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1. Trip notes - fact findings from our recent trip to Nicosia (Sep. 27th-29th)

In late September, we traveled to Nicosia where we met with high-level officials from the Central Bank, the Finance Ministry, the IMF, as well as market participants from the domestic financial sector. Our visit took place in the aftermath of the S&P upgrade to investment grade status and the successful tapping of international bond markets by the Republic of Cyprus for the third time since its exit from its economic adjustment program in late March 2016. Below we provide a summary of our findings about the recent developments in the Cypriot economy and the outlook for 2018, the thorny issue of NPEs and their remedial, the short & medium term unaddressed challenges and finally the recent upgrades by rating agencies.

- **Cyprus avoided a new MoU with international institutions in the last minute during last spring**. It came on the brink of a new MoU with the Troika after an onsite inspection of SSM in the Cyprus Co-operative Bank (CCB) revealed a short-fall of €900mn in provisions coverage in December, which would have pushed the capital ratio below the limit allowed for a bank to continue as a going concern.

- **The final solution was costly for the Cypriot tax-payer, yet it seems to be the option with the minimum fiscal and reputational costs among possible options**. Failure to address the issue of the Co-operative Bank would have resulted in the activation of the bail-in clause. Yet there was little of stakeholder money other than of stock-owners to bail-in, since there were no bank bonds on the liabilities side and the vast majority of the €9.7bn customer deposits were in accounts of less than €100 thousand and thus insured. Adding to this, the Cyprus depositors' insurance fund firepower is only €150mn – way too small to compensate insured depositors (those depositors whose bank accounts stood below the €100k threshold).

- **According to our contacts, the cost for the Cypriot tax-payer reached €3.5-4bn**. The aforementioned amount includes the value of the bonds that the Cypriot government issued plus the asset protection perimeter given to Hellenic Bank, which bought the performing asset of CCB. To calculate the net impact, the recovery rate of the NPEs should be taken into account.

- The effort to address this issue was more contentious and costly than initially thought or presented by the media in the news. Heavy outflows from the Co-operative Bank both in the period before and after the Presidential elections ran down the available liquidity of the bank to below acceptable levels

- **The resolution of the case of the Co-operative Bank is a game changer in the battle to address the thorny issue of NPEs**. The sizeable amount of NPEs removed from the banking sector will allow for an important -but one-off- decline in the NPEs ratio from 40% currently to the much lower 30%. The aforementioned official Central Bank statistics for the NPEs as of June have already mirrored the Bank of Cyprus (BOCY) securitization transaction with Apollo (€2.8bn)-to be approved by SSM by late 2018 or early 2019.

- **The carving-out of NPEs from the Co-operative Bank has generated a new set of challenges.** The establishment of a new management company to handle the sizeable volume of NPEs necessitates the implementation of a transparent, professional, efficient and publicly accountable governance framework. The success of this management company is crucial not only for the recoverability of the NPEs in order to minimize the cost to the taxpayer but also because failure to deliver could induce moral hazard in the rest of the system.

- **Further progress on the NPEs issue hinges upon two more game-changing factors**: 1) the successful implementation of the reformed insolvency and foreclosures frameworks 2) the evolution of the government subsidized ESTIA plan.

- The adoption of new **insolvency and foreclosures** laws by the parliament without any amendments has created optimism that the new framework will empower banks to pursue strategic defaulters more efficiently than previously. We look forward to see this happening.

- **ESTIA Plan:** The government has drafted and made public the so-called ESTIA plan, which incentivizes both parties' creditors (the banks) and debtors (borrowers) to come to an agreement on restructuring residence first mortgage loans 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. Then, provided the debtor fully services his remaining restructured debt, the government will subsidize 1/3 of the reduced installment at the end of the process.

- The announced criteria of **eligibility for the ESTIA plan** were **heavily criticized** as overly generous and moral hazard inducing. The plan also favors borrowers who are not in actual need for state aid in order to repay their debts. Those include many of the borrowers whose first residence property market value is less €350,000, their combined annual family income is less than €50,000, and their total net wealth is less than 1.25 times the market value of the underlying home.

- **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 - not an easy task- has to be maximized.

- **State intervention in the banking system** occurred **at the expense of** temporarily **reversing the downward trend in public debt dynamics**. The one-off banking system state injection pushed the projected public debt to GDP ratio temporarily up to 104% of GDP in 2018 from 97.5% in 2017. This increase is not expected to reverse the overall downward trajectory of debt-to-GDP, provided fiscal policy remains prudent and nominal

GDP growth remains robust. The public debt-to-GDP ratio is expected to decline to 97% in 2019 and further to 91% in 2020 and to 85% in 2021.

- **Rating agencies are rewarding the government' decisive action on NPEs**. S&P was the first rating agency to award investment grade status for the first time in the post-MoU era. Cyprus regained its investment grade status 2.5 years after the exit from the economic adjustment program in late March 2016.

- **Cyprus** capitalized on the upgrade by **tapping international financial markets**. Cyprus issued a new 10Y-Eurobond at a 2.4% yield, the lowest yield every achieved by the Republic in a bond issuance. This was the third issuance since its exit from its economic adjustment program in late March 2016.

- Elsewhere, **the upswing of the Cypriot economy continues,** driven by the robust performance of private consumption dynamics and the ongoing recovery of investments. Private consumption is underpinned by sustained sentiment improvement, mirroring the lasting progress within the expired programme, the impact from fiscal relaxation as MoU measures are being phased out, rapid labor market improvement, further property market stabilization and a flourishing tourism sector.

- The ongoing **recovery of investments is fueled by the rise in residential construction and large projects** such as the Casino. The program citizenship through inward investment (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) has helped to attract foreign funded investment in the real estate sector in the form of high-rise residential towers, which are located in the Limassol & Paphos areas.

- **The stream of construction projects** (already under construction, in the form of permits and in pending applications) **point to a looming 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, is environmental damaging and could increase the speculative behavior leading eventually to an asset bubble in the medium term. On the other hand, these projects are foreign-funded, relieving pressure from regulators to act, as the domestic banking sector is not directly exposed to these activities.

- From a long-term perspective, the sustainability of the current growth rally is challenged by evidence showing that GDP growth is driven entirely by the rise of employment while **labor productivity** either in terms per person employed or per hour worked is either **at** very **low levels** or even negative in the last three quarters up to Q2-2018.

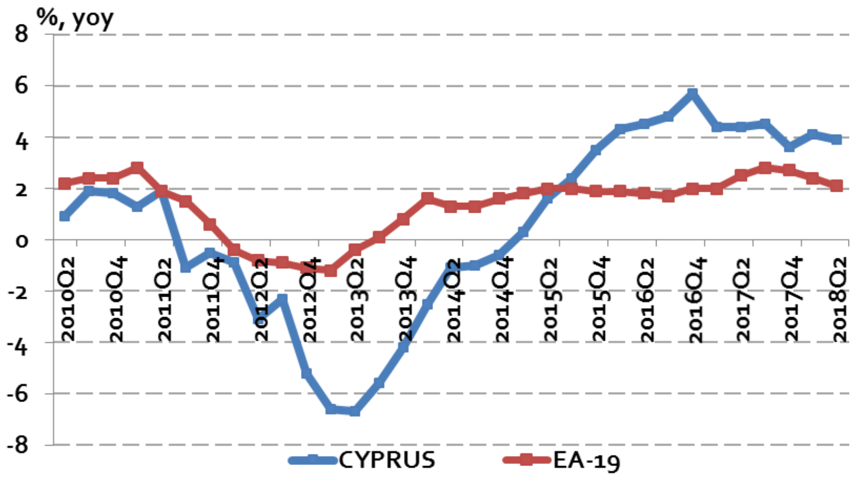
2. Latest Economic Developments & Outlook ahead

2.1 The latest GDP growth estimate for Q2-2018 – unchanged compared to the flash CYSTAT estimate- remains among the highest in the post-Lehman period, surpassing the most optimistic forecasts

The second and latest estimate of CYSTAT on the seasonally adjusted Q2-2018 GDP-reading confirmed the flash estimate of 0.8% QoQ/3.9% YoY. This strong reading compares to 1.0% QoQ/4.1% YoY in Q1-2018 vs. 1.0% QoQ/3.6% YoY in Q4-2017, up from 1.1% QoQ/4.4% YoY in Q4-2016.

Real GDP growth marked the fourteen consecutive positive reading on a both quarterly and annual basis after a previous three-year recession. The GDP growth rate of Q2-2018 is among the highest in EA-19 and EU-28, both on a quarterly and an annual basis (Figure2 & 3) and, for a thirteen consecutive quarter in a row, above that of EA-19 (Figure 1). This output performance is among the highest during the post-Lehman period, surpassing analysts' expectations and international organizations' full year initial or revised forecasts. It signals the economy has embarked on a faster growth path than previously envisaged. The Cypriot economy is likely to outperform the initial conservative official forecasts.

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



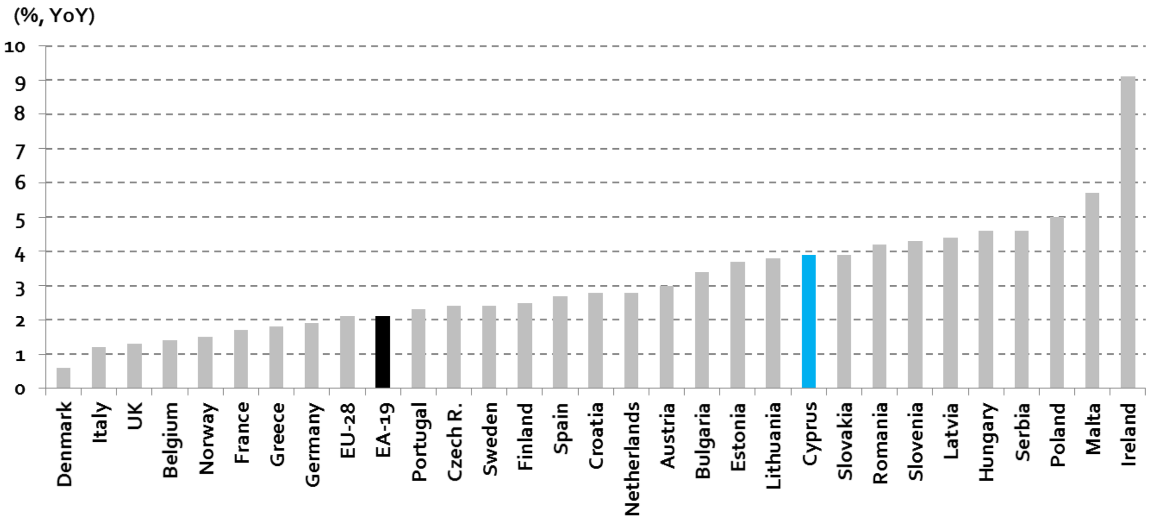
Source: Eurostat, CYSTAT, Eurobank Research

Finally, CYSTAT also announced[1] the revision of the national accounts data for 2016-2017. CYSTAT presented the finalized data of the national accounts for 2016 and revised upward the national accounts of 2017 in both nominal and real terms. The revision showed that the economy rebounded even faster in 2016 than previously thought: the Statistical Service revised the real GDP growth rate of FY2016 to 4.7% from 3.4% in the second estimate and

[1]http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/E99702C8D4AB3B9CC225830100351BD0?OpenDocument&sub=1&sel=1&e=&print

