol and Paphos.
  - Despite its success, the program "citizenship through investment" has received a lot of criticism by both the media and EU institutions. As a result, the minimum investment criteria have been raised, a cap on the number of passports awarded per year has been set and the overall integrity of the selection process is about to be strengthened further.
  - The stream of construction projects (those already under construction plus those in the form of permits and in pending applications) point to a continuing construction boom. The latter has raised concerns among policy makers that this type of non-tradable sector investment is not conducive to sustainable growth. It distorts incentives as it diverts resources from the tradable to the non-tradable sectors. Thus it undermines the country's competitiveness, damages the environment and could instigate a speculative behavior that could lead to an asset bubble in the medium

[1] An investment of €2mn in real estate enables the beneficial owner to acquire the Cypriot passport, an amount that can be reduced down after 3 years to just €500,000. Recently, the terms of the program were modified, adding a donation of €75,000 to the Government's Research and Development fund, plus €75,000 to the Land Development Organization.

term. On the other hand, the domestic banking sector is not directly exposed to these activities, thus is not directly linked to the risk of a bubble burst. The construction projects are foreign-funded, relieving pressure from regulators to act.

- Overall, although there is a stream of projects in the pipeline to support the construction sector in the short-term, in the medium term the contribution from construction-related projects is about to become less pronounced.
- Private consumption currently stands at 67% of GDP, after rising by 4.1% on average in 2016-2018. This unusually high growth was underpinned by a sustained sentiment improvement that mirrored the lasting progress within the expired programme, the impact of fiscal relaxation as MoU measures were being phased out, the rapid labor market improvement and the property market stabilization. Yet private consumption dynamics are about to become more realistic in the medium-term.
- A striking negative feature among the determinants of growth is the lack of improvement in labor productivity. GDP growth is driven entirely by the rise of employment while **labor productivity** growth- measured either in terms of per person employed or in terms of per hours worked - is either close to zero or even negative. The government is aware of the issue and is undertaking initiatives to boost it, such as the Block chain strategy.

- **Medium-term fiscal risks and uncertainties are on the rise:** So far, in 2016-2018, fiscal discipline and prudence were maintained despite the State support to the banking system and the rising public pressure for more spending. More specifically, excluding the fiscal burden of the sale and orderly winding down of Cyprus Co-operative Bank (CCB) to Hellenic Bank, the general government recorded a surplus on an accrual basis of 3.4% of GDP in 2018, up from a surplus of 1.8% of GDP in 2017 compared 0.3% of GDP in 2016. Moreover, according to the Ministry of Finance official forecasts in the Stability & Growth program, the general government surplus is estimated to reach 3% of GDP this year and is subsequently projected to decline marginally to 2.6% in 2020, 2.4% in 2021, and 2.2% and 2022. Similarly, the primary surplus from an estimated 5.3% in 2019 is projected to decline to 4.8% in 2020 and then stabilize at 4.4% and 4.1% of GDP in 2021 and 2022. Yet future risks are on the rise.
  - Strong fiscal performance and robust economic growth have given rise to wage demands in both the public and private sector. Those have not materialized in the private sector thus far due to the large pool of unemployed persons and the flexibility of foreign workers
  - In the public sector the situation is more complicated. In late March 2019, in three separate decisions, administrative courts ruled the legislation upon which public wage cuts were imposed in 2012-2013 was unconstitutional. The State appealed those decisions but the outcome is uncertain. There is a realistic possibility public wages are restored to pre-MoU levels, in which case the State would be forced to spend upfront an additional amount of €800mn-€1bn.
  - Finally, the introduction and implementation of a general health system poses additional fiscal challenges in the medium term.

- **Banking sector risks have subsided but remain a material source of concern**: NPEs decreased by the sizeable amount of €10.3bn in 2018, reflecting (i) the carving out of the Cyprus Cooperative Bank's (CCB) bad loans and (ii) the securitization of a large bad loans portfolio by the Bank of Cyprus to Apollo (widely known as project Helix). The surgical removal of a sizeable amount of NPEs from the banking sector allowed for an important -but one-off- decline in the NPEs ratio from 40% to the much lower current 30%.

- **Further progress on the NPEs issue hinges upon three game-changing factors**: 1) the implementation of the reformed insolvency and foreclosures frameworks, 2) the government-subsidized ESTIA plan, and 3) further sales of bad loans to private funds.

- The adoption of new **insolvency and foreclosures** laws by the parliament last year without any amendments had created optimism that the new framework would empower banks to pursue strategic defaulters more efficiently than previously. According to recent media reports, the number of foreclosures and successfully completed auctions has showed some improvement, yet still falls below expectations. Nevertheless, the reformed frameworks have increased the bargaining power of creditors thus resulting in an increase of debt-to-asset swaps, which in turn has increased the stock of properties banks have on their balance sheets. Thus far the banks have been able to manage the accumulation of real estate assets but in the medium term they will be pressured to dispose them in the market.

- **Risks of backtracking in the NPEs cleaning up**: On the negative side, new initiatives by opposition parties in Parliament have gathered sufficient support to grind away some of the provisions of the reformed frameworks. If those legislative initiatives remain in place after being referred back to the Parliament by the President, they could easily frustrate the NPE clean-up process, increase the capital requirements of domestic banks ahead of the 2020 stress-tests and could hurt the credibility and the image of the Republic in the eyes of investors internationally.

- **Following the carving-out of NPEs from the Co-operative Bank, new challenges emerge:** The establishment of a new management company responsible for handling the sizeable volume of NPEs necessitates the implementation of a transparent, professional, efficient and publicly accountable governance framework. The framework is necessary for the recoverability of the NPEs and the minimization of costs to the taxpayer. Failure to deliver could induce moral hazard in the rest of the system as well.

- **ESTIA Plan:** According to the latest information, the implementation of the ESTIA plan[2] is about to begin, yet obstacles have surfaced. Domestic banks have the draft MoU on their hands to decide upon their participation. To that end, domestic banks have already

[2] The ESTIA plan incentivizes both creditors (the banks) and debtors (borrowers) to come to an agreement on restructuring first mortgage loans for residence, which are in the red. The bank undertakes the responsibility to restructure the mortgage loan and forgive the loss coming from the difference between the market price and the book value of the collateral. In addition, at the end of the re-payment period, provided the debtor fully services his remaining restructured debt, the government will subsidize 1/3 of the reduced installment.

checked the eligibility of applicants and communicated it to their respective customers. Recall that in late January the Parliamentary Committee on Budgetary and Financial Affairs already approved the release of the 2019 funds designated for ESTIA. Yet the implementation of the scheme encountered delays. The draft MoU between the banks and the State came under scrutiny by the Legal Service, which has delayed its inauguration.

- **New securitization projects are in the bank plans**: Following the success of Helix 1, a similar securitization of bad loans is underway by the Bank of Cyprus, named Helix 2. If Helix 2 is completed on time, then the aggregate country NPEs ratio could drop to single digit levels by the end of 2019-early 2020.

- **NPEs remain in the broader economy** despite their removal from the banking system's balance sheet. The removal of a big component of NPEs from the balance sheet of the banks removes pressure off their back and creates more space for them to focus on their traditional markets. Yet to ultimately take the problem off the back of the economy, the recoverability of the outstanding non-performing loans has to be maximized. This is not an easy task.

- **Rating agencies either postponed or remained on hold in the last round of assessments**: All major rating agencies either postponed (S&P, Moody's) or remained on hold (FITCH, DBRS) in the last round of assessments in spring. Moody's remains the only rating agency not to assign investment grade to Cyprus.

- **Cyprus capitalized on the favorable momentum in international financial markets by tapping long-term tenors for the first time in the history of the Republic**: Cyprus issued two new 15Y and 30Y Eurobonds in late February and late April respectively at relatively very low yields. International investors' appetite for the issuances was strong. The first 15-year issue was priced at a 2.758% yield and the second 30-year issue was priced at a 2.835% yield. These were the fourth and fifth issuances since the Cypriot exit from the economic adjustment program in late March 2016.

2. Latest Economic Developments & Outlook

2.1 Euro-parliament elections are not a game changer yet the ruling party may find it more difficult to push for important structural reforms in the future

The ruling right-wing party DHSY won the euro-parliament elections with a small margin against the main opposition left-wing party AKEL. DHSY gained 29.0% of the vote (2 seats), losing almost nine percentage points down from 37.8% in the previous euro-parliament elections in 2014. The main opposition left-wing party AKEL climbed slightly to 27.5% compared to 27.0% in the previous euro-parliament elections. AKEL has again elected two MEPs, one of whom is the academician Mr. Nayzi Kiziliyourek, whose candidacy has been hotly debated throughout the pre-election period and became the first Turkish Cypriot ever elected in the euro-parliament.

The center-right DHKO came in third, gaining 13.8% of the vote (1 seat) compared to 10.8% in 2014. The socialist party EDEK, reaching double digit approval rate after many years, gained the last seat, winning 10.6% of the vote. Four smaller parties were not allocated a seat: the far-right ELAM (8.2%), the party of the former DHKO leader Mr. Marios Garoyan, DIPA (3.8%), the Greens-Citizens Alliance (3.3%) and the Yasemi party of the Turkish Cypriot Afrika publisher Mr. Sener Levent (1.7%). Finally, the abstention rate stood at 55% compared to an average of 50.5% in the EU-28 and marginally lower than in 2014.

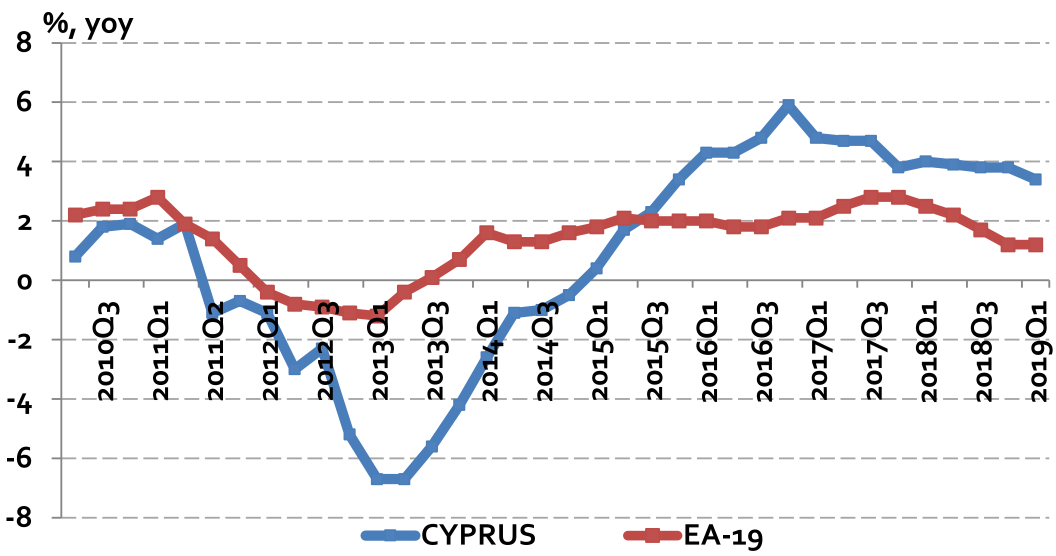
The euro-parliamentary election results are not a game changer as they are not national elections plus the system of the Republic is presidential. In addition, the ruling party DHSY was already dependent on smaller parties to pass legislation in the parliament given that it doesn't enjoy a majority in the MPs. That said, given the non-negligible electoral casualties of the ruling party, it is highly likely that smaller parties are going to be progressively less friendly to the ruling party. This is not very reassuring in view of a number of pending important structural reforms of the Economic Adjustment Program that need to be finished. Times are turbulent, hence the earlier reform momentum and prudent macroeconomic policies must continue in order for the economy not to backtrack.

2.2 The latest GDP growth estimate for Q1-2019 – a tad lower compared to the flash CYSTAT estimate- confirmed that a soft landing of economic activity has started

The second and latest estimate of CYSTAT on the seasonally adjusted Q1-2019 GDP-reading, trimmed by 0.1ppts on an annual basis off the flash, confirmed that economic activity has embarked on a decelerating path in the first quarter of 2019. Real GDP expanded by 0.7% (down from 0.9% in the flash) on a quarterly basis, bringing the annual rate of expansion at 3.4% YoY in Q1-2019 on a seasonally adjusted basis, lower than 3.8% YoY in Q4-2018 & Q3-2018, vs. 4.0% YoY in Q1-2018.

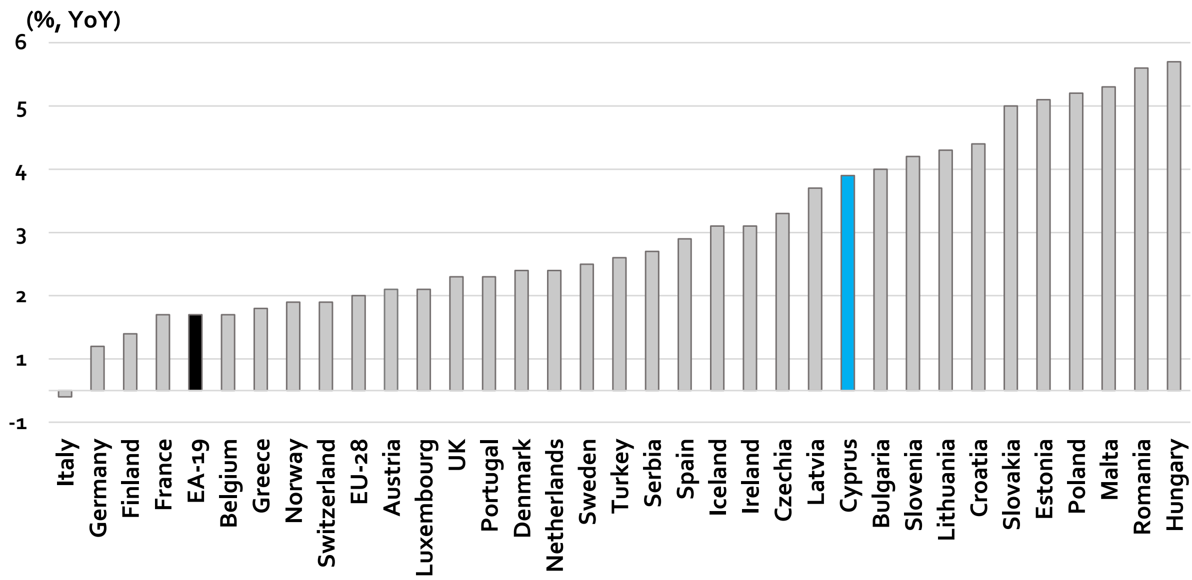
Real GDP growth marked the seventeenth consecutive positive reading on a both quarterly and annual basis after a previous three-year recession. The GDP growth rate of Q1-2019 is still among the highest in EA-19 and EU-28, both on a quarterly and on an annual basis and, for a fifteenth consecutive quarter in a row, above that of EA-19 (Figure 1,2,3). This output performance is still among the highest during the post-Lehman period, coming closer to analysts' expectations and international organizations' full year initial or revised forecasts. However, it marks the end of a period of buoyant growth and - ceteris paribus - suggests that the soft landing of the economy has already started.