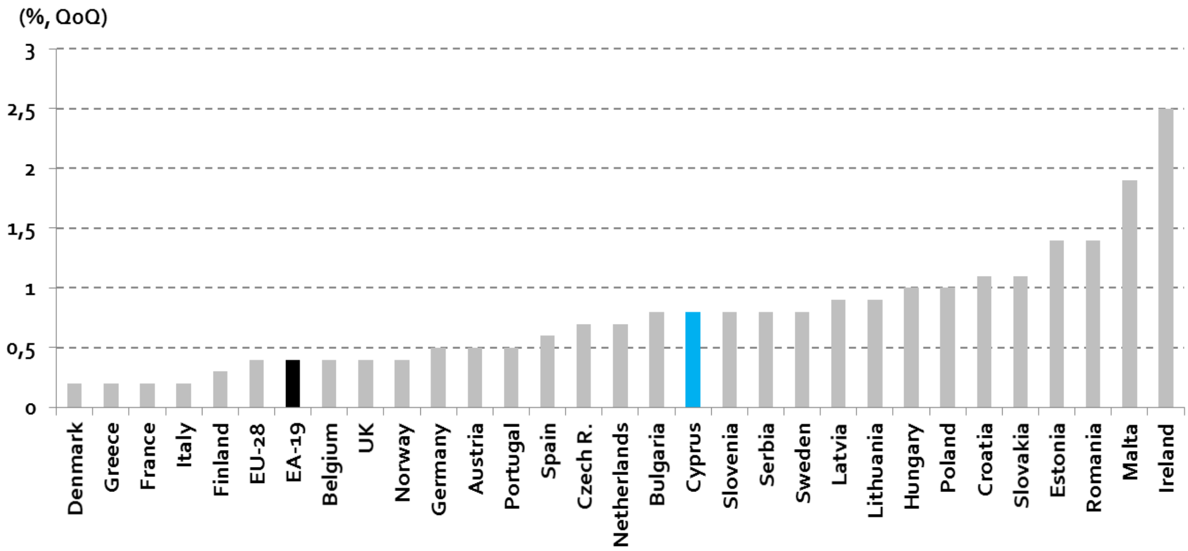
only 3% initially announced. Moreover, the real GDP growth rate of 2017 was revised to 4.2% from 3.7%. As a result, the level of GDP in 2017 in constant prices already stood 0.3% above that in 2008 and 3.6% above that of 2012. Therefore, the level of GDP in 2018 is expected to be above the level of 2008 under any conservative assumption of real GDP growth scenario.

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



Source: Eurostat, CYSTAT, Eurobank Research

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



Source: Eurostat, CYSTAT, Eurobank Research

2.2 The IMF staff mission to Cyprus concluding statement in early October took stoke of the government intervention in the banking sector praising it as a decisive step, while stressing the urgency of dealing with NPEs and highlighting the downside risks for the medium-term outlook

The statement of the IMF mission[2] on the occasion of the conclusion of the Article IV official staff visit noted that the near-term outlook remains favorable yet challenges remain on the horizon. IMF expects that further pick up in investment will offset the deceleration of private consumption dynamics in the near term. Private consumption is expected decelerate on higher debt servicing. In contrast, a stream of import intensive construction projects in residential properties, education and tourist infrastructure will support investment at the expense of widening the current account deficit. Over the medium-term, as the transitory effects of the investment boom dissipate, GDP growth is expected to slow to the potential GDP growth of around 2.5%. According to IMF, sustaining this medium-term growth will require progress in structural reforms crucial for lowering systemic financial risks and catalyzing productivity enhancing investments.

More importantly, the IMF mission took stoke of the government action in the banking sector praising it as a decisive step in dealing with the crisis legacy of a large NPL overhang and achieving consolidation in the banking system. The resolution of the Cyprus Co-operative Bank (CCB) and the passage of the long-delayed legislative package to strengthen the insolvency and foreclosure frameworks, have mitigated near-term risks to financial stability. The IMF mission noted that while the resolution of the CCB has come at a high cost to the public purse in turn it has boosted confidence and earned Cyprus a sovereign ratings upgrade to investment grade status.

Finally, the IMF mission cautioned that although NPLs have partially shifted from the banking sector to the public balance sheet, progress in resolving NPLs and in strengthening payment discipline is still limited. From that point of view, delays in NPLs resolution will continue to weigh on sentiment and growth potential until the problem has been adequately addressed. According to IMF, an increase in moral hazard and realization of contingent liabilities from publicly supported schemes could weaken the fiscal position and raise risk premiums, particularly under tightening global financial conditions. High dependence on Citizenship-by-Investment financed investments to propel growth could pose risks for its sustainability. External risks arising from escalating trade tensions, a sharper-than-expected slowdown in euro area growth or a hard Brexit could also affect export revenues and FDI.

In addition, the latest IMF flagship publication in October upgraded its forecasts to reflect the ones prescribed in the second post-program staff monitoring report of June[3] (Table 1). In terms of the macro-outlook of 2018-2019, the WEO now sees GDP growth inching up to 4% in 2018 and 4.2% in 2019. The average inflation projection in 2018 was raised to 0.8% in an illustration of upside prices pressures throughout the year so far up from 0.2% in the June

[2] https://www.imf.org/en/News/Articles/2018/10/05/mcs10518-cyprus-staff-concluding-statement-of-the-2018-article-iv-mission
[3] https://www.imf.org/~/media/Files/Publications/CR/2018/cr18153.ashx

monitoring report, while it is further seen at 1% in 2019. Unemployment is seen to decline from a projected 9.5% in 2018 down to 8% in 2019. The current account is seen as widening from 3.1% of GDP in 2018 to 5.2% in 2019.

The above optimistic growth forecasts of the IMF mission represented a newer assessment as they were not present in the IMF's earlier flagship publication, namely the April World Economic Outlook (WEO). In the earlier April 2018 WEO, the full year 2018 GDP growth was projected lower, at 3.6%, yet up from 2.6% in the October 2017 WEO and 2.3% in the April 2017 WEO. In that same April WEO, the GDP growth forecast of 2019 was even more conservative at 3.0%, contrasting sharply with the June Board forecast of 4.2%. In the same WEO publication, unemployment is forecasted to further decline from a projected 10.0% in 2018 to 9.1% in 2019. The average inflation is expected to remain subdued at 0.4% in 2018, down from 0.7% in 2017, and climb to 1.6% in 2019.

Table 1: IMF World Economic Outlook Forecasts for Cyprus

IMF WEO	2018		2019	
	April WEO Forecast	Oct WEO Forecast	April WEO Forecast	Oct WEO Forecast
GDP growth (%, YoY)	3.6	4.0	3.0	4.2
Consumer Prices (%, average)	0.4	0.2	1.6	1.0
Unemployment (% of Labour Force)	10.0	9.5	9.1	8.0
Current Account Deficit (% of GDP)	-4.1	-3.1	-4.6	-5.2

Source: IMF World Economic Outlook April 2018 & June 2018

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

The EU Commission upgraded the GDP growth forecasts for the Cypriot economy in its Spring-forecasts published last May. The EU Commission now sees Cyprus expanding at 3.6% in 2018, up from 3.2% in the Winter-forecasts, and from only 2.9% in the Autumn-forecasts. GDP growth is now forecasted to decelerate to 3.3% in 2019 vs. 2.7-2.8% in the Autumn-Winter forecasts. The growth momentum is expected to remain strong, fueled by foreign-funded investments and solid private consumption, the latter driven by the boost in confidence and disposable incomes following the decline in unemployment. Yet, the EU Commission underlined that the risks to the outlook have widened because of the recent developments in the financial sector. Tourism, a key sector, is faced with both upside and downside risks. On the one hand, the recently expanded capacity of air-transport and accommodation has brightened the outlook of the sector, yet on the other hand the re-opening of neighbor markets has increased competition.

Table 2: EU Commission Forecasts for Cyprus

IMF WEO	2018		2019	
	Autumn/Winter Forecast	Spring Forecast	Autumn/Winter Forecast	Spring Forecast
GDP growth (%, YoY)	2.9/3.2	3.6	2.7/2.8	3.3
Consumer Prices (%, average)	1.1/1.2	0.7	1.4/1.3	1.2
Unemployment (% of Labour Force)	10.0	9.0	9.3	7.1
Current Account Deficit (% of GDP)	-6.2	-9.0	-6.8	-9.7

Source: EU Commission forecasts Autumn 2017-Winter 2018-Spring 2018

2.4 Investments had the strongest positive contribution in second quarter's GDP growth, while final consumption dynamics remain strong

From a demand point of view, final consumption dynamics were strong for yet another quarter. The consumption rebound continued into Q2-2018, making a +3.3ppts contribution to GDP growth. Final consumption expanded by 1.7% QoQ /+3.9% YoY in Q2-2018, up from -0.2% QoQ/+3.1% YoY in Q1-2018, and up from 1.4% QoQ/+3.5% YoY in Q4-2017 compared to +0.8% QoQ/+4.3% YoY in Q2-2017. The consumption rally is underpinned by a number of factors, which all boil down to the rise of disposable incomes and the propensity to consume, namely: The strong sentiment improvement mirroring the earlier lasting progress within the programme, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from the fiscal relaxation and the acceleration of public consumption in Q4-2017.

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 Q2-2018, at constant prices, was significantly higher on an annual basis compared to Q2-2017 (+46.9% YoY), thereby having a significant positive contribution to GDP growth which reached +7.7 ppts. Looking deeper into the component statistics of investments, we conclude that this extraordinary outcome was mainly driven by investments in transportation equipment, which is most probably due to purchases of ships. The amount of the aforementioned category was three times higher on an annual basis in constant prices in Q2-2018 (€311.8mn up from €9.2mn). The performance of the two other key categories which refer to construction- both residential (+9.8% YoY) and other buildings (+17.2% YoY)-was also very supportive to investments.

Second, the negative investments' performance was more than offset by the net exports' positive contribution, a trend we witnessed again in Q2-2017. The contribution of net exports amounted to -7.7ppts. In Q2-2018 we actually witnessed a combined effect from both exports remaining contained at -14.7% QoQ/+1.0% YoY, and imports rising by +12.9% QoQ/+11.8% YoY. The slowdown in export activity reflects a sizeable quarterly decrease in the exports of goods' volume (-46.5% QoQ/+3.2% YoY). On top, exports of services failed to impress (+1.3% QoQ/+0.4% YoY) driven by lower activity in the sectors of gaming and financial services as a result of regulatory changes while the tourist season had not yet kicked in.

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 +0.5% QoQ/+5.0% YoY in Q2-2018, compared to 1.6% QoQ/+7.0% YoY in Q1-2018, and up from 1.5% QoQ/+6.3% YoY in Q4-2017 compared to +2.4% QoQ /+7.4% YoY in Q2-2017. 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.

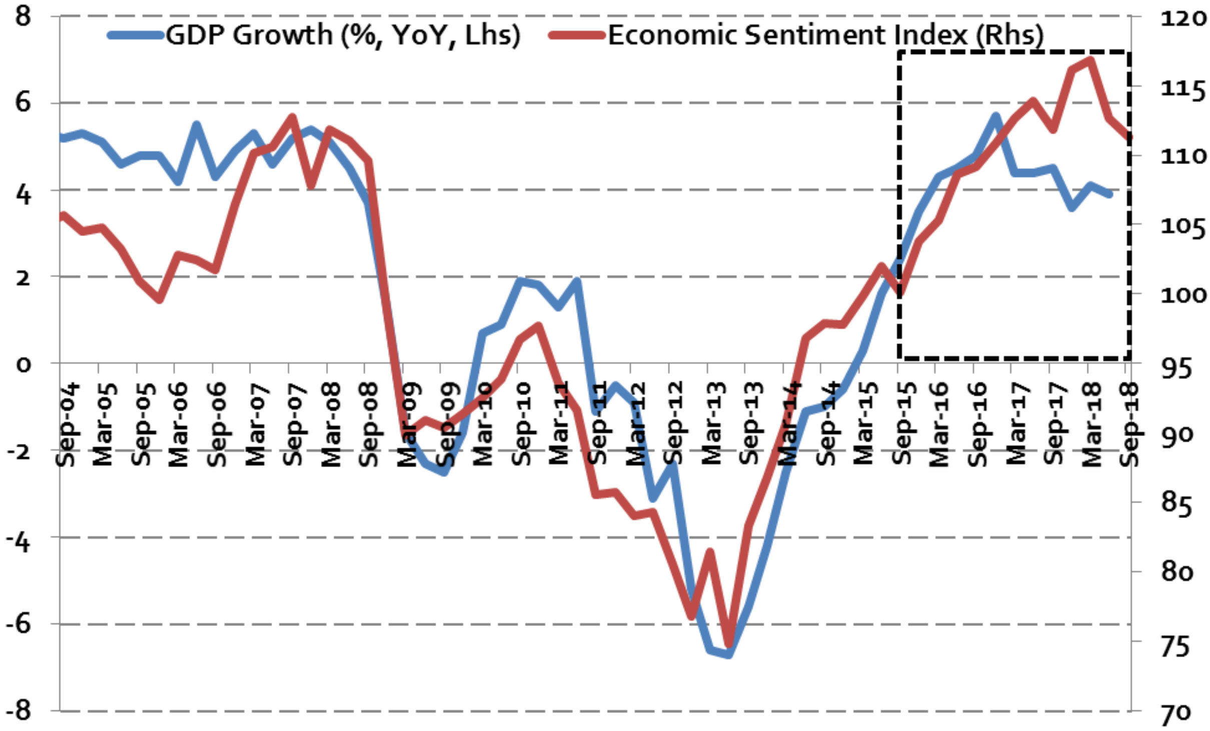
Manufacturing remained strong at +1.5% QoQ/+5.9% YoY in Q2-2018, down from +1.0% QoQ/+6.7%YoY in Q1-2018 vs. +1.6% QoQ/+8.3% YoY in Q4-2017 compared to +2.4% QoQ/+10.4% YoY in Q1-2017. In contrast, professional services edged up to +1.6% QoQ/+7.0% YoY in Q2-2018 compared to +2.2% QoQ/+6.6% YoY in Q1-2018 vs. +1.6% QoQ/+4.8% YoY in Q4-2017 up from +1.1% QoQ/+4.1% YoY in Q2-2017. Furthermore, construction accelerated its dynamic double-digit expansion even at a lower rate, expanding by +2.6% QoQ/+16.2% YoY in Q2-2018 vs. +4.0% QoQ/+20.6% YoY in Q1-2018 compared to +4.1% QoQ/+21.0% YoY in Q4-2017 down from +6.6% QoQ/+33.3% YoY in Q2-2017.

Financial Services is the exception to the upward momentum: They remained a drag on economic recovery, recording negative growth on annual basis for an eighth quarter in a row. Financial services have been in negative territory since Q3-2016. Nevertheless, the pace of contraction has slowed down in the last quarters. Financial services contracted by -0.6% QoQ/-2.1% YoY in Q2-2018, -1.1% QoQ/-2.2% YoY in Q1-2018 compared to -0.6% QoQ/-4.3% YoY in Q4-2017, down in absolute terms from -0.8% QoQ/-4.9% YoY in Q2-2017. 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.

2.5 Real economy indicators performed relatively well in Q3-2018, yet it is more likely we have seen the peak of the economic cycle

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. The sentiment slump in May-June had no meaningful impact for the GDP reading of Q2 and the short-term prospects of economic activity. The evolving negative case of Cyprus Cooperative Bank (CCB) of the last few months may have had an independent negative impact on sentiment, unrelated to the prospects of the economy. High frequency and leading indicators were performing relatively well in Q3-2018, yet it is more likely that we have seen 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 rebounded strongly in September on top of the small rise recorded in August. In more detail, ESI jumped further by 4.8 points to 114.7 in September, up from 109.9 in August, compared to 109.2 in July, retrenching back to comparable levels recorded in May.

- **Retail Trade:** Retail sales on a calendar and not seasonally adjusted basis, except for motor vehicles and motorcycles, expanded in volume terms by +2.4% YoY in July down from 5.8% YoY in June, bringing the year performance to July at +6.7% YoY. Similarly, retail sales in value terms expanded by +4.4% YoY in July down from 7.2% YoY in June, bringing the year performance to June at +5.9% YoY.

- **Credit-card transactions**: The value of credit-card transactions expanded by 32.2% YoY by Cypriots and 18.3% YoY by foreigners in 8M2018 (JCC Payments Ltd).

- **Tourism:** The positive momentum in the tourism industry continued in 8M-2018. Tourist arrivals increased by +8.0% YoY in 8M-2018. Similarly, tourism revenues expanded by +2.8% YoY in 7M-2018.

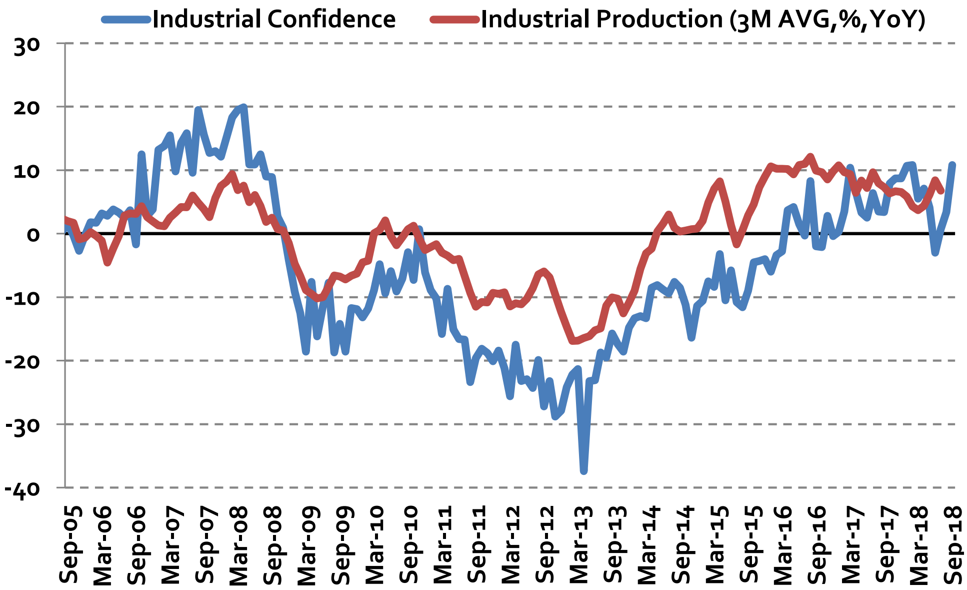
- **Industrial sector**: After expanding by 7.5% YoY in Q4-2017, industrial production on a calendar - not seasonally adjusted- terms, slowed down to 3.1% YoY in Q1-2018 and rebounded to 8.8% YoY in Q2-2018. After climbing last February to its highest pre-crisis level of June 2008 – the highest since April 2013, industrial confidence gradually retreated to lower levels in the following months. As of September, industrial confidence rebounded strongly back to levels seen in last February.

- **Labor market**: Unemployment continued its downward trend in Q3-2018, reaching new multi-month lows and now declining below the EA19 average. The unemployment rate in seasonally adjusted terms declined further to 7.5% August, down from 10.5% in August 2017 and from its peak of 16.7% in October 2013.

- **Deposits:** The resolution of the Cyprus Cooperative Bank (CCB) stabilized depositors' sentiment further in the summer months of July and August. From a flow point of view, total deposits recorded a net increase of €176.3mn in August on top of a substantial net increase of 796.4mn in July and a net substantial decrease of €745.2mn in June, up from a substantial net increase €201.2mn in May and €2,386.4mn in April.

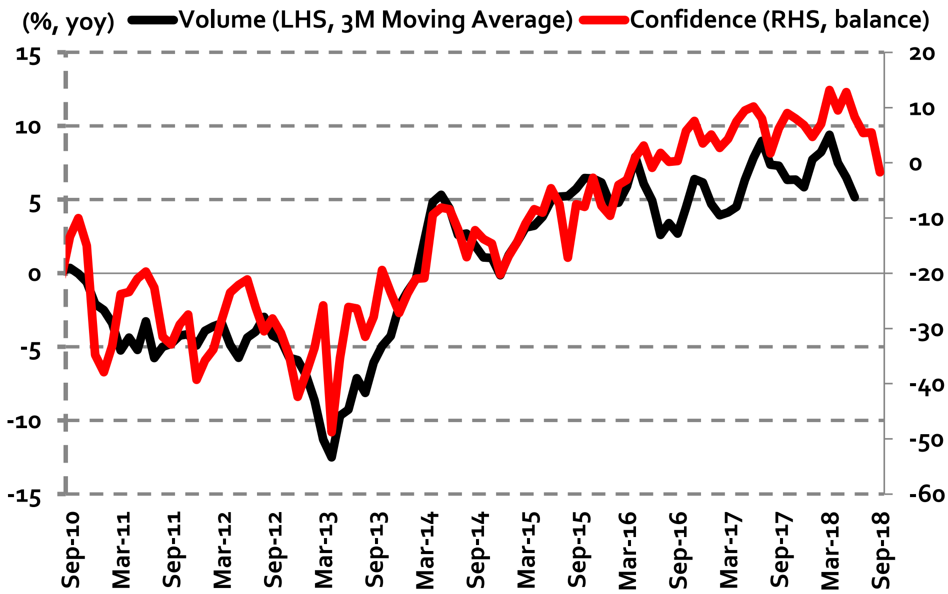
- **Property-market**:
  - **Construction:** The latest building permits release predisposes for a continuation in the construction output rebound. According to CYSTAT, the total value of building permits issued in the first seven months of the year increased by 21.5% YoY, while the total area of building permits rose by 25.5% YoY. During the period January – July 2018, 3,699 building permits were issued, up from 3,362 in the corresponding period of the previous year. Having expanded with double digits throughout 2017, construction output still increased by 13.1% YoY in Q2-2018 vs. 19.4% YoY in Q1-2018, notwithstanding the outstanding performance in Q2-2017 (+34.4% YoY) that had a negative base effects impact on the second quarter's reading
  - **Real estate transactions & prices:** The number of real-estate market sale contracts has risen by 21.4% YoY in 9M-2018 (from 5,523 to 6,706: Department of Lands and Surveys). Property prices were on an increasing path in Q2-2018. The Residential Property Price Index (RPPI) expanded by +1.7% YoY in Q2-2018 compared to +1.8% YoY in Q1-2018, recording the sixth 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 since Q4-2016. The HPI expanded on an annual basis by +0.6% QoQ/+1.2% YoY in Q2-2018 down from -1.8% QoQ/+3.7% YoY in Q1-2018 compared to +2.7% QoQ/+2.4% YoY in Q4-2017 vs. +3.1% QoQ/+3.6% YoY in Q2-2017. The Cypriot reading-although lagging behind that of EA-19 (+4.3% YoY) in this quarter- still bodes well with the ongoing rebound in the property market.