Figure 1: GDP growth (YoY) in Cyprus above that in EA19 since Q3-2015



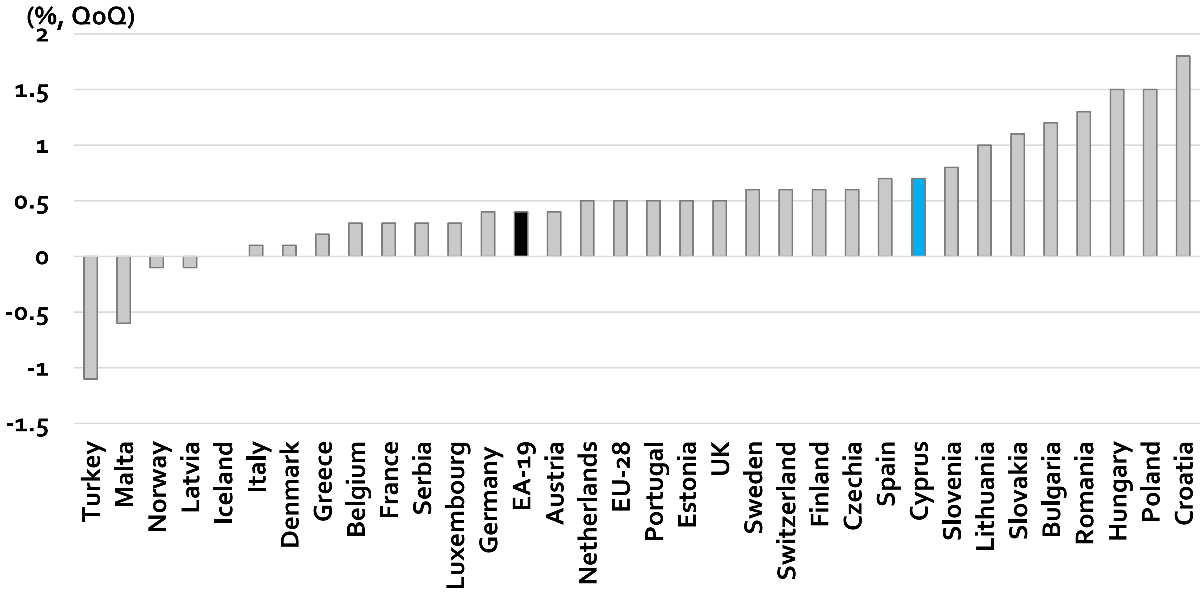
Source: Eurostat, CYSTAT, Eurobank Research

Figure 2: First Quarter GDP growth (YoY) in Cyprus among the highest in EA19 & EU28



Source: Eurostat, CYSTAT, Eurobank Research

Figure 3: First Quarter GDP growth (QoQ) in Cyprus above EA19 & EU28



Source: Eurostat, CYSTAT, Eurobank Research

A data revision earlier this year[3] showed that in 2017 the economy had rebounded from the earlier recession even faster than previously thought: The real GDP growth rate of 2017 was further revised up to 4.5% from 4.2%, against an initial announcement of 3.7%. As a result, the level of GDP in 2017 in constant prices already stood 0.5% above the level of 2008 and 3.8% above the level of 2012. Therefore, after the revisions and factoring in the performance of the past year, the level of GDP in 2018 now stands 4.4% above the 2008 level and 7.8% above the 2012 level.

2.3 The IMF Executive Board's statement at the conclusion of the third post-program monitoring (PPM) discussions confirmed the mission's findings in March and acknowledged that Cyprus' post-crisis economic recovery is gradually decelerating, yet the outlook remains favorable.

The statement of the IMF Executive Board's[4] at the conclusion of the third post-program monitoring (PPM) discussions confirmed the mission's findings in March. First of all, the Board acknowledged that Cyprus' post-crisis economic recovery is gradually decelerating but the outlook remains favorable. The Board acknowledged that economic growth has been strong - supported by construction, tourism and professional services, unemployment has

[3] Earlier on, the Statistical Service had revised the real GDP growth rate of FY2016 to 4.8% compared to 3.4% in the second estimate and only 3% initially announced. http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/E99702C8D4AB3B9CC225830100351BD0?OpenDocument&sub=1&sel=1&e=&print

[4] https://www.imf.org/en/News/Articles/2019/03/27/mcs032819-cyprus-staff-concluding-statement-of-the-third-post-program-monitoring-mission

declined further while the underlying budget remains in a large surplus. Downside risks to the growth outlook include a disorderly hard Brexit, tightening of foreign financing for investment, or realization of anti-money laundering/counter-terrorist financing (AML/CFT) risks.

In line with the mission's recommendations on the main vulnerabilities the economy is confronted with, the Executive Board focused on three areas: 1) reducing NPLs and strengthening bank profitability 2) avoiding pro-cyclical fiscal policy and maintaining debt sustainability 3) strengthening structural reforms. On the banking sector, the IMF called for steadfast implementation of the amended legislative framework on foreclosures including e-auctions to address the troubled legacy assets. It also stressed the need to enhance the governance and supervisory framework for the recently-established asset management company. On the public finances, the IMF said spending growth should be firmly maintained at a pace below that of medium-term nominal GDP growth and cyclical and windfall revenues should be saved, to ensure a neutral fiscal policy stance, build up buffers, and anchor public debt on a firmly downward path. Finally, the Board sees a window of opportunity to push for the reform agenda given that the next parliamentary elections are scheduled no earlier than in 2021. On strengthening structural reforms, the IMF prioritized the ongoing judicial reform which would help address the legacy of the crisis and improve the investment climate.

In terms of the macro-outlook of 2019-2020, the IMF Board now sees GDP growth reaching a still-robust 3.0-3.5% in 2019–20, from 3.9% in 2018, led by foreign direct investment. The average inflation projection in 2019 was downgraded to 0.5% in an illustration of upside price pressures throughout the year so far, down from 1.8% in the October World Economic Outlook (WEO) report, while it is further seen at 1.6% in 2020. Unemployment was seen to decline from a projected 8.4% in 2018 down to 7% in 2019 and further to 6% in 2020. The current account was seen as widening to 7.3% in 2019 and moderate to 6.5% in 2020.

Over the medium term, economic growth is projected to slow to its long-run potential rate of around 2.5%, as the transitory effects of the investment boom gradually dissipate. The above growth forecasts are more or less now in line with those published in the IMF's flagship publication, namely the April World Economic Outlook (WEO), but represent a newer and less optimistic assessment compared to the Executive Board statement on the occasion of the conclusion of the Article IV consultation with Cyprus in last December.[5] At that time, the Executive Board had assessed the near-term outlook as favorable, expecting GDP growth to remain at around 4.2% in 2018–19. The IMF flagship publication in October2018 had upgraded its forecasts to reflect the ones prescribed earlier in the second post-program staff monitoring report of June[6] (Table 1).

[5] https://www.imf.org/en/News/Articles/2018/11/30/pr18448-cyprus-imf-executive-board-concludes-2018-article-iv-consultation
[6] https://www.imf.org/~/media/Files/Publications/CR/2018/cr18153.ashx

Table 1: IMF World Economic Outlook Forecasts for Cyprus

IMF WEO	2019		2020	
	Oct 2018 WEO Forecast	April 2019 WEO Forecast	Oct 2018 WEO Forecast	April 2019 WEO Forecast
GDP growth (%, YoY)	4.2	3.5	3.3	3.3
Consumer Prices (%, average)	1.8	0.5	2.0	1.6
Unemployment (% of Labour Force)	8.0	7.0	7.0	6.0
Current Account Deficit (% of GDP)	-5.2	-7.3	-4.9	-6.5

Source: IMF World Economic Outlook October 2018 & April 2019

2.4 In its spring 2019 forecasts, the EU Commission downgraded its growth forecasts for Cyprus in 2018-2019, while stressing that risks to the outlook have widened

The EU Commission downgraded the GDP growth forecasts for the Cypriot economy in its Spring-forecasts published last May. The EU Commission now sees Cyprus expanding at 3.1% in 2019, down from 3.3% in the Winter-forecasts, further down from 3.5% in the Autumn-forecasts, compared to 3.3% in the previous Spring-forecasts, up from 2.8% in the previous Winter-forecasts. GDP growth is now forecasted to decelerate to 2.7% in 2020 unchanged from its previous forecast vs. 2.9% in the Autumn-forecasts.

The growth momentum is supported by solid private consumption, the latter driven by the boost in confidence and disposable incomes following further labor market tightening and moderately higher wages. Public consumption is also expected to provide more support, underpinned by the automatic indexation of public wages, wage increments and the unfreezing of promotions. In addition, investment is forecasted to expand in double digits, making a positive contribution on the back of strong construction activity in the areas of tourism infrastructure projects and residential housing, the latter financed by foreign inflows stemming from the Citizenship by Investment programme. Net exports are expected to be a drag on growth given the high import content of domestic demand and the challenges confronted by the tourism sector, one of the key export industries of the Cypriot economy. In that direction, the EU Commission underlined the risks from the less favorable external environment in 2019-2020. Slowing growth in the euro area and persistent uncertainties in major trading partners weigh on Cyprus' outlook and increase downside risks. Moreover, the economy is also heavily reliant on foreign funding which leaves it vulnerable to external developments.

In the fiscal metrics, the European Commission anticipates the general government to record a surplus of 3% of GDP in 2019-2020 after posting a temporary deficit of 4.8% of GDP in 2018 due to the one off support measures related to the sale of Cyprus Cooperative Bank. Finally, the EU Commission identified that the main downside risks to the fiscal outlook relate to uncertainties surrounding the macroeconomic outlook, the outcome of court rulings on past measures concerning the public sector wage bill and the potential deficit of public healthcare providers during the first years of the national health insurance system.

Table 2: EU Commission Forecasts for Cyprus

IMF WEO	2019		2020	
	Autumn/Winter Forecast	Spring Forecast	Autumn/Winter Forecast	Spring Forecast
GDP growth (%, YoY)	3.5/3.3	3.1	2.9/2.7	2.7
Consumer Prices (%, average)	1.3/0.7	0.9	1.4/1.2	1.1
Unemployment (% of Labour Force)	6.3	6.7	4.8	5.9
Current Account Deficit (% of GDP)	-9.5	-8.0	-9.5	-9.4

Source: EU Commission forecasts Autumn 2018-Winter 2019-Spring 2019

2.5 Investments had the strongest positive contribution in first quarter's GDP growth, while final consumption dynamics remained strong

Domestic demand has had the lion's share in the GDP growth reading of Q1, while net exports are most likely to have come under pressure echoing the deterioration in the world economic environment. From a demand side point of view, final consumption dynamics were strong for yet another quarter, making a +3.1ppts contribution to GDP growth in Q1-2019. Despite its robust performance, it is evident that the final consumption dynamics have started to adjust slowly towards lower and more sustainable levels. To that end, final consumption recorded its first quarterly decrease since Q4-2014. Final consumption expanded by -0.3% QoQ/+4.8% YoY in Q1-2019 compared to +2.6% QoQ/+5.5% YoY in Q4-2018, +0.5% QoQ/+3.5% YoY in Q3-2018, +1.9% QoQ/+3.7% YoY in Q2-2018 and +0.3% QoQ/+2.7% YoY in Q1-2018.

Final consumption strength underpinned by a number of factors, which all boil down to the rise of disposable incomes and the propensity to consume, namely: sustained sentiment improvement (the ESI index still close to multi-month highs), tightening labor market conditions (unemployment at 7.3% in Q1-2019, now standing below EA-19 levels), further property market stabilization (RPPI index in positive territory in the last seven quarters), the impact from the fiscal relaxation after the graduation from the economic adjustment programme and the acceleration of public consumption in 2H-2018.

As far as the other growth components, there are two points to make. First, investments' volatile performance continued in this quarter too. Investment spending in Q1-2019, at constant prices, was significantly higher on an annual basis (+70.4% YoY), thereby having a significant positive contribution to GDP growth which reached +7.9 ppts. Looking deeper into the component statistics of investments, we conclude that this extraordinary outcome was comprised of almost entirely by construction (79% of gross fixed capital formation). The performance of the two key categories which refer to construction- both residential (+13.7% YoY) and other buildings (+25.8% YoY)-was very supportive to investments. Investments in transportation equipment, which is most probably related to the shipping activity, contributed also to investments. The negative amount of investment in transportation equipment-reflecting most probably lower deregistration of ships- was one third lower on an annual basis in constant prices in Q1-2019 (-€95.7mn up from -€328.9mn) thus contributing to the overall expansion on an annual basis.

Second, the positive investments' performance was more than offset by the net exports' negative contribution, a trend we witnessed again in Q3-2018. The contribution of net exports amounted to -8.5ppts. In Q1-2019 we actually witnessed a combined effect from both exports contracting by +2.8% QoQ/-9.1% YoY, and imports rising by -2.4% QoQ/+3.0% YoY. The slowdown in export activity reflects a sizeable decrease in the exports of goods' volume on an annual basis (+14.7% QoQ/-24.7% YoY) which is partially explained by negative base effects from higher export of goods activity by SPEs in Q1-2018 but also due to deterioration of the world economic environment prospects. On top, exports of services failed to impress (-0.9% QoQ/-1.6% YoY) driven by lower activity in the sectors of professional and financial services and negative early signs from the tourism revenues front.