Figure 5a: Industrial Production & Confidence in Cyprus



Source: Eurostat, CYSTAT, Eurobank Research

Figure 5b: Retail Trade & Confidence in Cyprus



Source: Eurostat, CYSTAT, Eurobank Research

3. Recent domestic banking sector developments

3.1 The stock of NPEs decreased by €3.3bn in June driven by NPE sales & the Bank of Cyprus securitization transaction with Apollo, bringing the NPEs ratio down to 40.3%

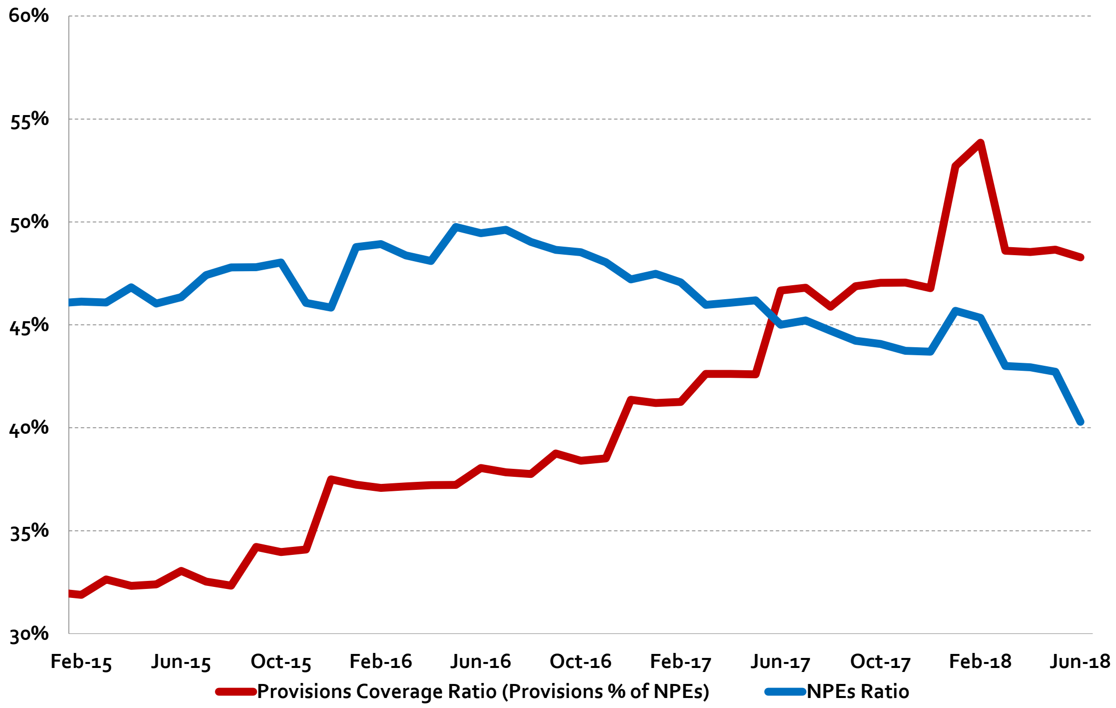
According to data released by the Central Bank of Cyprus, the stock of non-performing exposures (NPEs) decreased by €3.3bn in June relative to May, bringing the stock of NPEs down by 16.5% over the period from March2018 to June2018. Inter alia, the cumulative drop over the period from December 2014 to June 2018 has reached 39.1%. The decline in NPEs reflects three main factors: (i) the sale of NPE loans (ii) the reclassification of NPE loans as debt instruments held for sale (iii) the migration of successful restructurings to performing loans after the completion of the observance period, and (iv) write-offs and settlements through immovable property exchange. More specifically, the official statistics reflected primarily the impact of two major transactions in the month of June. The first refers to the sale of €365mn in NPEs loans by Alpha Bank Cyprus and the securitization transaction of Bank of Cyprus with Apollo which accounts for the sizeable amount of €2.8bn.

Deleveraging of the banking sector continues. Total loan exposures (performing plus non-performing) decreased by €5,051mn from €46,332mn in March 2018 to €41,281mn in June2018, which is a slightly larger drop than the decrease in their non-performing component alone. Despite the deleveraging, the ratio of NPEs (non-performing to total exposures) declined, from 43.0% in March 2018 to 40.3% in June 2018, compared to 43.7% in December 2017, 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 (€6.4bn out of €9.4bn in May 2018). At the end of Q2-2018, out of the 14,402 accumulated applications for restructuring, agreements with the borrowers, 3,175 cases (22.1%) had been concluded, in 10,364 cases (72%) had been carried forward to be examined in the next quarter, while 863 cases (6%) had been rejected either by the bank or the borrower.

NPEs remain the elephant in the room, as we have consistently highlighted in all our previous reports. As of June2018, 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 is a lot larger when measured relative to the size of the economy. As of June2018, the NPEs as a percentage of projected 2018 GDP stood at 82.3% - below the 100% threshold - compared to 105.1% in December 2017- down from 128.8% in December 2016, compared to 150.3% in December 2015 and 155.4% in December 2014.

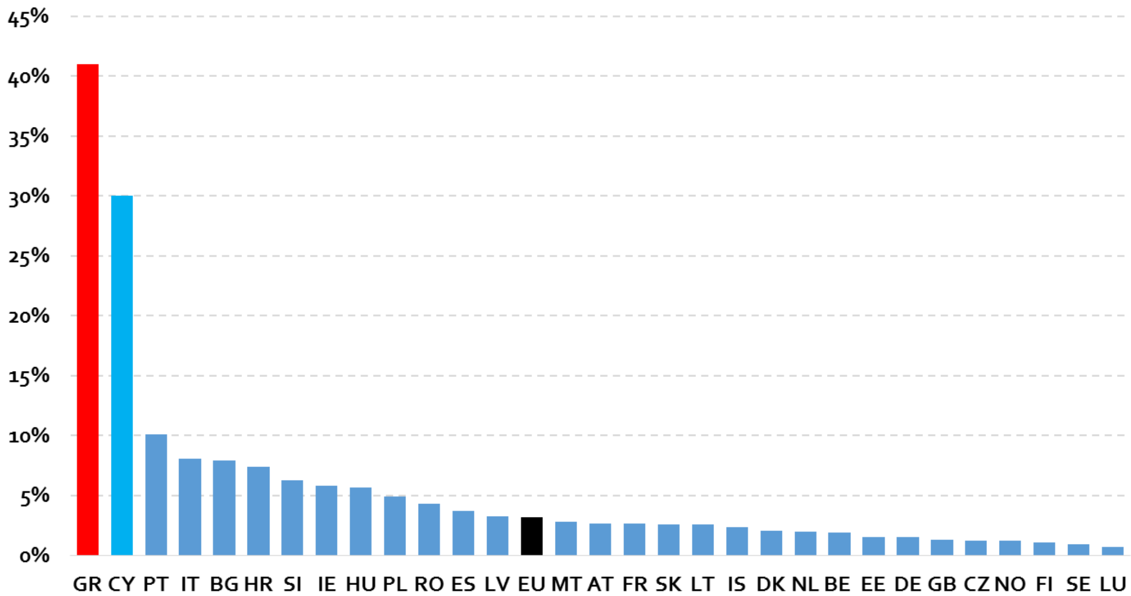
The resolution of the case of the Co-operative Bank is a game changer in the battle to address the thorny issue of NPEs. The sizeable amount of NPEs removed from the banking sector (approximately €6bn) is not yet reflected in the official statistics. It will allow for an important -but one-off- decline in the NPEs ratio further down to 30%. Further progress on the NPEs issue hinges upon two more game-changing factors: 1) the implementation of the reformed insolvency and foreclosures frameworks 2) the government subsidized ESTIA plan. The adoption of the new insolvency and foreclosures laws by the parliament without any amendments has created optimism that the new framework will empower banks to pursue strategic defaulters more efficiently than previously. The government has drafted and made public the so-called ESTIA plan which incentivizes both parties' creditors (the banks) and debtors (borrowers) to come into an agreement on restructuring first residence mortgage loans in the red. The announced criteria of eligibility for the ESTIA have been heavily criticized as overly generous and inducing moral hazard.

Figure 6a: Banking Sector Provisions Coverage & NPE ratio



Source: Central Bank of Cyprus, Eurobank Research

Figure 6b: NPEs (%of total exposures) as of Q2-2018



4. Investment grade status regained for the first time since 2011 plus Cyprus issues new 10Y government bonds at low yield

4.1 Standard and Poor's becomes the first and Fitch the second rating agency to award Cyprus investment grade status in the post-MoU era.

On September 14, 2018, **S&P** was the first rating agency to **upgrade** the long-term sovereign rating of Cyprus in the post-Lehman era by one notch from BB+ **to BBB- with a stable outlook**. According to S&P, the decision reflects three main views. First, it is based on the assumption that the Cypriot economy will continue to grow at a solid pace on average by 3.25% (4% in 2018 and by 3% on average in 2019-2021) throughout the forecast horizon until 2021, supporting a further reduction in the debt burden. Second, S&P praises the recent government measures to reduce the volume of NPEs via financial support and legislative changes, which have improved the banking system's health and are likely to facilitate further recovery efforts. Finally, S&P assessed that any additional financial state support to the banking sector will only moderately affect the sovereign balance sheet. The stable outlook balances the view of Cyprus' strong growth prospects against its still highly leveraged public and private balance sheets. S&P could consider raising the ratings of Cyprus over the next two years if the economy deleveraged significantly.

On October 19th, **Fitch** became the second rating agency to upgrade to **upgrade** the long-term sovereign rating of Cyprus in the post-Lehman era by one notch from BB+ **to BBB- with a stable outlook**. According to Fitch, the decision reflects that Cyprus will maintain its prudent fiscal policy which, along with the buoyant revenues, will maintain fiscal surplus high at 2.4% and 2.2% of GDP in 2019 and 2020, respectively, compared with 3.1% and 2.9% targeted in the 2019 Draft Budgetary Plan. Accordingly, the public debt to GDP ratio will remain on a firm downward trajectory, despite a one-off expected increase to 104.4% in 2018. Moreover, the rating agency acknowledged the decisive action to address the legacy issues of the banking system both in the area of strengthening the regulatory framework as well as the carve out of the CCB NPEs (ca. €5.7bn) that is expected to push down the NPE ratio to 30% when the transaction is reflected in the Central Bank data as of September.

Earlier, on July 27, **Moody's** had **upgraded** the long-term sovereign rating of Cyprus by one notch from Ba3 **to Ba2 with a stable outlook**. According to Moody's, the decision for the upgrade reflected two main drivers: First, the ongoing recovery of Cyprus's banking system through the liquidation process of Cyprus Cooperative Bank (CCB), and second, the positive fundamental trend of the government's balance sheet, which is based on a robust nominal growth and a primary surplus, irrespective of the one-off increase related to the recent CCB transaction. The stable outlook on Cyprus's Ba2 ratings balances Cyprus's strong fiscal dynamics against pressures for higher public expenditure. It also reflects uncertainty around the extent to which new legal tools will enable a material decline in the banking system's non-performing loan (NPL) ratio. Moody's would consider changing the outlook to positive and eventually upgrading the rating if macroeconomic conditions and actions of the Cypriot government would lead to a significant decline in the government debt stock and in the stock of non-performing loans in the domestic banking sector. Downward pressure that could lead to a negative outlook and eventually to a downgrade of the rating could develop if growth or fiscal policy decisions were to cause a reversal of the supportive fundamental debt trend. A failure to translate recent legislative actions and interventions in the banking sector into a significant decline in the non-performing loan ratio would also be credit negative.

On May 25, DBRS had upgraded the long-term sovereign rating of Cyprus by one notch from BB (Low) to BB with a positive outlook (they call it “trend”). The rating agency cited the decline in the banking system NPLs and the better-than expected fiscal performance. The stock of corporate NPLs declined by 36% in the Apr2015-Dec2017 period and the stock of household NPLs declined by 16% in the Feb2015-Dec2017 period, bringing the NPLs ratio of the banking system down to 42.5% of total loans in December 2017, compared to the 49.0% peak in May 2016.

Despite their decline, the agency had cited the NPLs as the main risk to financial stability and a major rating challenge for Cyprus. DBRS currently forecasts real GDP growth to remain robust in the coming years and average 4.0% in 2018-19, driven by important investment projects, exports, and consumption. So far, growth has been broad-based, with tourism, shipping, professional services, manufacturing, and construction all making a contribution. Meanwhile, fiscal performance is expected to remain positive so that the government budget will maintain a healthy surplus above 1.5% of GDP over the next four years, supported by strong revenues and contained expenditure.

Summing up, Fitch is the last rating agency to upgrade the long-term sovereign rating of Cyprus during 2018 so far, yet the second one to award Cyprus with investment grade status in the post-MoU era. Recall also that S&P was the first agency to downgrade Cyprus in early 2012 to junk status. Cyprus regained its investment grade status 2.5 years after its exit from the economic adjustment program in late March 2016. All major rating agencies (FITCH, DBRS, Moody’s and now S&P) upgraded their long-term sovereign rating of Cyprus in 2017-2018, awarding at least one notch in their respective rankings.

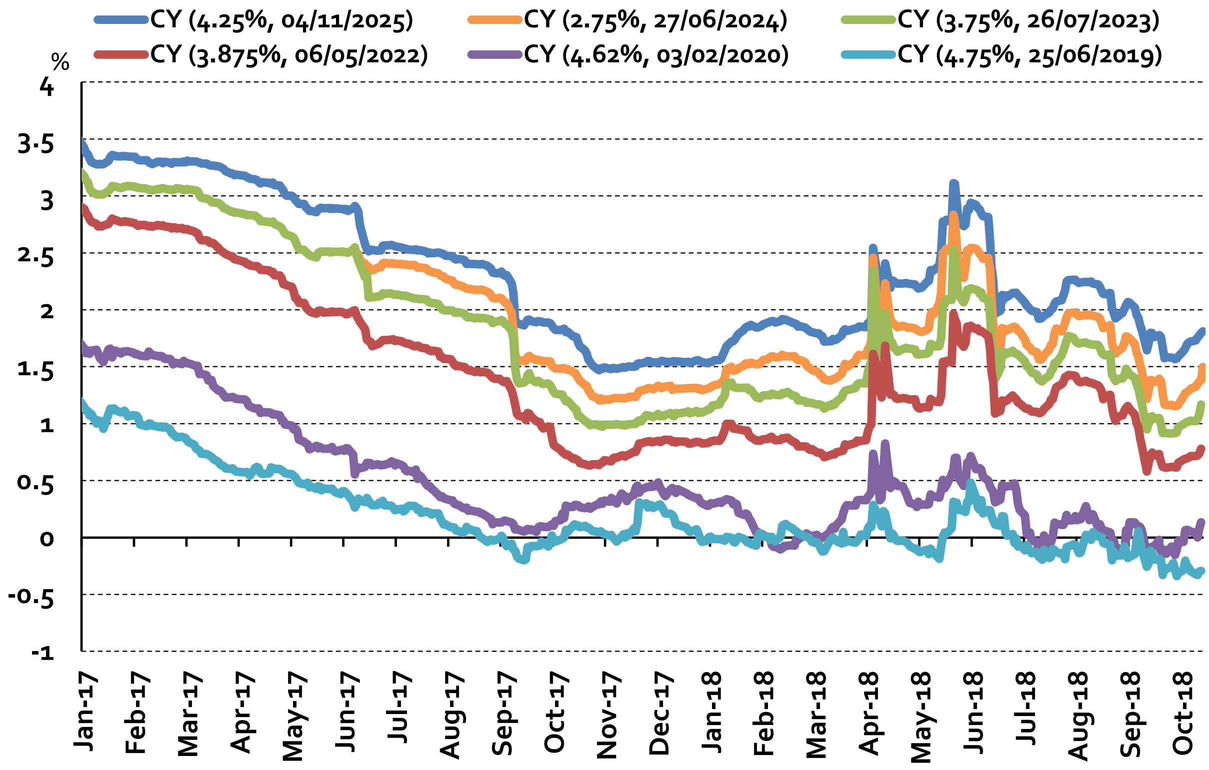
Following the last round of assessments, there still remains a **slight divergence** of views between the rating agencies on the sovereign rating of Cyprus (Table 3). The distance from government bond investment grade status for the rest of the main rating agencies is: two notches for DBRS (currently at BB, last upgrade in late May) and for Moody’s (currently at Ba2, last upgrade in July).

4.2 Cyprus tapped international markets with a new 10Y-Eurobond for the third time after exiting from the Economic Adjustment Programme in March 2016

Until mid-September, the lack of investment grade status prevented Cyprus from qualifying to join ECB’s Quantitative Easing (QE) program. Earlier, when Cyprus was still in a Program, an ECB waiver allowed participation in QE. Following the upgrade, the ECB announced that the Cypriot bonds became eligible and that it has started buying Cypriot bonds within the framework of the Quantitative Easing program, which is, however, expected to end in

December. The press release added that "the Eurosystem's pace of purchase in Cypriot government bonds will take the specific market liquidity situation of the Cypriot government bond market into account in calibrating a gradual and measured increase in Eurosystem holdings towards Cyprus's share in the ECB capital key".

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



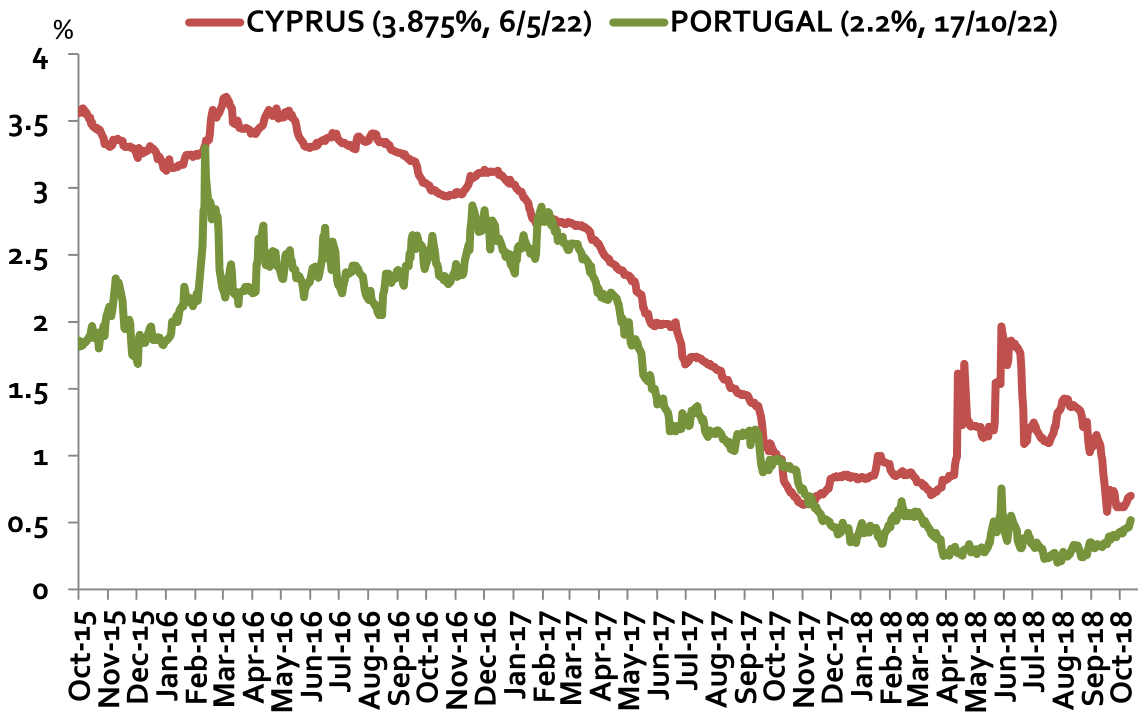
Source: Bloomberg, Eurobank Research

Note: The maturity of each bond declines as we move from left to right on the diagram. The first observation is on December 15, 2016 and the last observation is on July 19, 2018. On that date, the longest 04/11/2025 bond had a maturity of 7 & 1/4 years. At the other end, the shortest 25/06/2019 bond had a maturity of 11 months.

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 (Figures 7a-7b).

Overall, Cyprus enjoys uninterrupted access to international capital markets. In mid-September 2018, Cyprus tapped international markets with a new 10Y-Eurobond for the third time after exiting from the Economic Adjustment Programme in March 2016. It was issued at the lowest cost ever achieved in a benchmark bond issuance. In the latest tender, the Public Debt Management Office (PDMO) sold an offered amount of €1.5bn instead of €1bn initially planned of 10-year government bonds. 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 €5.5bn. Following the competitive bids, the average accepted price was at 99.686 and the corresponding yield at 2.40%. The latter yield compares with an initial guidance of 2.6%. The issue matures on June 27, 2028 and bears a 2.375% fixed annual coupon.

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.

Table 3
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	SD	DDD	D	Default
C	D	DD		
C	D	D		

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

5. Interpreting the latest Cypriot Economic News (August-September 2018)

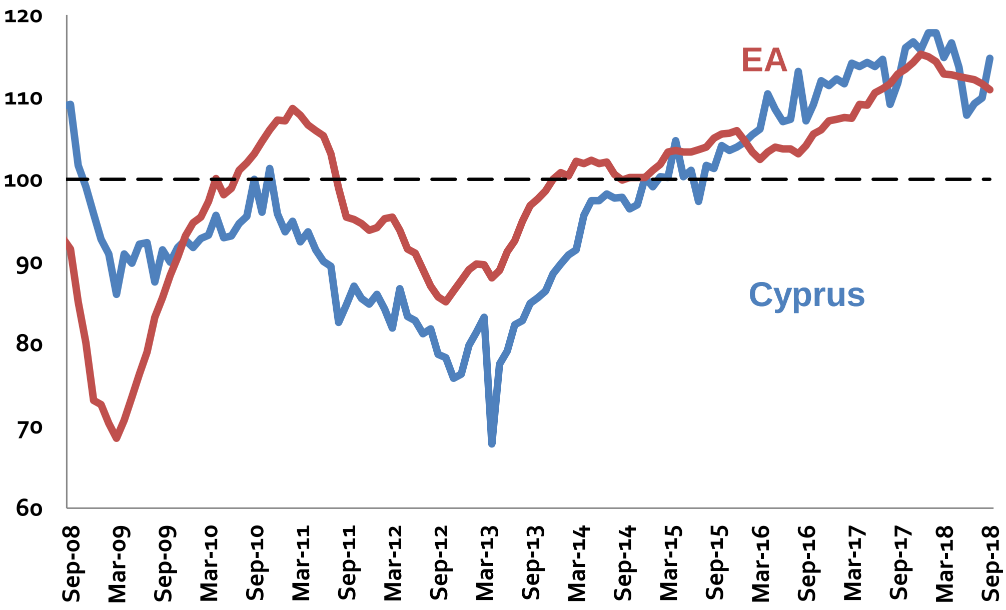
High-frequency indicators behaved relatively well in Q3 despite rising world environment uncertainties

<u>Economic Sentiment Index (ESI Index)</u>
Confidence rebounds strongly in September, retrenching back to levels recorded in May

The ESI Index rebounded strongly in September on top of the small rise recorded in August. In more detail, ESI jumped further by 4.8 points to 114.7 in September, up from 109.9 in August, compared to 109.2 in July, retrenching back to comparable levels recorded in May. The picture was mixed among different sectors. The more pronounced improvement in expectations came from the industry and services components, which expanded by 7.4 and increased by 8.2 points respectively. Consumer sentiment showed a minor improvement by 1.1 points in September. In contrast, retail and construction (declined) by 9.2 and 12.2 points respectively.