On the supply side, GDP dynamics were shaped by the steady performance of key sectoral pillars of the economy. Output in the combined sectors of "wholesale and retail trade, transport, accommodation and food service activities," expanded by +0.3 QoQ/ +1.6% YoY in Q1-2019 down from -1.0% QoQ/ +3.2% YoY in Q4-2018, down from +2.3% QoQ/+5.3% YoY in Q3-2018, +0.1% QoQ/+4.4% YoY in Q2-2018, compared to 1.8% QoQ/+6.5% YoY in Q1-2018. The performance of these national accounts items reflects largely the robust private consumption dynamics and is being reinforced by the performance of the flourishing tourism industry, primarily in the summer months. Manufacturing stabilized to +0.8% QoQ/+4.1% YoY in Q1-2019 compared to +1.2% QoQ/+ 4.8% YoY in Q4-2018, up from +0.5% QoQ/+4.4% YoY in Q3-2018 down from +1.3% QoQ/+6.3% YoY in Q2-2018 compared to +1.5% QoQ/+6.9%YoY in Q1-2018.

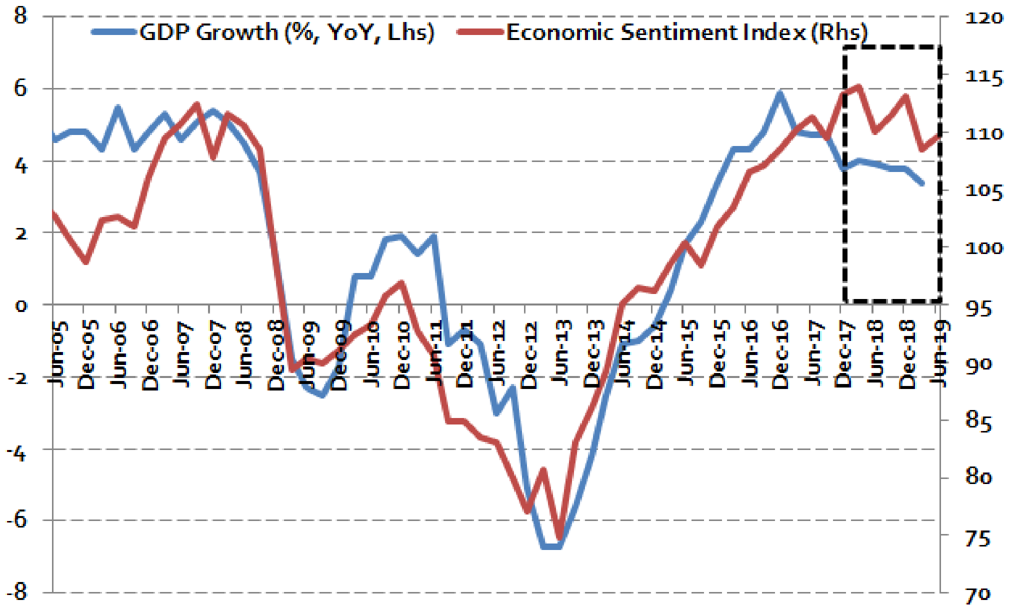
In contrast, professional services remained flat on annual basis at +1.3% QoQ/+6.1% YoY in Q1-2019 down from +1.6% QoQ/ 6.1% YoY in Q4-2018 up from +1.4% QoQ/+6.2% YoY in Q3-2018 compared to +1.5% QoQ/+6.7% YoY in Q2-2018 compared to +1.4% QoQ/+6.9% YoY in Q1-2018 vs. +1.7% QoQ/+6.8% YoY in Q4-2017 up from +1.9% QoQ/+6.7% YoY in Q3-2017. Furthermore, construction slowed down to -0.3% QoQ/+13.7% YoY in Q1-2019, down from +2.9% QoQ/+25.1% YoY in Q4-2018, compared to +6.1% QoQ/+29.1% YoY in Q3-2018, +4.5% QoQ/+22.3% YoY in Q2-2018 vs. +9.7% QoQ/+22.0 % YoY in Q1-2018.

Similarly, Financial Services remained a drag on economic recovery, recording negative growth on an annual basis. Financial services have been in negative territory since Q3-2016, except Q4-2018. Nevertheless, the pace of contraction has slowed down in the last quarters. Financial services contracted by -1.2% QoQ/-4.2% YoY in Q1-2019, +3.8% QoQ/-4.1% YoY in Q4-2018, -5.2% QoQ/-8.9% YoY in Q3-2018 compared to -1.5% QoQ/-4.7% YoY in Q2-2018, down from -1.0% QoQ/-4.3% YoY in Q1-2018, up from -1.4% QoQ/ -7.5% YoY in Q4-2017. The negative contribution to GDP growth by the financial sector reflects largely the bank restructuring activities (debt to asset swaps), write-offs and the ongoing deleveraging.

2.6 Real economy indicators performed relatively well in Q2-2019, yet it is more likely that the soft-landing of the economy has started

Economic sentiment and economic growth are highly correlated. The slump in sentiment raises a flag on growth, yet it may not necessarily signal lower growth ahead. For example, the sentiment slump in May-June2018 had no meaningful impact for the GDP reading of Q2-2018 and the short-term prospects of economic activity. Yet, this time is different. The sentiment decline in Q1-2019 was reflected in the concurrent GDP growth reading. High frequency and leading indicators were performing relatively well in Q2-2019, yet now it is more evident that the soft landing has already begun and the economy is now past the peak of the economic cycle.

Figure 4: Economic Sentiment & Economic Growth in Cyprus



Source: Eurostat, CYSTAT, Eurobank Research

More specifically:

- **Sentiment:** The ESI Index remained on a declining trend in Q2-2019. In more detail, ESI posted a small increase of 1.2 points in June to 110.2, after a small decline of 1.8 points in May to 109, down from 110.8 in April, 109.2 in March, retrenching back to comparable levels recorded in spring 2018.

- **Retail Trade:** Retail sales except for motor vehicles and motorcycles, expanded in volume terms by +4.2% YoY in April up from -0.4% YoY in March, bringing the year performance to April at +2.4% YoY. Similarly retail sales in value terms expanded by +4.6% YoY in April up from +0.4% YoY in March, bringing the year performance to April at 3.0% YoY.

- **Credit-card transactions**: The value of credit-card transactions expanded by 29.2% YoY by Cypriots and 19.7% YoY by foreigners in 5M2019 (JCC Payments Ltd).

- **Tourism:** The latest data releases predispose for a difficult year for the tourism industry. Tourist arrivals declined by -0.9% YoY in January-June 2019. Similarly, tourism revenues declined by -1.9% YoY in January-April 2019.

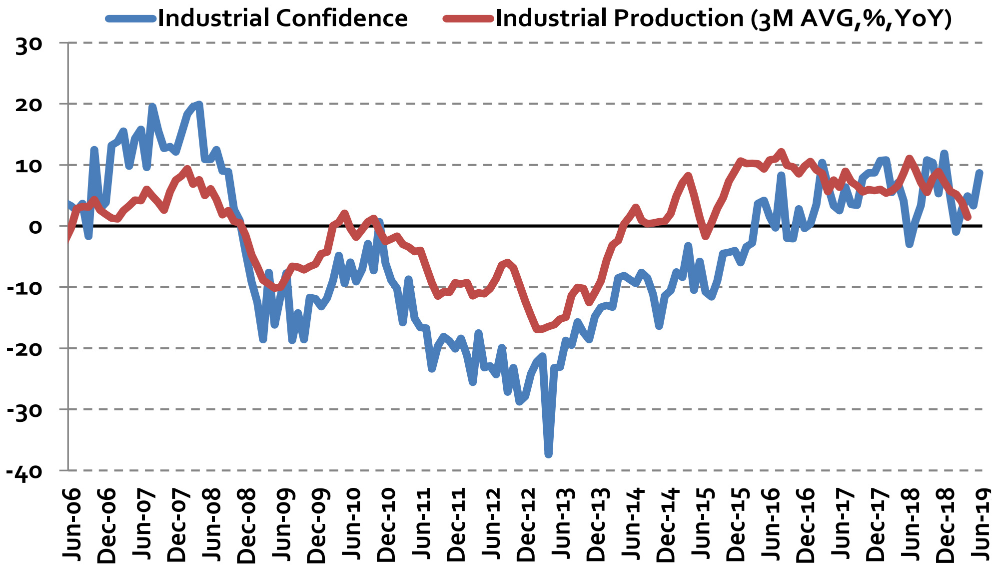
- **Industrial sector**: After expanding by 10.5% YoY in Q2-2018, industrial production on a calendar-not seasonally adjusted terms, slowed down to 6.1% YoY in Q3-2018, climbed up a little to 6.3% YoY in Q4-2018 and slowed down again to 5.4% YoY in Q1-2019. After slumping last February to levels comparable only to June-July2018, industrial confidence gradually rebounded in the following months. As of June 2018, industrial confidence still lies below autumn2018 levels.

- **Labor market**: Unemployment continued its downward trend in Q2-2019, reaching new multi-month lows and now declining below the EA19 average. The unemployment rate in seasonally adjusted terms declined further to 6.5% in May, down from 8.3% in May 2018 and from its peak of 16.8% in October 2013.

- **Deposits:** The depositors' sentiment has stabilized further in April-May. From a flow point of view, total deposits recorded a net increase of €688.3mn in May, compared with a net increase of €236.9mn in April, up from a net decrease of €327.7mn in March.

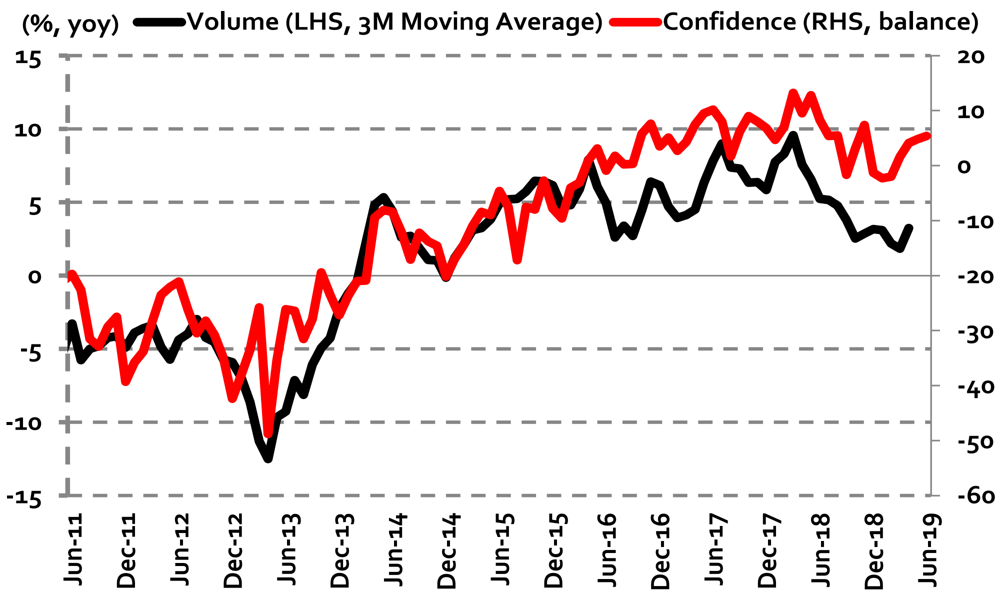
- **Property-market**:
  - **Construction:** The latest building permits release predisposes for a continuation in the construction output rally. According to CYSTAT, the total value of building permits issued during the period January-April 2019 increased by **133.4%YoY**, up from **27.5%YoY** in January-April, vs 19.5%YoY in FY2018. Accordingly, the total area of building permits rose by **45.4%YoY** during the period January-April 2019, **24.5%YoY** during the period January-April 2018 and 11.9% YoY during FY2018. During the period January-April 2019, 2.111 building permits were issued, up from 1.984 in the corresponding period of the previous year. Having expanded with double digits throughout 2017, construction output still increased by 12.8% YoY in Q1-2019 vs. 15.2% YoY in Q4-2018, and 25.8% YoY in Q3-2018.
  - **Real estate transactions & Real estate prices:** The number of real-estate market sale contracts has increased by 24.4% YoY in 6M-2019 (from 4,470 to 5,560: Department of Lands and Surveys). Overall property prices were on an increasing path in 2H-2018.

Figure 5a: Industrial Production & Confidence in Cyprus



Source: Eurostat, CYSTAT, Eurobank Research

Figure 5b: Retail Trade & Confidence in Cyprus



Source: Eurostat, CYSTAT, Eurobank Research

- The latest available data for the Residential Property Price Index (RPPI) were available for Q4-2018 due to the technical issues raised by the carving out of the CCB's NPEs and their transfer to the state management company. The RPPI expanded by +1.6% YoY in Q3-2018 compared to +1.7% YoY in Q2-2018 and +1.8% YoY in Q1-2018, recording the seventh consecutive annual increase on a monthly basis for the first time since 2008 (Central Bank of Cyprus).
- The House Price Index (HPI), another metric calculated and published by CYSTAT, is in positive territory again. The HPI expanded by +0.8% QoQ/+4.3% YoY in Q1-2019 up from +3.5% QoQ/+1.6% YoY in Q4-2018, -0.7% QoQ/+0.8% YoY in Q3-2018, +0.6% QoQ/+1.2% YoY in the Q2-2018, -1.6% QoQ/+3.7% YoY in the Q1-2018. The

Cypriot reading-now above that of EA-19 (+4.3% YoY) in this quarter for the first time since 2013- bodes well with the ongoing rebound in the property market.