Having slumped in Q2, the ESI index resumed its rising trend in Q3 despite rising world environment uncertainties. The ESI index had reached a new pre-Lehman Brothers period peak in January-February 2018 at 117.8 (the previous pre-Lehman period peak stood at 117.3, which was recorded in August 2007). The ESI Index decline in Q2 was not reflected in the concurrent GDP growth reading. In our previous report, we had expressed our reservations in interpreting the ESI reading decline as a leading indicator of a more pronounced slowdown for the short-term economic activity prospects given that in August2017 we had witnessed a decline of similar size. Summing up, the ESI Index stands above its long-term average. The improvement recorded in the past four years – a total of 46.9 points since the crisis period in April 2013 - is still the highest among all countries in EU-28 over the same sample period. Sentiment improvement has been one of the key drivers of the consumption rebound, which feeds into output growth.

Figure 8: Index of Economic Sentiment



Source: Eurostat, Eurobank Research

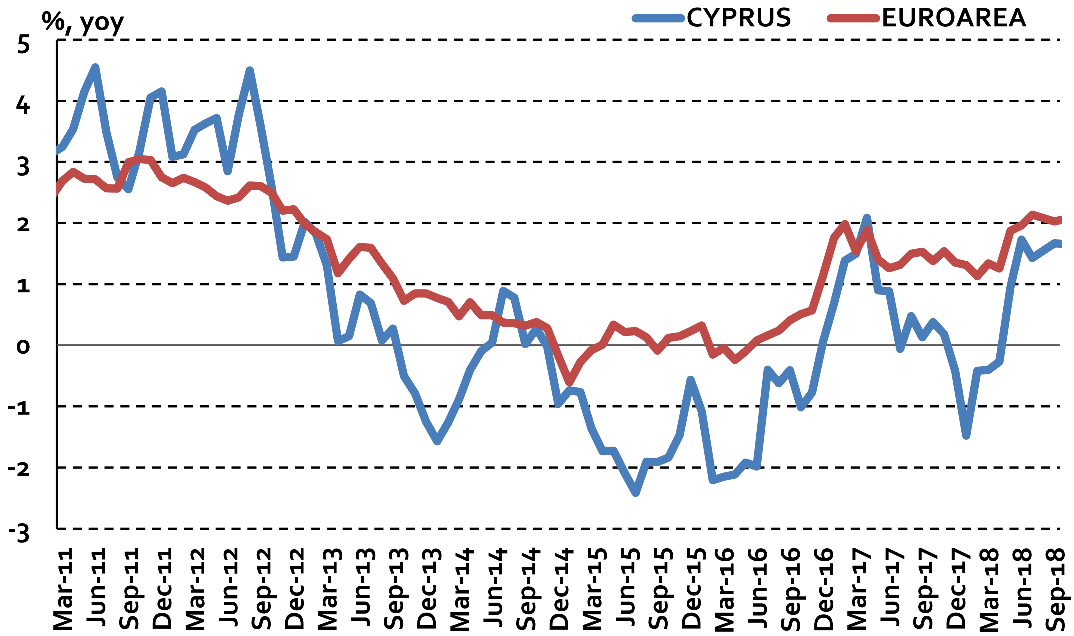
Consumer prices (HICP)
Inflation accelerated further in Q3-2018 on higher energy and food prices

Having re-entered in positive territory in May 2018, consumer prices, measured by HICP, climbed further in August-September2018. Having jumped to a multi month high at +1.0% MoM/+2.1% YoY in April2017, compared to only +0.3% MoM/+0.1% YoY in December2016, HICP dived again in negative territory in late 2017-early 2018. After a five month disinflation break between December 2017 and April 2018, HICP started climbing again. More specifically, HICP came at -0.8% MoM/+1.7% YoY unchanged vs. +1.2% MoM/+1.7% YoY in August 2018, up from -0.2% MoM/+1.4% YoY in July 2018, compared to +1.0% MoM/+1.7% YoY in June 2018, +1.4% MoM/+1.0% YoY in May 2018 and +1.1% MoM/-0.3% YoY in April 2018.

The biggest increase on an annual basis was observed in the categories of “Utilities” (+3.2% MoM/+12.2% YoY in September up from +1.2% MoM/+7.1% YoY in August vs. +0.6% MoM/+6.1% YoY in July). The rise is driven by the spike in world energy prices while the rise in “utilities” reflects also the subsequent increase in the local electricity tariffs by the state-owned energy company mirroring the spike in world energy prices. “Food & Non-alcoholic Beverages” stands out because it was the category with the second highest annual increase (-0.1% MoM/+3.9% YoY in September vs. +2.1% MoM/+3.8% YoY in August vs. +0.0% MoM/+2.6% YoY in July).

As of September, the rise of energy prices and prices of services accounted for 1.4ppts and 0.2ppts of HICP inflation respectively, the volatile food (fruit and vegetables) another 0.5ppts while non-energy industrial goods subtracted -0.3 ppts from the headline respectively. Having emerged out of a four year deflation, the average annual HICP climbed to 0.7% YoY in 2017 up from -1.2% YoY in the 2016, -1.5% YoY in 2015 and -0.3% YoY in 2014. However, it temporarily declined again to -0.8% YoY in Q1-2018 only to rebound to 0.8% YoY in Q2-2018 and further double to 1.6% YoY in Q3).

Figure 9: HICP in Cyprus vs. EA-19



Source: Eurostat, Eurobank Research

Deposits & Loans

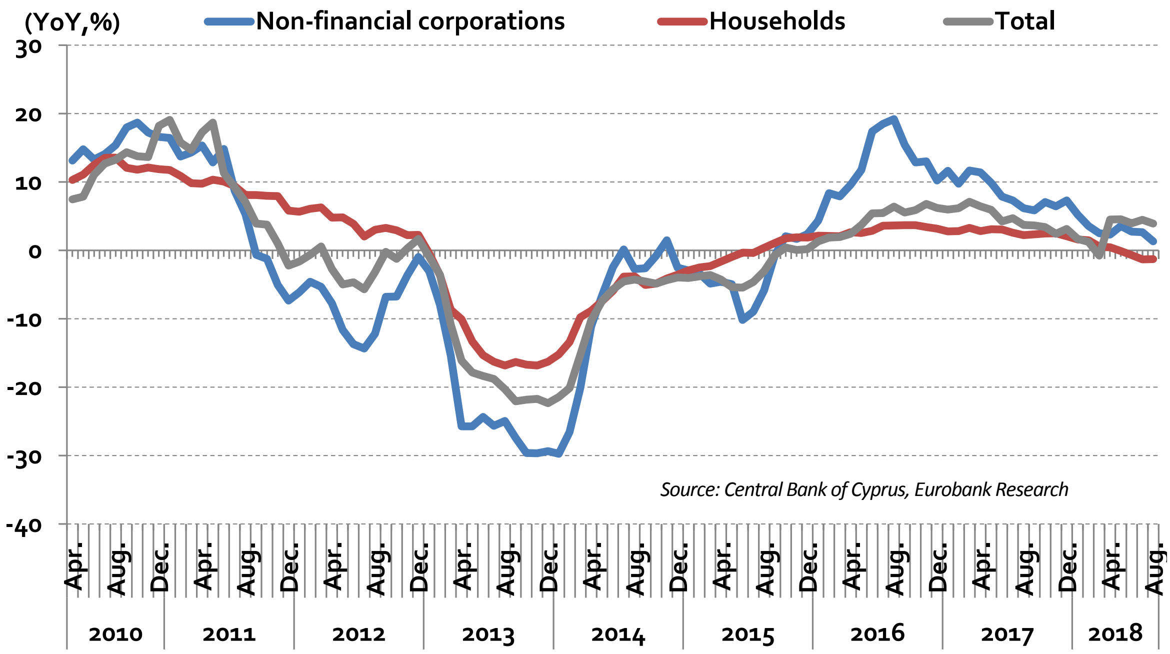
Banking system deposits expand for a second consecutive month in August mirroring further normalization of financial conditions

The Central Bank of Cyprus published on September 27th the Monetary and Financial Statistics (MFS) of August.[4] From a flow point of view, total deposits recorded a net increase of €176.3mn in August on top of a substantial net increase of 796.4mn in July and a net substantial decrease of €745.2mn in June, up from a substantial net increase €201.2mn in May and €2,386.4mn in April. The substantial increase of April can be attributed to the deposit placed by the Cypriot government to CCB equal to €2.5bn.

The annual rate of expansion in deposits - which has been in positive territory since October2015 with the exception of only one month in March2018 -stood at 3.8% YoY in August vs. 4.5% YoY in July up from 3.9% YoY in June, 4.6% YoY in May, 3.1% YoY in Dec2017, compared to 6.2% YoY in Dec2016 and only 0.2% YoY in Dec2015. Total deposits stood at €51.1bn in August marginally up from €50.9bn in July compared to €50.2bn in June vs. €50.9bn in May, €50.5bn in April, compared to €49.0bn in December 2016 and €45.97bn in December 2015.[5]

Total loans in August exhibited a net decrease of €184.7mn on top of a net decrease of €74.7mn in July, on top of a net increase of €305.2mn in June and a net decrease of €66.8mn in May. The annual growth rate of contraction was still low at -0.8% YoY in August vs. -0.6% YoY in July compared to -1.1% YoY in June, -1.8% YoY in May, compared to -1.7% YoY in December 2017 and -10.7% YoY in December 2016. A substantial part of these repayments concern previous transfers of loans from non-resident MFIs and are not related to the domestic economic activity. The outstanding amount of loans reached €45.9bn in August compared to €46.2bn in July down from €46.7bn in June and €48.8bn in May compared to €51.4bn in December 2017 and €55.3bn in December 2016.

Figure 10: Annual growth of deposits



[4] https://www.centralbank.cy/images/media/xls/MFS_August2018eng.xls

[5] 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)-Q2-2018

The RPPI Index recorded in Q2-2018 the sixth increase on an annual basis

The Central Bank of Cyprus published in mid-October the residential property price index (RPPI) for Q2-2018. On a quarterly basis, the RPPI increased by +0.3% QoQ, recording the eighth consecutive quarterly rise since 2009, compared to +0.6% QoQ in Q1-2018, +0.4% QoQ in Q4-2017, +0.4% QoQ in Q3-2017, +0.5% QoQ in Q2-2017. The quarterly rise reflects the combined effect of an increase in both flat apartments and house prices by +0.7% QoQ and +0.2% QoQ respectively. On an annual basis, the RPPI Index expanded by +1.7% YoY in Q2-2018 compared to +1.8% YoY in Q1-2018, recording the sixth consecutive monthly increase for the first time since 2008 (Figure 11B). 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.