3. Recent domestic banking sector developments

3.1 In absence of any new sales of NPEs (non-performing exposures) portfolios, the NPE ratio edged up to 31.3% in February from 30.3% in January, mirroring the decline in the loans stock by €917mn

The volume of non-performing exposures (NPEs) edged down by €19mn in February, compared to a small increase by €47mn in January, after having declined by €834mn in December2018, bringing the stock of NPEs down by 62.4% over the period from December2014 to February2019. Recall that, NPEs decreased by 10.3bn in 2018, reflecting the carve-out of the Cyprus Cooperative Bank (CCB) bad loans and the securitization of a large bad loans portfolio by the Bank of Cyprus to Apollo (widely known as project Helix). Meanwhile, the process of deleveraging continues rapidly. Having declined by €13.2bn in 2018, loan exposures (performing plus non-performing) by €917mn in February- which is a higher decrease than that in their non-performing component alone- on top of small increase of €145mn in January.

The deleveraging has caused the ratio of NPEs (non-performing to total exposures) to edge up to 31.3% in January vs. 30.3% in December down from 31.8% in November vs. 40.3% in June 2018, compared to 43.7% in December2017, 47.2% in December 2016, 45.8% in December 2015 and 47.8% in December 2014. Recall that according to the EBA conservative definition, a restructured NPE is still classified as an NPE for a probation period of at least 12 months, even if it is properly serviced without incurring new arrears. As a result, a large fraction of the restructured loans are still classified as NPEs (€4.6bn out of €6.5bn in February 2019).

Further progress on the NPEs issue hinges upon three game-changing factors:

1) the implementation of the reformed insolvency and foreclosures frameworks,
2) the government-subsidized ESTIA plan, which is expected to induce many home-owners to restart servicing their mortgages, and
3) further sales of bad loans to private funds.

As far as the first factor is concerned, the results so far are not encouraging at first sight. According to recent media reports, the number of foreclosures and successfully completed auctions has showed little improvement. However, the reformed frameworks have increased the bargaining power of creditors thus resulting in an increase of debt-to-asset swaps and restructurings.

On the negative side, the opposition parties' individual initiatives culminated in a new legislation approved in mid-July. With a majority of 35MPs in favor and 15MPs against, the parliament endorsed amendments in the reformed insolvency and foreclosures frameworks.

The amendments to the existing legislation reverse partially or completely some of the provisions of the reformed frameworks.

First, the new law prolongs the process of the foreclosure so that according to their representatives, banks will not be able to foreclose the collateral property before 14 to 16 months following the first delay in debt servicing is noticed. Among other modalities, distressed borrowers have now gained the right to file an appeal to the court system against the banks for failing to exhaust efforts to restructure their loans, hence enabling strategic defaulters to make wrong use of it. More specifically, the new regulations provide:

i) An extension of the deadline for repayment of due amounts from the date of the first notice from thirty to forty-five days.
ii) The appointment of two appraisers from the list of the Cadastre director for the determination of the market value of mortgaged property.
iii) The obligation of the mortgagee to inform interested buyers about the mortgage property.
iv) A prolongment of the length of time from 3 months to 6 months that the reservation selling price is maintained at 80% of the market value, while at 50% of the market value is preserved as a selling reserve price indefinitely.
v) An extension of the period following the auction notice from thirty to forty-five days so that there is sufficient time for the distressed borrower to react and secure better reserved prices.

Second, the new law foresees a freeze in foreclosures eligible to join the ESTIA government plan until September 1st. The suspension of all foreclosure proceedings aims to act as an additional safeguard for homeowners who could be eligible for ESTIA. Advocates of the legislation suggest that this is necessary to ensure that no primary residences will be foreclosed until it is clear who is eligible for the ESTIA scheme.

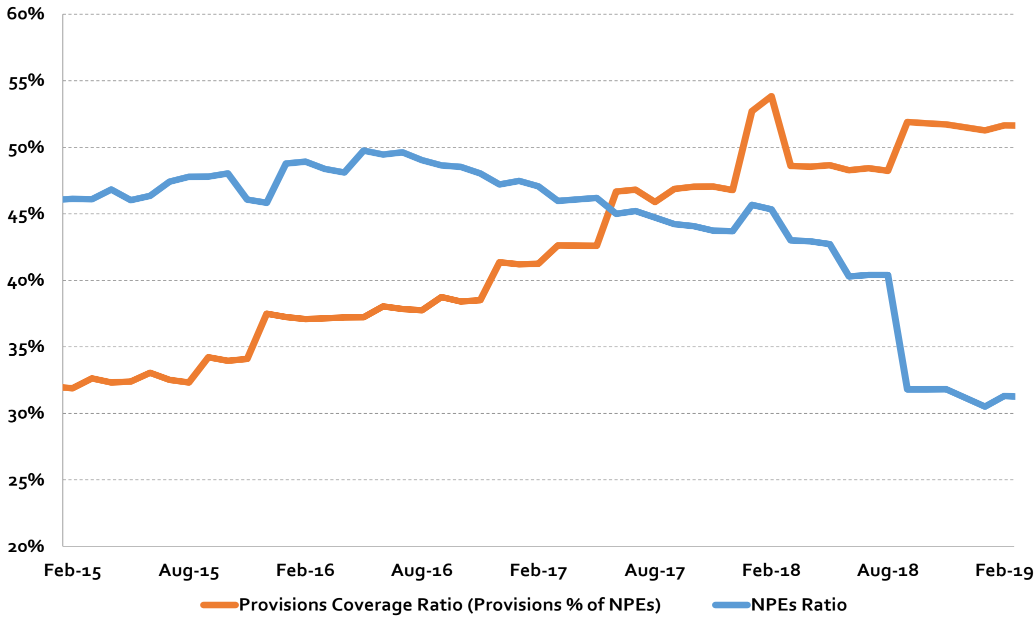
The amendments are heavily criticized as running counter to the solution of problems in the banking sector as they put creditors at a disadvantaged position in pursuing the foreclosure of the collateral properties in an efficient manner. If the amendments remain in place, they could backtrack the cleaning up process of NPEs and, moreover, result in an increase of the borrowing costs as well as the provisioning needs and the capital requirements of the Cypriot banks, especially ahead of next year's stress tests.

Last but not least, those last-minute amendments damage the credibility and prestige of the Republic. This is because they change of rules for investors who have already acquired portfolios of NPEs, resulting in lower prices for the portfolios to be sold in the future.

According to the latest information available, after months of delays, the ESTIA plan implementation is about to begin. To that end, domestic banks have already checked the eligibility and communicated it to their respective customers who are expected to start filing applications from September. In late January of this year, the parliamentary committee on budgetary and financial affairs approved the release of the funds designated for the ESTIA government plan in 2019. However, the implementation of the scheme had encountered further delays as the MoU draft between the banks and the state was under the scrutiny of the Legal Service-an independent judiciary institution of the Republic-for a prolonged period of time. At the moment, the domestic banks have been given the finalized draft of the MoU to decide upon whether they will participate in the scheme.

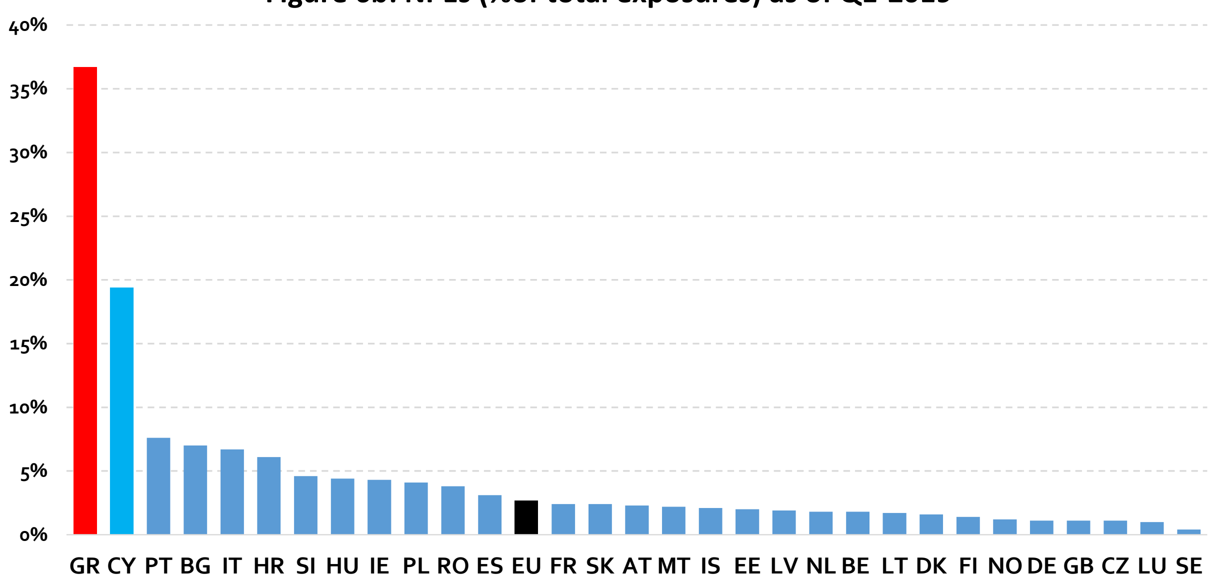
Finally, after the sale of two chunks of NPEs, one by Hellenic Bank and another by the Bank of Cyprus, the Bank of Cyprus currently prepares a new securitization of bad loans, named Helix 2. If all things were to go as planned, then the country NPE ratio could drop to single digit levels by the end of 2019-early 2020.

Figure 6a: Banking Sector Provisions Coverage & NPE ratio



Source: Central Bank of Cyprus, Eurobank Research

Figure 6b: NPEs (%of total exposures) as of Q1-2019



Source: EBA, Eurobank Research

Summarizing, as we have consistently highlighted in all our previous reports, NPEs remain the elephant in the room. As of February 2019, the ratio in Cyprus is still the second highest in the Euro Area behind Greece. It is important to note that the stock of NPEs when measured relative to the size of the economy has improved in recent years, driven not only by the decline in the numerator but also because of the robust nominal GDP growth in 2017-2019. As of February 2019, the NPEs as a percentage of projected 2019 GDP stood at 48.4% of GDP, compared to 50.2% in December 2018, 104.7% in December 2017, 128.8% in December 2016, 150.3% in December 2015, and 155.2% in December 2014.

4. Sovereign ratings & bond markets update

4.1 Rating agencies remain on hold in the last round of assessments.

On April 12th, **FITCH** affirmed the sovereign rating of Cyprus at BBB- with a stable outlook. In its analysis, FITCH cited that the ratings balance the broad-based economic recovery and a substantial budget surplus but with the crisis legacy of high public debt and non-performing exposures (NPEs) in the banking sector. FITCH pointed out that the buoyant cyclical recovery of the economy - driven by domestic demand- continued in the past year exceeding that of Euro Area. From that point of view, FITCH forecasts GDP growth to slow in 2019 and 2020 to 3.5% and 2.8%, respectively, as the spare capacity in the economy has been gradually absorbed and the external environment becomes less supportive. FITCH praised Cyprus for its fiscal metrics improvement pointing out that although primary surpluses are expected to decline, they will remain substantial, and combined with robust growth and contained nominal effective interest rates will reduce public debt to 70% of GDP by 2026 down from 102.5% in 2018. Finally, FITCH assessed that addressing the addressing the legacy issues in the banking sector remains an economic policy priority, recalling the recent legislative amendments aimed at strengthening the foreclosures and insolvency frameworks and facilitating NPEs securitizations & sales. The high private sector indebtness and NPEs ratio, despite their recent decline stemming mostly from debt-to-asset swaps, loan write-offs and high nominal GDP growth rather than loan repayment, constrains credit growth.

In its latest review, **DBRS** affirmed the long-term sovereign rating of Cyprus unchanged at BBB- with a stable outlook (they call it trend). According to DBRS, the stable outlook reflects the view that while the Cypriot economy continues to perform robustly, more progress is needed to reduce risks to financial stability further. DBRS took note of the sizeable and material decline in NPEs last year following the orderly exit of CBB, the sale of NPEs by private banks and the government ESTIA scheme which is expected to push retail mortgages NPEs down upon implementation later this year. However, Cyprus still faces significant credit challenges related to still sizable NPEs in the banking sector, high levels of private and public sector debt, external imbalances, and the small size of its service-driven economy, which exposes its economy to adverse changes in external demand. Further on, Cyprus' ratings could come under upward pressure from sustained healthy economic growth and sound fiscal position, which would contribute to the downward trajectory in the public debt ratio.

Moreover, further progress in substantially reducing banks' NPEs and private sector debt, and the strengthening of the banking sector would be positive for the ratings. However, Cyprus' ratings could come under downward pressure in a period of significantly weak growth, combined with large fiscal imbalances or materialization of large contingent liabilities. Finally, a reversal of the downward trajectory in NPEs could also be negative.

Earlier, on March 29th, **Moody's** became the second agency in a row to postpone the scheduled sovereign rating assessment of Cyprus. Recall, that Standard & Poor's postponed its own on March 9th. This is not the first time rating agencies postpone an assessment. For instance, Moody's had done it in February 2018. Nevertheless, it was widely expected that Moody's would upgrade the sovereign rating of Cyprus by at least one notch. In the press release, Moody's cited that that it had completed a periodic review of sovereign issuers which includes Cyprus. However, it clarified that the review did not involve a rating committee, and its publication does not announce a credit rating action and is not an indication of whether or not a credit rating action is likely in the near future.

According to Moody's, the credit profile of Cyprus is supported by the country's moderate economic strength, which reflects the country's 2% medium- to long-term growth potential and balances the country's high wealth levels against its small size and relatively undiversified economy. Cyprus's high institutional strength reflects both the effectiveness of domestic institutions and the fact that the country defaulted on private-sector obligations in 2013; Its moderate fiscal strength, takes account of the country's high debt burden as well as its affordable debt-servicing burden; and its high susceptibility to event risk is driven by the still-substantial risks that persist in the banking sector given high levels of NPEs.

Summing up, all major rating agencies (DBRS, FITCH, Moody's, S&P) upgraded their long-term sovereign rating of Cyprus in 2018, awarding at least one notch in their respective rankings. However, this year in the last round of assessments, the rating agencies appeared reluctant to make public their latest views. Following the last round of assessments, there still remains a **slight divergence** of views between the rating agencies on the sovereign rating of Cyprus (Table 5). Moody's is the only agency among the four major ones which classifies Cyprus two notches below investment grade status.

In the following table we present the sovereign rating review calendar of 2019.

Table 3: Sovereign Rating Review Calendar 2019

Fitch	April 12th	October 11th
S&P	March 8th	September 6th
Moody's	March 29th	September 20th
DBRS	May 17th	November 15th

Table 4
Foreign Currency Long Term Sovereign Ratings of Cyprus

Moody's	S&P	Fitch	DBRS	Rating Description
Aaa	AAA	AAA	AAA	Prime
Aa1	AA+	AA+	AA High	High Grade
Aa2	AA	AA	AA	
Aa3	AA-	AA-	AA Low	
A1	A+	A+	A High	Upper Medium Grade
A2	A	A	A	
A3	A-	A-	A Low	
Baa1	BBB+	BBB+	BBB High	Lower Medium Grade
Baa2	BBB	BBB	BBB	
Baa3	BBB-	BBB-	BBB Low	
Ba1	BB+	BB+	BB High	Non-Investment Grade
Ba2	BB	BB	BB	
Ba3	BB-	BB-	BB Low	
B1	B+	B+	B High	
B2	B	B	B	
B3	B-	B-	B Low	
Caa1	CCC+	CCC+	CCC High	
Caa2	CCC	CCC	CCC	
Caa3	CCC-	CCC-	CCC Low	
Ca	CC	CC	CC High	
			CC	
			CC Low	
	C	C	C High	
			C	
			C Low	
C C C	SD	DDD	D	Default
	D D	DD		
		D		

Source: Rating Agencies
(Upgrade within the last review is marked with green color. Affirmation is marked with grey color)

4.2 Cyprus tapped international markets in a short period of time with very long-term tenors for the first time in the history of the Republic: A new 15-year Eurobond in February and a double issue comprising of a 5-year and a 30-year Euro-denominated bonds in late April

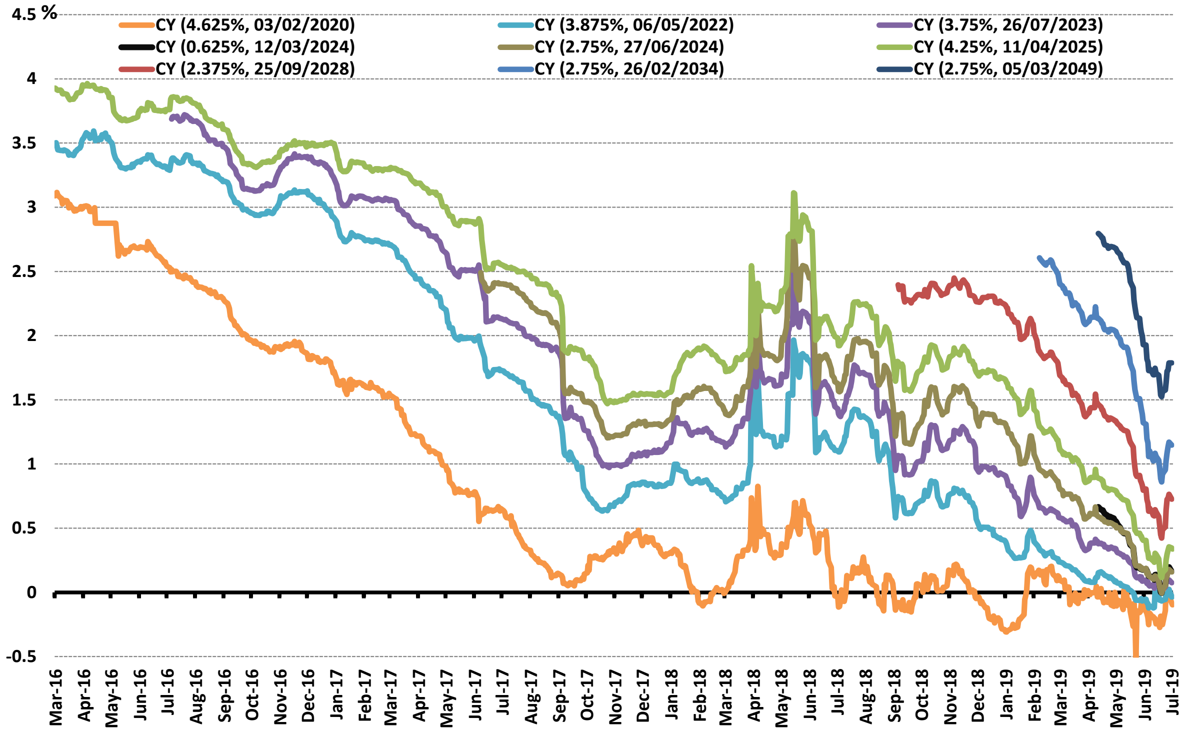
In late February 2019, the Public Debt Management Office (PDMO) sold an offered amount of €1bn of 15-year government bonds for the first time in its history. Citi, Goldman Sachs and HSBC were appointed by the Cypriot government as joint lead managers. The issue was heavily over-subscribed with total bids amounting to €8.1bn. Following the competitive bids, the average accepted price was at 99.903 and the corresponding yield at 2.758%. The latter yield compares with an initial guidance of 3.008%. The issue matures on February 26, 2034 and bears a 2.75% fixed annual coupon. Part of the proceeds of the issue will be utilized to repay two installments of €312.5mn of the bi-lateral loan with Russia.

In late April 2019, the Public Debt Management Office (PDMO) sold an offered amount of €1,25bn of 5Y and 30Y government bonds. Barclays, Deutsche Bank, Goldman Sachs, JP Morgan, Morgan Stanley and SG CIB were appointed by the Cypriot government as joint lead managers. The issue was heavily over-subscribed with total bids amounting to €4.8bn for the 5-year and €6.3bn for the30-year bond. Following the competitive bids, the average accepted price was at 99.738 and 98.298 respectively. The corresponding yield at 0.673% and 2.835% respectively. The issues mature on December 3, 2024 and May 3, 2049 and bear a 0.625% and 2.835% fixed annual coupon respectively. The total gross borrowing needs of Cyprus amount to €2.9bn or 13.4% of projected GDP in 2019. Those include the €1.3bn early prepayments of bonds maturing in 2020-2021 and €1.6bn of treasury bills, bonds and loans.

Despite not participating in ECB's QE, the medium-term Cypriot bond yields were on a declining trend since March 2016, which was interrupted for six months by market fears for the CCB resolution. Yet upon the parliamentary approval of the state guarantees for the asset protection scheme attached to the CCB assets acquired by of Hellenic Bank and the revamping of the foreclosure and repossession frameworks in early to mid-July, government yields declined sharply. Upon regaining investment grade status in late September 2018, Cypriot bonds rallied further throughout Q4-2018. After a short spike in January, the Cypriot bonds embarked again in new declining trend so that now two short-term government bonds maturing in 2020 and 2022 had negative yields (Figures 7a-7b).

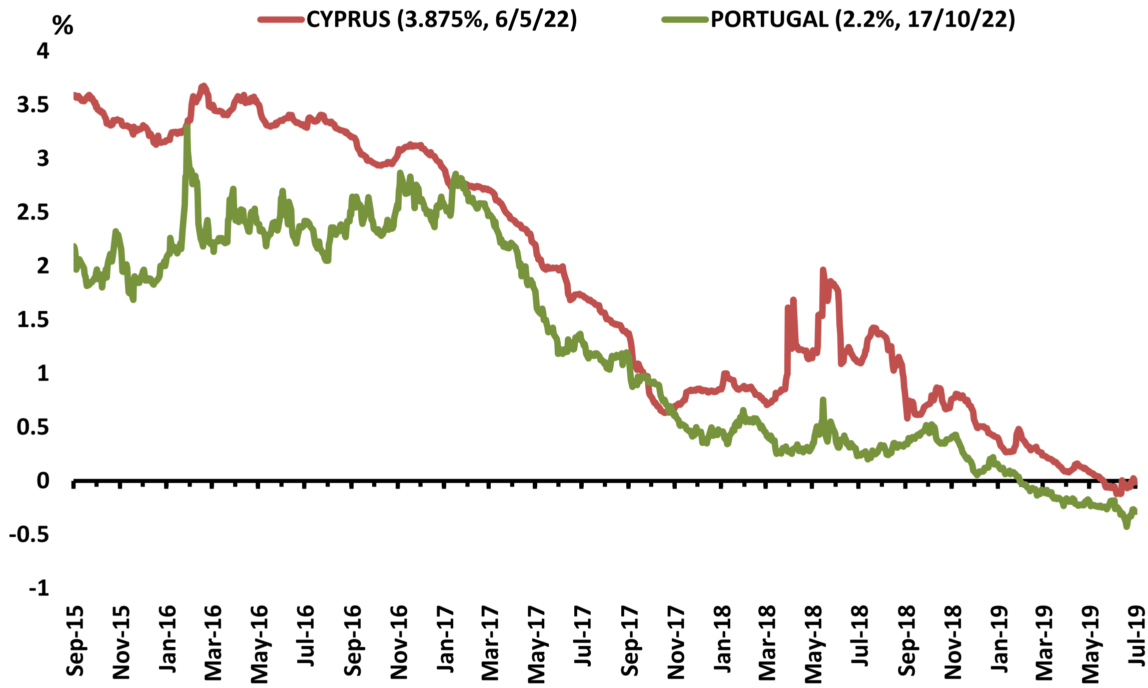
The declining trend was reinforced by the participation of the Cypriot bonds in the ECB's public sector purchase programme (PSPP). Cyprus had participated for a brief period in the ECB's asset purchase programme before it completed its adjustment programme in early 2016. The ECB's cumulative purchases of Cypriot government bonds had reached €214mn. By the end of 2018 when the ECB terminated new bond purchases as part of the PSPP, the stock of Cypriot government bonds acquired by the ECB amounted to €678mn. Even though ECB no longer conducts net purchases, it continues to reinvest the principal payments from maturing securities held in the PSPP portfolio. Thus, ECB purchased Cypriot government bonds amounting to €96mn in June with the total stock reaching €1,178 mn.

Figure 7a: Annualized Yields to Maturity of outstanding Cypriot Government Bonds



Source: Bloomberg, Eurobank Research

Figure 7b: Annualized Yields to Maturity of Government Bonds maturing in 2022: Cyprus vs. Portugal



Source: Bloomberg, Eurobank Research

Note: The Cypriot bond matures in May 2022 and the Portuguese about six months later, in October 2022.

5. Interpreting the latest Cypriot Economic News (March-June 2019)

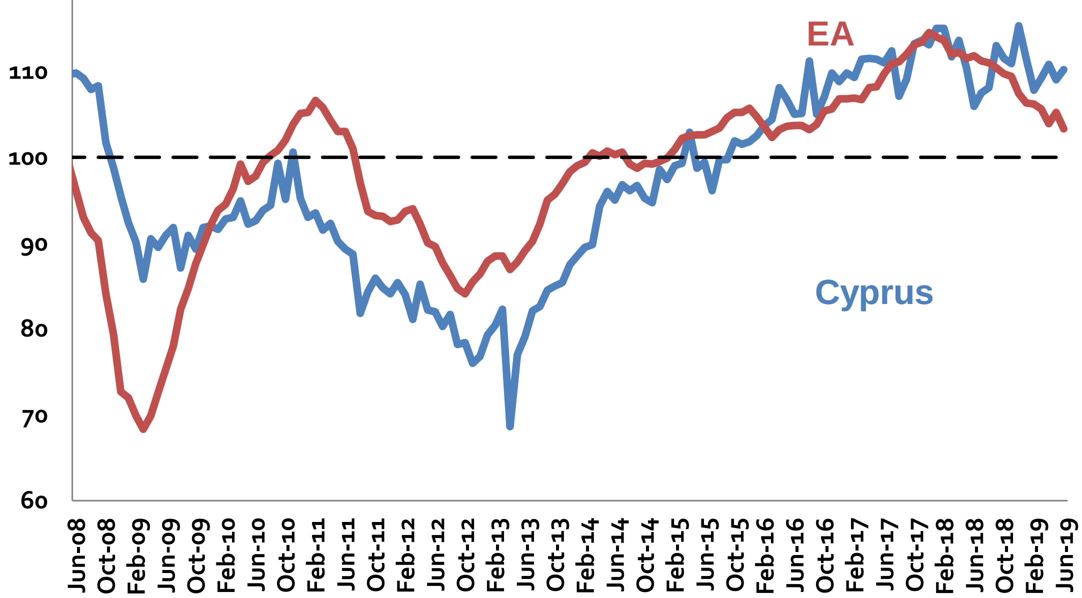
High-frequency indicators behaved relatively well in Q2 despite rising world environment uncertainties

<u>Economic Sentiment Index (ESI Index)</u>
Confidence trending lower in Q2, retrenching back to levels recorded in spring 2018

The ESI Index remained on a declining trend in Q2–2019 retrenching back to comparable levels recorded in spring 2018. Having registered a small rebound in March – April, the ESI index remained range-bound in May-June. In more detail, ESI posted a small increase of 1.2 points in June to 110.2, after a small decline of 1.8 points in May to 109, down from 110.8 in April, 109.2 in March, up from 107.8 in February, compared to 111.4 in January. All sub – indices except for industry and retail trade deteriorated in June. The more pronounced deterioration in exceptions came from construction and services. Having jumped by 10.7 points in May, the highest rise in the last twelve months, construction declined by 4.1 points in June. Services declined by 6.7 points back to levels seen in August – September 2018. Industry, consumer and retail trade components improved by 5.4, 1 and 1.9 points respectively.

The ESI index had reached a new post-Lehman Brothers period peak in December 2018 at 115.8. In our previous report we had pointed out that the decline in economic sentiment in Q1-2019-comparable only to that recorded in May & June 2018 which was very likely related to the negative news surrounding the resolution of Cyprus Cooperative Bank (CCB)-most likely reflects rising global uncertainties and trade disputes. To some extent, it is also correlated and synchronized with the ESI index declining trajectory in the full Euro Area. In contrast to what happened in Q2-2018, this time, the ESI Index decline in Q1 was reflected to some extent in the concurrent GDP growth reading. If global uncertainties and trade disputes don't subside in the 2H-2019, then the impact on the short-term prospects of domestic economic activity will most likely become even more pronounced. Summing up, the ESI Index stands above its long-term average. In any case, the improvement recorded in the past four years – a total of 41.6 points since the crisis period in April 2013 - is still the highest among all countries in EU-28 over the same sample period.