Overall, the RPPI trajectory in the past quarters, in combination with other high frequency data from the construction industry hint towards further recovery of the real estate sector. Having expanded with double digits throughout 2017, construction output still increased by 13.1% YoY in Q2-2018 vs. 19.4% YoY in Q1-2018, notwithstanding the outstanding performance in Q2-2017 (+34.4% YoY) that had a negative base effects impact on the second quarter's reading.

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

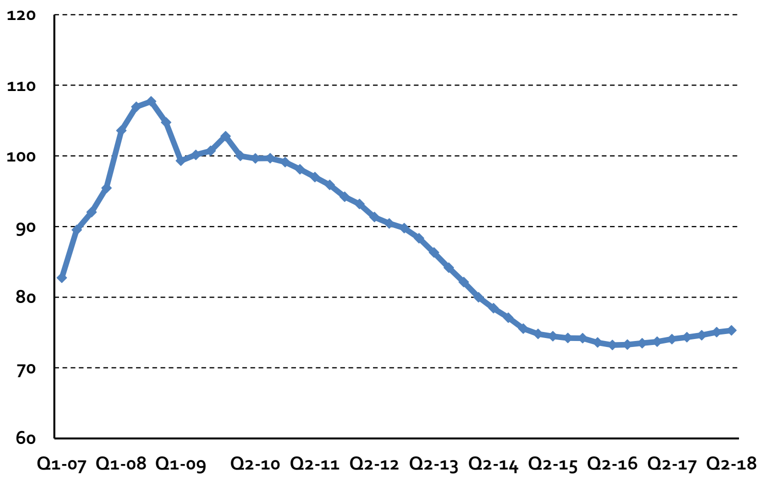
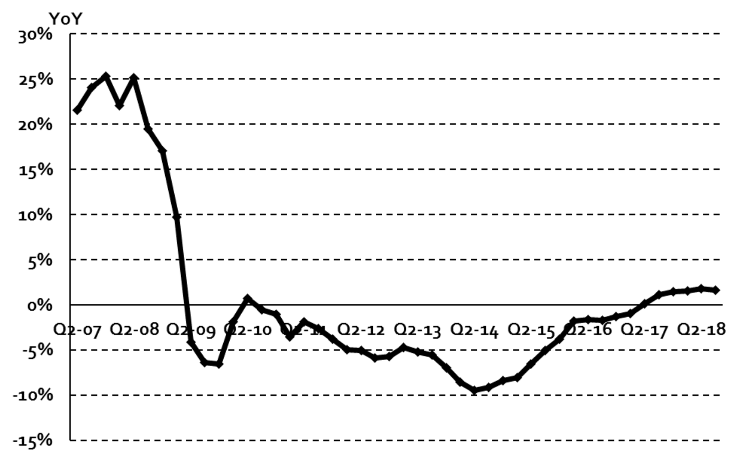


Figure 11b: RPPI Index (%, YoY)



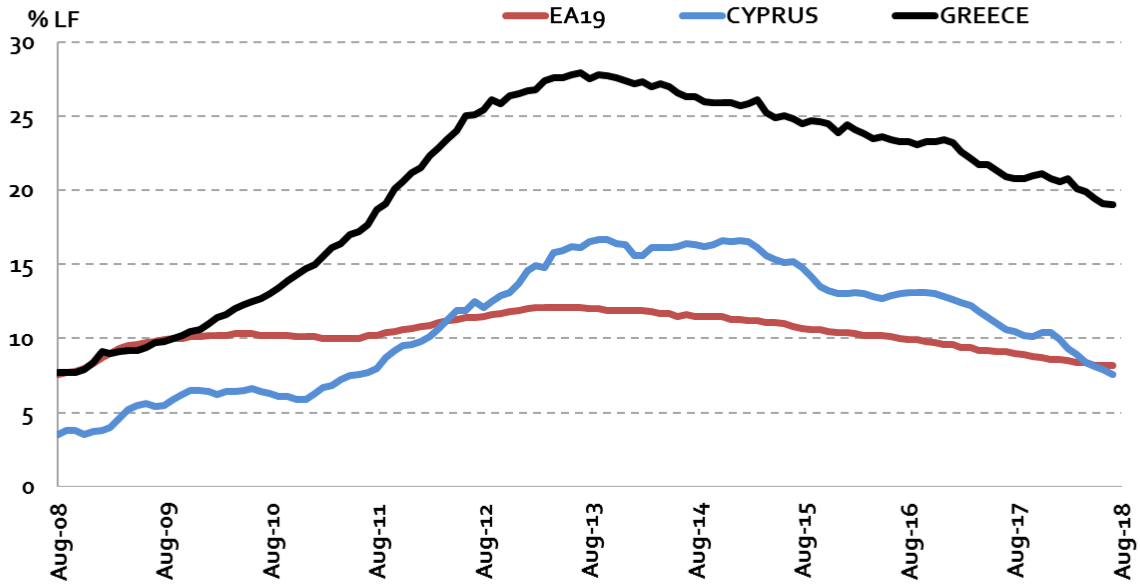
Source: Central Bank of Cyprus, Eurobank Research

Unemployment

Unemployment reaches new multi-month lows in Q3-2018, dropping below the EA19 average for the first time since 2012

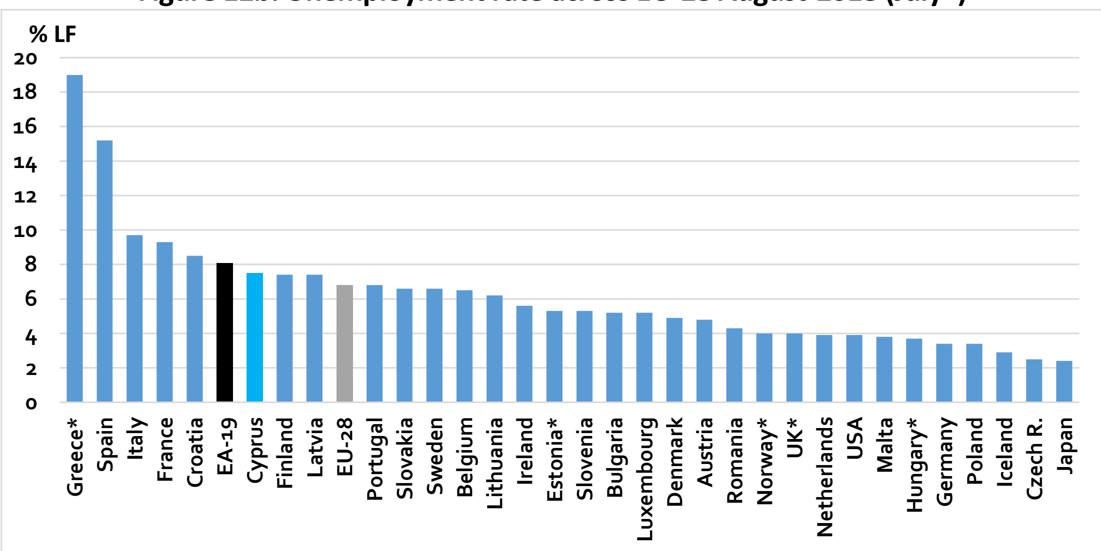
According to the latest Labor Force Survey (LFS), unemployment on a seasonally adjusted basis declined further to 7.5% in August-reaching a new multi-month low- down from 7.6% in July, 7.9% in June 10.4% in December 2017, 12.8% in December 2016, 13.1% in October 2016, and 16.7% at its peak in October 2013. Overall, Cyprus recorded the highest unemployment decline (by 2.9 ppts) in EU-28 in the first eight months of 2018, so that unemployment has now declined below that of Euro Area (See Figure 12). Despite the improving trend, unemployment in Cyprus is still the seventh largest (behind Greece, Spain, Italy, France Croatia and Finland) in EU-28. Youth unemployment is a source of concern and requires more attention.

Figure 12a: Unemployment rate



Source: Eurostat, Eurobank Research

Figure 12b: Unemployment rate across EU-28 August-2018 (July*)



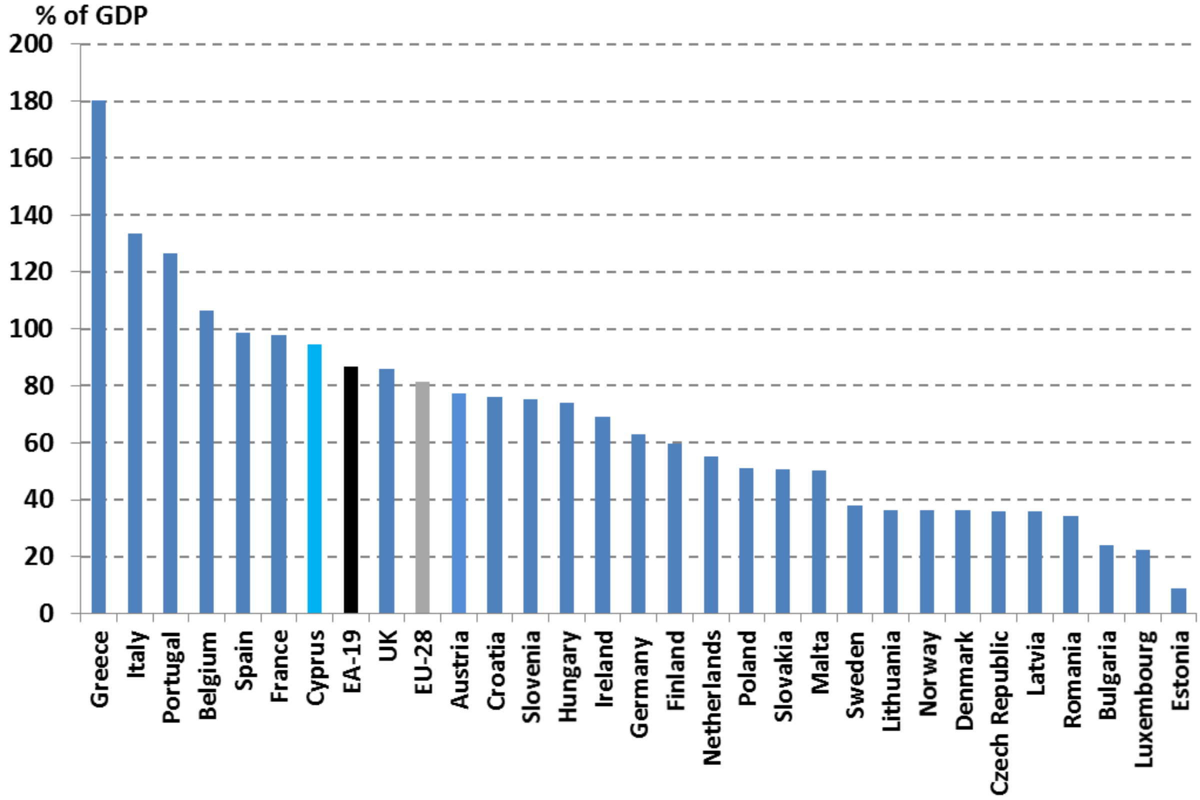
<u>Q1-2018 General Government Deficit and Public Debt (ESA2010 terms)</u>

Cyprus improves temporarily in the public indebtness ratio in Eurostat ranking

On July 20, Eurostat announced the provisional data for the fiscal deficit and public debt in the first quarter of 2018.[6] In ESA2010 terms, Cyprus recorded a €297.3mn general government surplus in Q1-2018 which is approximately 6.3% of the GDP in the same quarter, switching from an earlier deficit of €130.15mn or -2.7% of the *GDP in the same quarter* in Q4-2017, compared to a balanced position in Euro Area and a EU-28 deficit of 0.3% and 0.9% respectively in the same period.