Figure 8: Index of Economic Sentiment



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Source: Eurostat, Eurobank Research

Consumer prices (HICP)

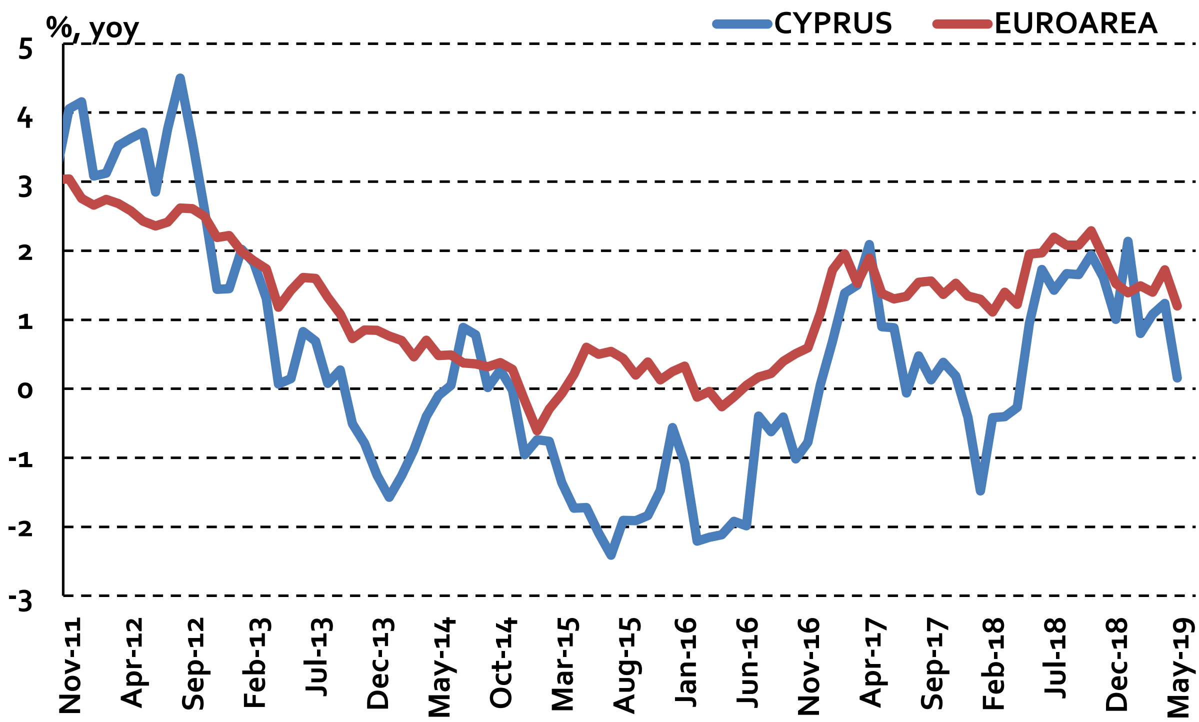
Inflation moderated further in Q2-2019 reflecting broadly the effect of two opposite forces: lower food and higher utility prices

Having re-entered in positive territory in May 2018, consumer prices, measured by HICP, peaked in January 2019. Having jumped to a multi month high at +1.0% MoM/+2.1% YoY in January 2019, compared to only +0.3% MoM/+0.1% YoY in December 2016, HICP started decelerating again in 1H-2019. More specifically, HICP came at +0.3% MoM/+0.2% YoY in May down vs. +1.3% MoM/+1.2% YoY in April, up from +1.1% MoM/+1.1% YoY in March, compared to -0.2% MoM/+0.8% YoY in February and -0.9% MoM/+1.0% YoY in December 2018.

The biggest increase on an annual basis was observed in the categories of “Utilities” (+0.6% MoM/+5.8% YoY in May, bringing the Jan-May 2019 rate of expansion at 7.9% YoY, down from -0.7% MoM/+6.4% YoY in April vs. +0.4% MoM/+8.0% YoY in March). The rise in “utilities” reflects the subsequent adjustment in the local electricity tariffs by the state-owned energy company mirroring the spike in world energy prices. “Clothing & Footwear” (+1.0% MoM/-3.8% YoY in May, -0.5% YoY in Jan-May2019) and “Communications” (+3.3% MoM/-2.8% YoY in May, -5.2% YoY in Jan-May 2019) stand out because they were the categories with the highest annual decrease in May. Food & Non-alcoholic prices declined to -0.6% MoM/-1.3% YoY in May bringing the Jan-May 2019 rate of expansion at 3.3% YoY.

As of May, the rise of energy prices and volatile food (fruit and vegetables) accounted for 0.1 ppts and -0.1ppts of HICP inflation respectively while non-energy industrial goods subtracted another -0.5ppts from and services added another 0.6ppts to the headline respectively. Having emerged out of a four year deflation, inflationary pressures remain relatively low. The average annual HICP climbed to only 0.8% YoY up from 0.7% YoY in 2017 compared to -1.2% YoY in the 2016, -1.5% YoY in 2015 and -0.3% YoY in 2014.

Figure 9: HICP in Cyprus vs. EA-19



Source: Eurostat, Eurobank Research

Deposits & Loans

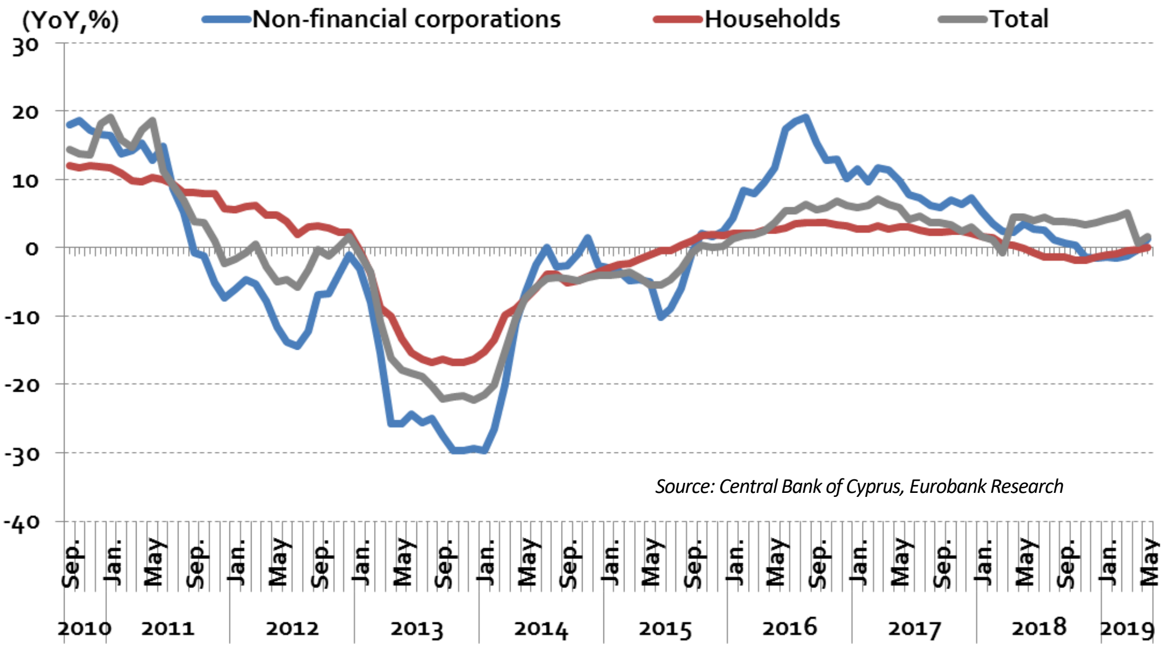
Banking system deposits expand for a second consecutive month in May mirroring further normalization of financial conditions

The Central Bank of Cyprus published on July 1st the Monetary and Financial Statistics (MFS) of May.[7] From a flow point of view, total deposits recorded a net increase of €688.3mn in May, compared with a net increase of €236.9mn in April, up from a net decrease of €327.7mn in March. The annual rate of expansion in deposits - which has been in positive territory since October 2015 with the exception of only one month in March 2018 –increased to 1.7% YoY in May up from 0.6% YoY in April and down from 5.1% YoY in March on negative base effects from last year's government liquidity injection of €2bn in the banking system. Total deposits reached €48.4bn in May up from €47.7bn in April compared to €47.9bn in December 2018 against €49.4bn in December 2017 vs. €49.0bn in December 2016[8].

Total loans exhibited a net increase of €37.8mn in May up from a net decrease of €206.4mn in April on top of a net increase of €63.2mn in March, and a net increase of €19.0mn in February. The annual growth rate of contraction came at -2.1% YoY in May compared to -2.3% YoY in April and -2.0% YoY in March, -2.6% YoY in December 2018, compared to -1.7% YoY in December 2017 and -10.7% YoY in December 2016. The outstanding amount of loans reached €38.0bn in May unchanged vs. April, €38.3bn in March and February, compared to €46.2bn in December vs. €51.4bn in December 2017 and €55.3bn in December 2016.

Overall, the government liquidity injection and the stabilization of depositors' sentiment after the absorption of the CCB's performing assets by Hellenic Bank coupled with the ongoing deleveraging process has allowed for an improvement in the domestic liquidity conditions. According to the latest available SSM data, the domestic system enjoys the second highest liquidity coverage ratio – behind Slovenia- among Euro area members. The relevant ratio climbed further to 333.5% in Q4-2018 up from 305.67% in Q3-2018, above the EU average of 152.0% and more than two times higher than the Basel III required threshold.

Figure 10: Annual growth of deposits



7 https://www.centralbank.cy/images/media/xls/MFSJune2019eng.xls

8 The Central Bank is using ECB methodology to calculate the annual growth with a special formula, taking into account the monthly transactions

Residential Property Price Index (RPPI)-Q3-2018

The RPPI Index recorded in Q3-2018 the seventh increase on an annual basis

The Central Bank of Cyprus published in early March the residential property price index (RPPI) for Q3-2018. On a quarterly basis, the RPPI increased by 0.3% QoQ, remaining unchanged compared to the previous quarter, compared to 0.6% QoQ in Q1-2018, 0.4% QoQ in Q4-2017, 0.4% QoQ in Q3-2017. The quarterly rise reflects the combined effect of an increase in flat apartments prices by 1.2% QoQ and house prices staying flat. The sub-indices of residential property prices by district have increased across the board, with the exception of Paphos, which recorded a marginal decrease of 0.2% on a quarterly basis.

On an annual basis, the RPPI Index expanded by 1.6% YoY in Q3-2018 vs. 1.7% YoY in Q2-2018 compared to 1.8% YoY in Q1-2018, recording the seventh consecutive quarterly increase for the first time since 2008. This was up from 1.5% YoY in Q4-2017, 1.4% YoY in Q3-2017, 1.1% YoY in Q2-2017 up from 0.2% YoY in Q1-2017, -0.9% YoY in Q4-2016 compared to -1.3% YoY in Q3-2016, -1.7% YoY in Q2-2016, and smaller in absolute terms than -1.6% YoY in Q1-2016, -1.8% YoY in Q4-2015 and -3.7% YoY in Q3-2015. All residential prices district sub-indices (Famagusta, Nicosia, Larnaca, Limassol) have recorded increases on an annual basis, with the exception of Paphos where prices recorded a small decline (-0.4% YoY). The largest annual increase in house prices was recorded in Famagusta (4.6%) and in apartment prices in Limassol (6.1%).

Figure 11a: RPPI Index (2010Q1=100)

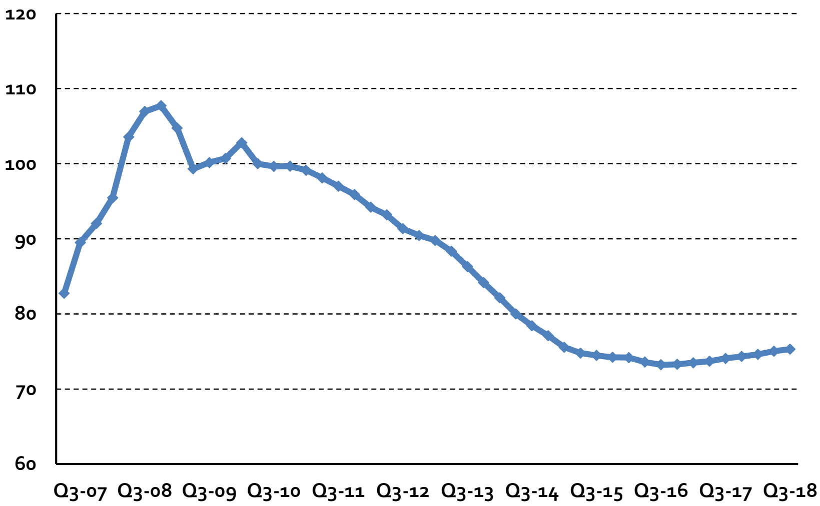
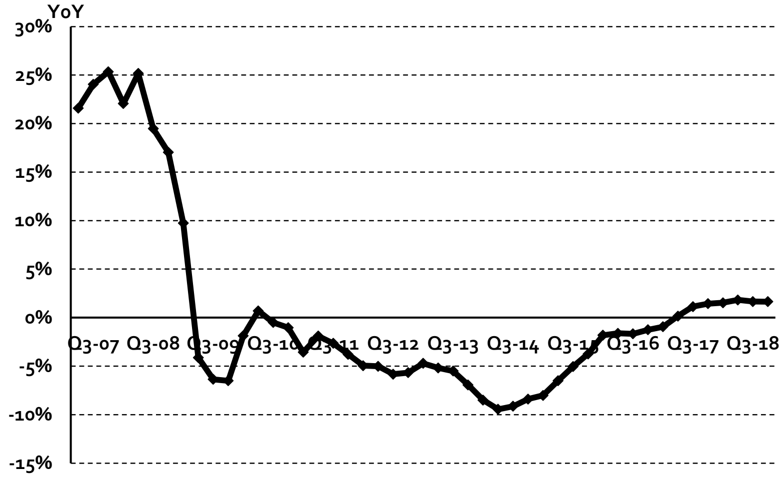


Figure 11b: RPPI Index (%, YoY)



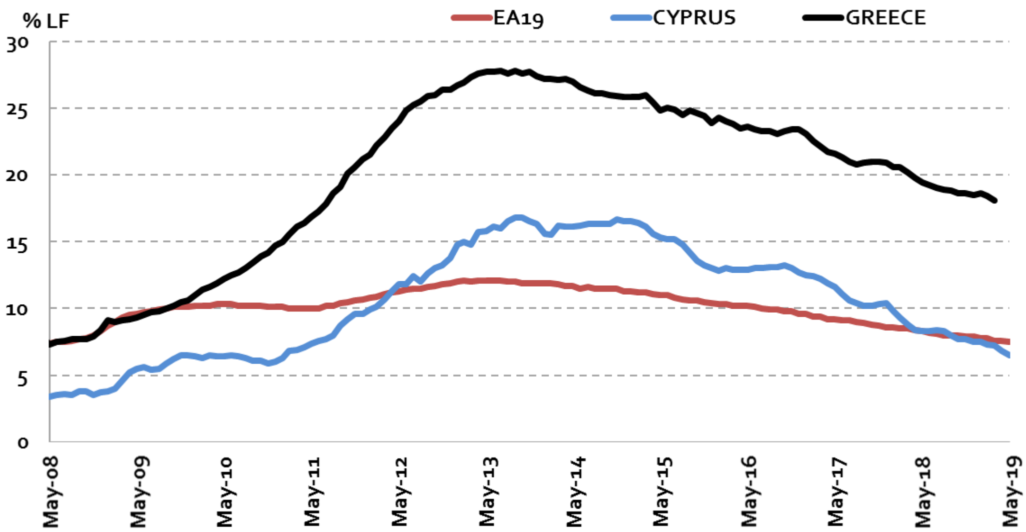
Source: Central Bank of Cyprus, Eurobank Research

Unemployment

Unemployment reaches new multi-month lows in Q2-2019, dropping below the EA19 average for the first time since 2012

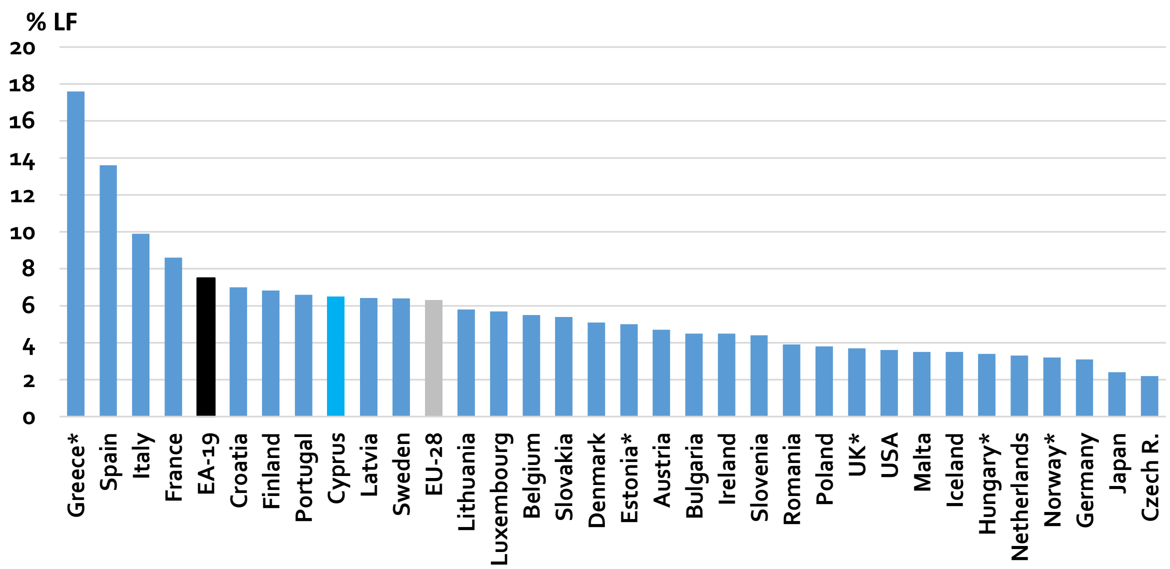
According to the latest Labor Force Survey (LFS), unemployment on a seasonally adjusted basis declined further to 6.9% in April - reaching a new multi-month low - down from 7.2% in March, 7.4% in February, 7.5% in December 2018, 10.4% in December 2017, 12.7% in December 2016, and 16.8% at its peak in October 2013. Overall, Cyprus recorded the highest unemployment decline (by 0.6 ppts) in EU-28 in the first four months of 2019 and one of the highest (by 1.5ppts) in EU-28 in last twelve months, so that unemployment has now declined below that of Euro Area (See Figure 12). Despite the improving trend, unemployment in Cyprus is still the sixth largest (behind Greece, Spain, Italy, France and Croatia) in EU-28. Youth unemployment is a source of concern and requires more attention.
5

Figure 12a: Unemployment rate



Source: Eurostat, Eurobank Research

Figure 12b: Unemployment rate across EU-28 May-2019 (April*)



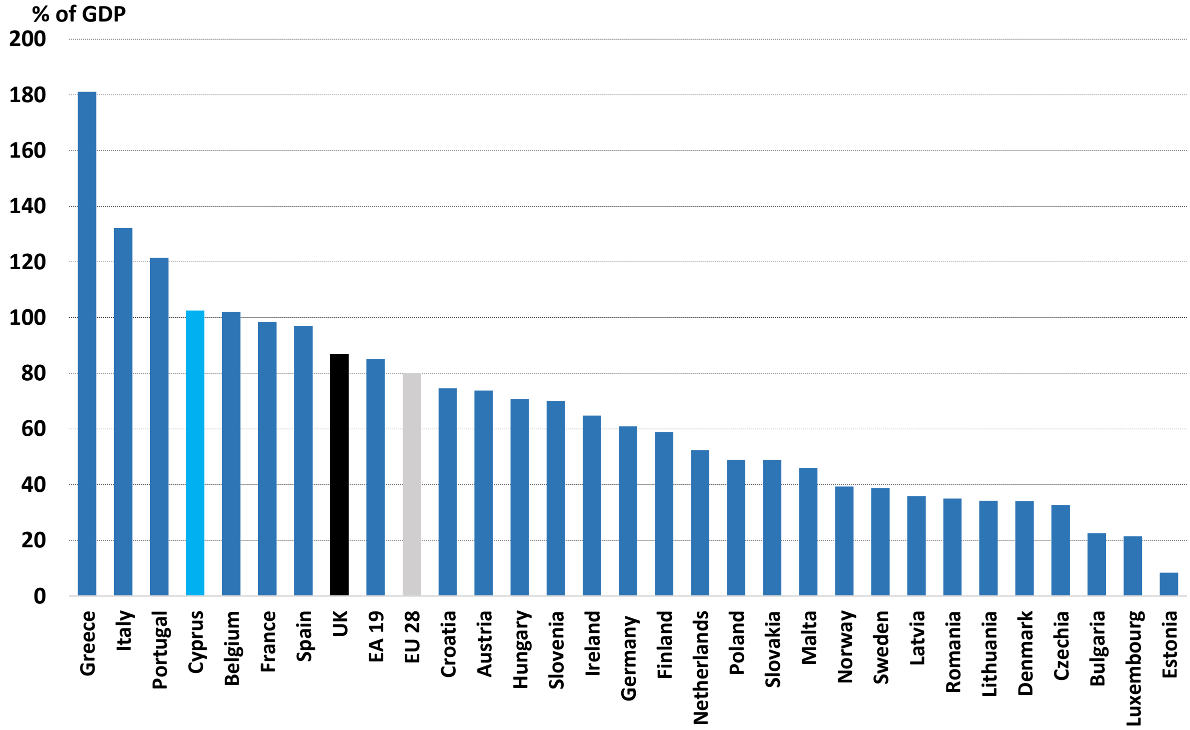
Source: Eurostat, Eurobank Research

Q4-2018 General Government Deficit and Public Debt (ESA2010 terms)
Cyprus improves temporarily in the public indebtness ratio in Eurostat ranking

On April 24th, Eurostat announced the provisional data for the fiscal deficit and public debt in the fourth quarter of 2018.[9] In ESA2010 terms, Cyprus recorded a €111.8mn general government deficit in Q4-2018 which is equivalent of -2.1% of the GDP in the same quarter compared to a €1325.4mn general government deficit in Q3-2018 which is approximately -25.1% of the GDP in the same quarter, switching from an earlier surplus of €106.0mn or 2.0% of the GDP in the same quarter in Q2-2018, compared to a balanced position in EU-28 of -1.2% and a Euro Area deficit of -0.6% in the final quarter of 2018.

As a result, the general government debt as percentage of GDP climbed to 102.5% or €21.2bn in Q4-2018 up from 110.1% of GDP or €22.6bn in Q3-2018, compared to 102.9% of GDP or €20.9bn in Q2-2018, down from 92.9% or €18.5bn in Q1-2018, compared to 95.8% or €18.8bn in Q4-2017. Cyprus' ranking among EU-28 members deteriorated: As of Q4-2018, the Cypriot government debt as a percentage of GDP was the fourth highest, behind that of Greece (181.1%), Italy (132.2%) and Portugal (121.5%). The public debt of Cyprus is primarily in the form of debt securities (52.2% of total) and loans (49.7% of total).

Figure 13: General Government Debt across EU-28 members in Q4-2018



Source: Eurostat, Eurobank Research

[9] https://ec.europa.eu/eurostat/documents/2995521/9737341/2-24042019-AP-EN.pdf/ca776eb7-ad40-416b-bbd2-090cf7ba43af

January-May 2019 Budget execution

The budget was in surplus in the first five months of 2019

The consolidated government surplus increased to €517.7mn in 5M-2019, up from €393.4mn in 5M-2018. As a percentage of GDP, the consolidated government surplus came at +2.4% in 5M-2019, compared to +1.9% of GDP in 5M-2018. The primary surplus stood at +3.1% of GDP in 5M-2019 compared to +2.7% of GDP during the same period a year ago. Total revenues improved by +6.9% YoY, driven by double digit growth in social security contributions (+11.0% YoY) while indirect taxes (-2.5% YoY) and their most important component, VAT revenues collection (+0.3% YoY) were lagging behind. On the other hand, total expenditure remained relatively contained, expanding by +3.5% YoY driven by higher spending on public wages (+5.7% YoY), current transfers (+8.1% YoY) and capital expenditure (+12.4% YoY). Spending items such as pensions (+1.2% YoY), social security payments (+1.1% YoY) and interest payments (-5.8% YoY) remained contained or even decreased.

Table 5: General Government Budget Execution

General Government Adjusted Budget Balance on cash basis (January-May 2019)		
in % GDP	January-May 2018	January-May 2019
I. Government Budget and SSF		
Total Revenue	14.0%	14.4%
Current revenue	13.8%	13.8%
Direct Taxes	3.7%	3.7%
Indirect Taxes	6.1%	5.8%
of which, VAT	3.9%	3.8%
Social security contributions	2.5%	2.7%
Non-tax revenue	1.4%	1.6%
Capital Revenue	0.0%	0.0%
Grants	0.3%	0.6%
Total Expenditure	12.4%	12.3%
Current expenditure	12.1%	12.0%
Wages and Salaries	3.4%	3.4%
Goods and services	0.7%	0.7%
Subsidies	0.2%	0.1%
Social Security payments	2.9%	2.9%
Pensions	1.1%	1.1%
Social Pensions	0.1%	0.1%
Current transfers	2.8%	2.9%
Non-allocated	0.1%	0.0%
Interest payments	0.8%	0.7%
Capital expenditure	0.3%	0.3%
Balance (I)	1.7%	2.1%
II. Other General Government Bodies		
including		
Local Authorities	0.0%	-0.1%
Semi-public Entities	0.0%	0.1%
Other Entities	0.1%	0.1%
Balance (II)	0.0%	0.1%
III. ESA 2010 adjustments		
Balance (III)	0.2%	0.2%
III. General Government Balance		
Budget Balance (I+II+III)	1.9%	2.4%
Primary Balance (excl. interest)	2.7%	3.1%
Cyprus GDP (Mrd EURO-CYP)	20,705.3	21,570.8

Source: Ministry of Finance, Eurobank Research

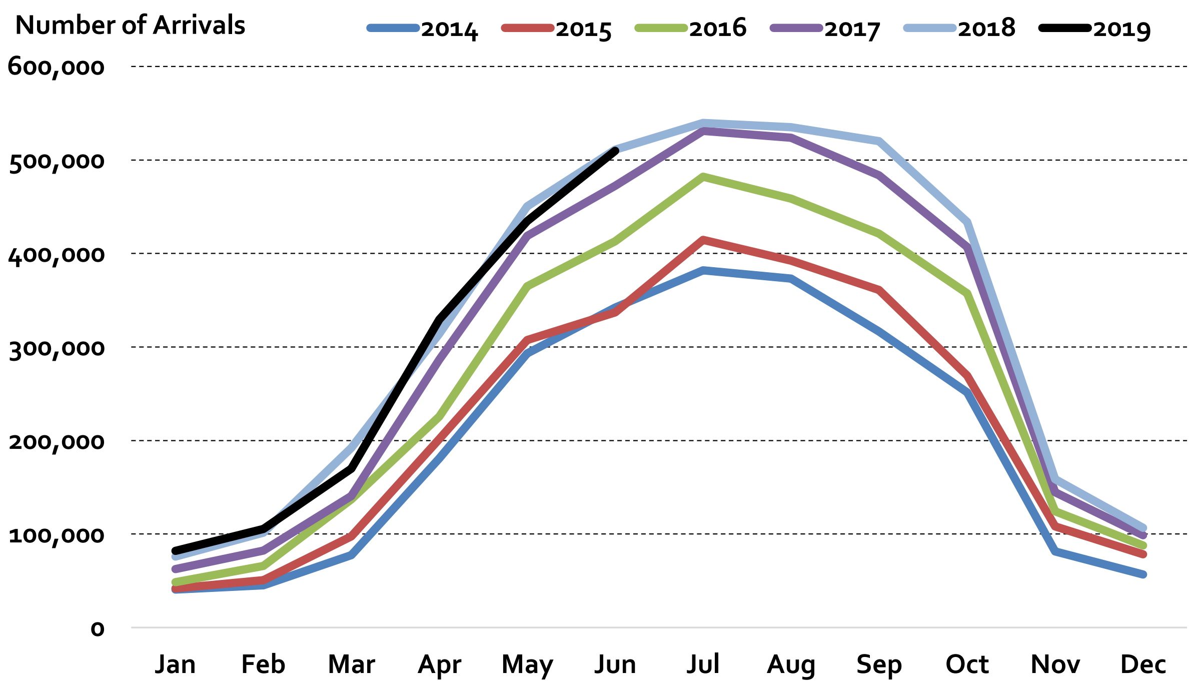
Tourism arrivals (January-June 2019) & revenues (January-April 2019)
Tourism industry confronted with challenges in 2019

The latest data on arrivals predispose for a difficult year in the tourist industry. Having registered the first decline on an annual basis in March that marked the end to an unbroken run since 2015, tourist arrivals to Cyprus dropped for a third time this year in June. According to the latest statistics released, tourist arrivals declined by -0.3% YoY in June (from 511.073 in June 2018 to 509.662 in June 2019), bringing the rate of contraction down to -0.9% YoY in the first six months of the year.

Tourist arrivals from the UK – the island's biggest market – were virtually unchanged (+0.4% YoY) while the second largest market that of Russia, recorded a -4.4% YoY decline in Jan-Jun2019. Arrivals from key markets such as Germany and Greece were also down by -18.2% and -7.6% respectively. In contrast, tourist arrivals from Israel had a significant increase (+11.5% YoY). Finally the additional positive performance of some smaller markets such as Norway (+13% YoY) and Ukraine (+36.2% YoY) was not enough to offset the overall decline.

On top, tourism revenues declined by -1.9% YoY in January-April 2019 to €375.2mn, down from €382.5mn compared to the same period last year. On top, the corresponding statistics for expenditure per person are on a declining trend. The expenditure per person for 4M-2019 reached €546,32 compared to €559,54 in the corresponding period of the previous year, recording a decrease of 2.4%. In fact, the expenditure per person/per day for the period of January-April 2019 compared to the period of January-April 2018 remained flat (from €66,61 to €66,62). There are a number of reasons to explain this declining trend not only limited to the changing composition of tourist arrivals, such as shifting markets with lower income and purchasing power (e.g. Eastern Europe) or the disruption of the traditional tourist product from new digital platforms of the sharing economy (e.g. Airbnb)

Figure 14: Tourism Arrivals



Source: CYSTAT, Eurobank Research

Eurobank Cyprus Research

Economic Indicators	Description	Source	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
National Accounts																	
Population	Number	Eurostat	722,893	733,067	744,013	757,916	776,333	796,930	819,140	839,751	862,011	865,878	858,000	847,008	848,319	854,802	864,823
GDP (%YoY)	Constant Prices	Eurostat	5.0	4.9	4.7	5.1	3.7	-2.0	1.3	0.4	-2.9	-5.8	-1.3	2.0	4.8	4.5	3.9
Households and NPISHs Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	7.2	3.9	3.9	9.7	8.2	-6.5	3.0	-0.5	-1.2	-5.7	1.0	2.4	4.5	4.1	3.7
General Government Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	-1.8	2.3	7.2	3.4	6.4	6.3	-0.3	1.5	-2.5	-4.8	-7.5	-0.5	-0.8	3.1	4.3
Gross Fixed Capital Formation (YoY%)	Constant Prices	Eurostat	5.8	6.5	20.9	7.5	8.4	-13.6	-2.9	-11.9	-20.4	-16.6	-19.0	13.8	41.8	29.0	-7.1
Exports of Goods and Services (YoY%)	Constant Prices	Eurostat	3.2	3.1	2.3	5.4	-0.6	-4.7	4.5	5.7	-2.7	2.1	4.3	5.2	4.6	6.0	3.3
Imports of Goods and Services (YoY%)	Constant Prices	Eurostat	7.4	1.0	5.7	9.6	13.0	-15.3	7.8	-3.2	-4.7	-4.0	3.6	8.4	6.6	12.2	2.0
GDP	Current Prices, SA ,mil	Cyprus Statistical Service	13938.0	15039.3	16263.8	17591.0	19006.2	18673.5	19299.5	19731.0	19489.7	18140.5	17610.0	17746.0	18490.2	19648.7	20730.9
GDP (%YoY)	Current Prices, SA ,mil	Cyprus Statistical Service	7.9	7.0	8.0	9.5	8.5	-1.8	3.4	2.2	-1.2	-6.9	-2.9	0.8	4.2	6.3	5.5
Labour Market																	
Unemployment Rate	% active population	Eurostat	4.6	5.3	4.6	3.9	3.7	5.4	6.3	7.9	11.9	15.9	16.1	15.0	13.0	11.1	8.4
Labor Productivity	Real, Per employee, % Change	Eurostat	1.0	1.2	2.8	0.6	0.1	-2.0	0.9	0.4	0.3	0.1	0.5	0.5	0.2	0.2	-0.1
Labor Productivity	Real, Per hour worked, % Change	Eurostat	3.0	2.9	3.6	-0.9	-1.0	-1.4	1.6	1.2	0.7	1.8	1.0	0.5	0.1	0.4	0.2
Unit Labor Costs	Index, 2010=100	Eurostat	83.2	87.7	88.9	90.0	92.8	100.2	100.0	101.7	103.1	97.4	93.5	91.9	90.7	91.2	91.5
Unit Labour Cost Growth Total Economy	YoY%	Eurostat	1.1	5.4	1.4	1.2	3.1	7.9	-0.2	1.7	1.4	-5.5	-4.0	-1.7	-1.4	0.6	0.3
Short-term business statistics																	
Economic Sentiment Index (ESI)	EoP, SA	EU Commission	106.3	98.4	106.4	106.9	95.8	92.6	95.8	84.8	76.3	88.5	100.2	103.9	113.3	115.7	115.3
Industry	EoP, SA	EU Commission	-36.4	-26.2	-31.8	-40.8	-39.2	-40.5	-46.7	-61.3	-43.9	-20.2	-10.0	-4.0	-0.4	8.7	11.9
Construction	EoP, SA	EU Commission	-4.4	-32.7	2.7	-7.9	-27.5	-38.8	-44	-51.5	-56.5	-54.5	-49.8	-30.3	-27.4	-24.3	-11.3
Retail trade	EoP, SA	EU Commission	3.3	5.2	0.7	11.2	-12.8	-22.5	-22.6	-29.0	-31.8	-19.1	-10.6	-1.6	8.5	10.0	1.5
Services	EoP, SA	EU Commission	14.4	6.1	15	8.7	1.8	-3.6	3.6	-25.2	-40.7	-24.2	11.4	8.2	28.4	36.5	44.3
Industrial Production General Index	NSA	Eurostat	135.0	135.7	136.3	142.8	149.2	135.3	132.9	122.6	110.6	95.7	95.1	100	109.3	117.1	123.4
Industrial Production General (%YoY)	NSA	Eurostat	1.5	0.9	0.6	4.5	4.1	-9.1	-1.8	-7.6	-9.9	-13.5	-0.6	5.2	9.2	7.5	5.2
Housing and Real Estate																	
Building Permits	Number	Cyprus Statistical Service	8252.0	9098.0	9794.0	9521.0	8896.0	8950.0	8777.0	7506.0	7172.0	5341.0	4933.0	5014.0	5354.0	5728.0	6408.0
Value of permits	mil €	Cyprus Statistical Service	1994.6	2288.9	2473.4	2782.3	2904.6	2815.8	2639.5	2065.1	1632.3	1141.0	859.5	1071.4	1047.1	1719.8	1297.7
Area of permits	(Thousand Sqm)	Cyprus Statistical Service	3015.7	3417.0	3507.5	3612.8	3689.1	3136.5	2917.9	2253.0	1499.9	1044.8	784.9	881.1	1157.6	1542.7	1338.4
Dwelling Units	Number	Cyprus Statistical Service	15743.0	18770.0	18915.0	20486.0	20082.0	16688.0	14312.0	8839.0	5879.0	4141.0	2855.0	3197.0	3649.0	4939.0	6201.0
Personal/Household Sector																	
Credit for Consumption	mil €	ECB MFIs Statistics		2,577	2,848	3,118	4,261	4,770	3,390	3,371	3,341	3,039	2,794	2,792	2,583	2,486	1,813
Lending for House Purchase	mil €	ECB MFIs Statistics		4,140	5,450	6,989	8,584	10,492	12,033	12,658	12,772	11,943	11,747	11,735	11,587	11,187	8,718
Other Lending Cyprus	mil €	ECB MFIs Statistics		5,645	5,676	6,111	6,366	5,600	7,381	7,855	8,025	7,558	7,433	7,099	6,736	6,274	3,030
Total MFI Loans to Non-MFIs Domestic Residents	Monetary & Financial Statistics	Central Bank of Cyprus		25,005	27,511	33,995	43,452	45,681	49,403	52,870	53,936	50,082	49,583	51,201	45,310	43,116	30,877
Total deposits of Non-MFIs held with MFIs Domestic Residents	Monetary & Financial Statistics	Central Bank of Cyprus		24,874	27,401	32,294	39,462	41,012	45,379	43,748	43,317	32,973	32,283	32,868	36,586	37,807	37,599
Gross Household Saving Rate	% of Gross Disposable Income	Eurostat	8.7	11.5	11.6	6.2	5.0	9.2	6.5	6.4	3.7	-1.8	-6.2	-4.5	-3.2	-3.1	N/A
International Trade & Balance of payments																	
Current account balance (%GDP)	BMP6	Eurostat, IMF (2018)					-15.5	-7.7	-11.3	-4.1	-6.0	-4.9	-4.3	-1.5	-5.1	-8.4	-7.0
Current Account, Goods & Services Net Balance (%GDP)	BMP6	Eurostat, IMF (2018)					-12.8	-5.4	-7.3	-2.9	-1.5	1.8	2.0	0.8	-0.6	-3.5	-2.0
Current Account, Primary Income Net Balance (%GDP)	BMP6	Eurostat, IMF (2018)					-2.5	-1.3	-3.0	0.0	-3.0	-4.7	-3.6	0.6	-2.0	-2.7	-2.8
Current Account, Secondary Income Net Balance (%GDP)	BMP6	Eurostat, IMF (2018)					-0.3	-1.0	-1.0	-1.1	-1.4	-2.1	-2.7	-2.9	-2.4	-2.1	-2.0
Imports of Goods (%GDP)	BMP6	Eurostat, IMF (2018)					42.2	34.7	36.8	35.5	33.6	31.2	31.9	33.0	35.1	37.7	38.0
Exports of Goods (%GDP)	BMP6	Eurostat, IMF (2018)					12	13.1	13.9	15.3	15.6	15.0	15.9	16.2	14.1	13.4	16.9
Imports of Services (%GDP)	BMP6	Eurostat, IMF (2018)					20.7	19.4	20.7	20.4	21.3	25.7	28.1	30.8	30.1	30.9	29.1
Exports of Services (%GDP)	BMP6	Eurostat, IMF (2018)					38.1	35.7	36.3	37.6	37.8	43.7	46.1	48.3	50.5	51.7	48.0
Financial Account (%GDP)	BMP6	Eurostat, IMF (2018)					-18.5	-8.4	-8.6	-1.2	-2.1	-1.9	-7.1	-1.6	-4.7	-5.6	-4.2
Net International Investment Position (%GDP)	BMP6	Eurostat, IMF (2018)					-79.1	-100.3	-111.2	-129.9	-129.1	-138.7	-147.0	-145.0	-123.0	-121.1	-114.7
External Debt (%GDP)	BMP6	Central Bank of Cyprus					592%	687%	665%	632%	617%	569%	554%	573%	576%	552%	495%
Government Finance & Debt																	
General Government Deficit (-) or Surplus (+) (% GDP)	including Coops banks' recap	Cyprus Statistical Service	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-9.0	-1.3	0.3	1.8	-5.1
General Government Debt EDP Procedure (% GDP)		Cyprus Statistical Service	64.8	63.4	59.3	54.0	45.6	54.3	56.8	66.2	80.1	103.1	108.0	108.0	105.5	95.7	102.5
Prices																	
CPI (%YoY)	Annual Average	Cyprus Statistical Service	2.3	2.6	2.5	2.4	4.7	0.3	2.4	3.3	2.4	-0.4	-1.4	-2.1	-1.4	0.5	1.4
Cyprus HICP All Items (% YoY)	Annual Average	Eurostat	1.9	2.0	2.2	2.2	4.4	0.2	2.6	3.5	3.1	0.4	-0.3	-1.5	-1.2	0.7	0.8
Tourism																	
Tourist & Excursionist Arrivals	Number	Cyprus Statistical Service	2,349,007	2,470,057	2,400,919	2,416,075	2,403,744	2,141,187	2,172,993	2,392,223	2,464,903	2,405,387	2,441,231	2,659,400	3,186,531	3,652,073	3,938,625
Revenue From Tourism	mil €	Cyprus Statistical Service	1,678,419	1,718,302	1,755,252	1,858,106	1,792,787	1,493,246	1,549,801	1,749,306	1,927,600	2,082,400	2,023,400	2,112,100	2,363,400	2,639,100	2,639,800
Market Indicators																	
10Y Gov Bond Yield Rate	%, EMU criterion series	Eurostat	5.8	5.2	4.1	4.5	4.6	4.6	4.6	5.8	7.0	6.5	6.0	4.5	3.8	2.6	2.2
Cyprus Stock Exchange Index	EoP, Composite Index	Bloomberg	1012.27	1704.76	3900.39	4820.72	1101.42	1597.23	1055.21	295.94	114.86	103.31	85.70	67.75	66.41	69.50	66.77