As a result, the general government debt as percentage of GDP declined to 94.7% of GDP or €18.5bn in Q1-2018, compared to 97.5% of GDP or €18.7bn in Q4-2017, down from 102.5% or €19.5bn in Q3-2017, compared to 105.6% or €19.8bn in Q2-2017, down from 106.0% or €19.5bn in Q1-2017. Cyprus' ranking among EU-28 members improved: As of Q1-2018, the Cypriot government debt as a percentage of GDP was the seventh highest, behind that of Greece (180.4%), Italy (133.4%), Portugal (126.4%), Belgium (106.3%), Spain (98.8%) and France (97.7%). The public debt of Cyprus is primarily in the form of loans (60.1% of total) and debt securities (34.0% of total).

Figure 13: General Government Debt across EU-28 members in Q1-2018



Source: Eurostat, Eurobank Research

[6] http://ec.europa.eu/eurostat/documents/2995521/9087362/2-20072018-AP-EN.pdf/d9ca7f92-ea01-4a6d-a6d1-f64445be272a

January-August 2018 Budget execution
The budget was in surplus in the first eight months of 2018

The budget was in surplus during the first eight months of 2018. The consolidated government surplus increased to €732.6mn in 8M-2018, up from €433.5mn in 8M-2017. As a percentage of GDP, the consolidated government surplus came at +3.6% in 8M-2018, compared to +2.2% of GDP in 8M-2017. The primary surplus stood at +5.3% of GDP in 8M-2018 compared to +4.0% of GDP during the same period a year ago. Total revenues improved by +6.6% YoY, driven by double digit growth in VAT revenues collection (+16.6% YoY) and social security contributions (+11.0% YoY). On the other hand, total expenditure remained relatively contained in an election year, expanding by +1.6% YoY driven by higher spending on public wages (+4.0% YoY), social benefits (+2.7% YoY) and current transfers (+3.2% YoY). On the other hand, spending items such as interest payments (-15.1% YoY) and capital expenditure (-7.5% YoY) decreased.

Table 4: General Government Budget Execution

General Government Adjusted Budget Balance on cash basis (January-August 2018)		
in % GDP	January-August 2017	January-August 2018
I. Government Budget and SSF		
Total Revenue	**23.7%**	**24.6%**
Current revenue	23.6%	24.3%
Direct Taxes	7.3%	7.4%
Indirect Taxes	9.5%	10.3%
of which, VAT	5.7%	6.5%
Social security contributions	3.9%	4.2%
Non-tax revenue	2.9%	2.4%
Capital Revenue	0.0%	0.0%
Grants	0.2%	0.3%
Total Expenditure	**21.6%**	**21.4%**
Current expenditure	21.0%	20.8%
Wages and Salaries	5.5%	5.6%
Goods and services	1.3%	1.4%
Subsidies	0.2%	0.2%
Social Security payments	5.1%	5.1%
Pensions	1.8%	1.8%
Social Pensions	0.2%	0.2%
Current transfers	4.7%	4.7%
Non-allocated	0.1%	0.1%
Interest payments	2.0%	1.6%
Capital expenditure	0.7%	0.6%
Balance (I)	**2.1%**	**3.2%**
II. Other General Government Bodies		
including		
Local Authorities	0.1%	0.0%
Semi-public Entities	0.0%	0.1%
Other Entities	0.1%	0.1%
Balance (II)	0.2%	0.2%
III. ESA 2010 adjustments		
Balance (III)	0.0%	0.0%
III. General Government Balance		
Budget Balance (I+II+III)	**2.2%**	**3.6%**
Primary Balance (excl. interest)	**4.0%**	**5.3%**
Cyprus GDP (Mrd EURO-CYP)	19,570.9	19,796.2

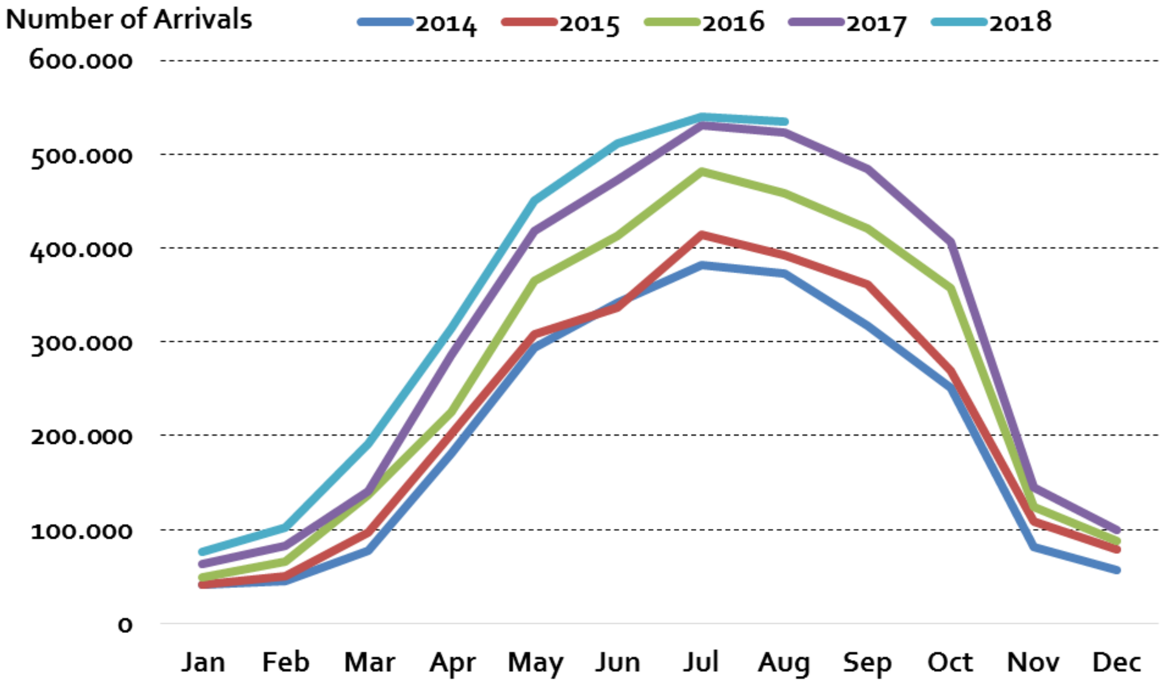
Source: Ministry of Finance, Eurobank Research

<u>Tourism arrivals (January-August2018) & revenues (January-July2018)</u>
Poised for another year of records in tourism arrivals

The positive momentum in the tourism sector continued into 8M-2018. Tourist arrivals expanded by 2.1% YoY in the month of August 2018 to 534.8 thousand, up from 523.7 thousand in same month a year earlier (August 2017). The month of August was the thirty eighth consecutive month with a positive rate of increase on an annual basis. This sets a new record as it was the highest volume of tourist arrivals ever recorded in Cyprus during August.

Overall, the number of tourist arrivals increased by 8.0% YoY in 8M-2018 (2,719,622 vs. 2,517,887 in the same period last year). Tourist arrivals from Eastern Europe countries such as Poland (+52.9% YoY) and Ukraine (+47.3 YoY) and Nordic countries such as Finland (+25.3% YoY) and Sweden (+17.9% YoY) recorded a hefty increase. Tourist arrivals from some traditional markets such as Germany (+1.9% YoY), Greece (+10.8% YoY), Israel (-9.7% YoY), and UK (+5.3% YoY) had a mediocre performance in 8M-2018. In addition, tourist arrivals from niche markets such as Russia (-5.1% YoY) were weak. Accordingly, tourism revenues also expanded by +2.8% YoY in January-July 2018 to €1,461.5mn, up from €1,422.4mn compared to the same month last year. However, the corresponding statistics for expenditure per person are on a declining trend. The expenditure per person for January – July 2018 reached €668,04 compared to €713,08 in the corresponding period of the previous year, recording a decrease of 6.2%. In fact, the expenditure per person/per day for the period of January – July 2018 compared to the period of January – July 2017 also recorded a decrease of 4.1% (from €77,51 to €74,33). Overall, the tourism industry is poised for another year of records in 2018 contributing to the GDP growth rebound of the Cypriot economy.

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
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
GDP (%YoY)	Constant Prices	Eurostat	4.6	3.7	4.5	4.8	3.9	-1.8	1.3	0.3	-3.1	-5.9	-1.4	2.0	3.4	3.9
Households and NPISHs Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	7.2	3.5	4.4	10.2	7.9	-6.4	3.3	-0.7	-1.3	-5.9	0.7	2.6	3.3	4.2
General Government Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	1.2	2.8	7.0	3.3	5.7	6.4	1.2	2.1	-1.8	-8.1	-7.2	-2.8	-0.4	2.7
Gross Fixed Capital Formation (YoY%)	Constant Prices	Eurostat	4.7	6.9	21.0	7.8	8.8	-13.6	-2.6	-12.1	-20.5	-12.9	-17.5	13.6	35.0	27.8
Exports of Goods and Services (YoY%)	Constant Prices	Eurostat	2.3	2.1	1.3	5.3	-0.7	-4.1	4.5	5.6	-2.7	2.1	4.2	5.8	4.0	3.4
Imports of Goods and Services (YoY%)	Constant Prices	Eurostat	6.9	1.6	5.7	10.5	12.5	-15.0	8.0	-3.0	-4.4	-4.8	4.6	7.4	6.8	10.1
GDP	Current Prices, SA ,mil	Cyprus Statistical Service	13856.4	14822.3	16000.0	17511.6	19006.2	18673.5	19299.5	19731.0	19489.7	18140.5	17605.6	17742.0	18219.1	19213.8
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	-3.0	0.8	2.7	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
Labor Productivity	Real, Per employee, % Change	Eurostat	0.6	0.1	2.6	0.4	0.3	-1.8	0.8	0.3	0.1	0.0	0.4	0.5	0.1	0.3
Unit Labor Costs	Index, 2010=100	Eurostat	82.3	87.7	89.1	90.4	93.0	100.2	100.0	101.8	103.4	97.9	94.0	92.4	91.6	91.8
Unit Labour Cost Growth Total Economy	YoY%	Eurostat	1.6	6.5	1.6	1.5	2.9	7.7	-0.2	1.8	1.6	-5.3	-4	-1.7	-0.8	0.2
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
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
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
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
European Commission Services Confidence Indicator Cyprus	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
Industrial Production General Index	NSA	Eurostat	134.7	136	136.7	142.9	148.8	135.3	132.9	122.8	110.6	95.7	95.1	100	109.3	118.2
Industrial Production General (%YoY)	NSA	Eurostat	1.5	1	0.5	4.5	4.1	-9.1	-1.8	-7.6	-9.9	-13.5	-0.6	5.2	9.3	8.1
European Commission Capacity Utilization Cyprus SA	SA	Cyprus Statistical Service	69.9	72.5	66.7	71.2	69.4	63.0	63.9	58.1	53.7	50.8	54.5	61.1	59.6	59.1
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
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
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
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
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
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
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
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
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
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	-6.3	-5.0	-2.3	N/A
International Trade & Balance of payments																
Current account balance (%GDP)	BMP6	Eurostat					-15.5	-7.7	-11.3	-4.1	-6.0	-4.9	-4.3	-1.5	-4.9	-6.7
Current Account, Goods & Services Net Balance (%GDP)	BMP6	Eurostat					-12.8	-5.4	-7.3	-2.9	-1.5	1.8	2.1	0.8	-0.8	-2.0
Current Account, Primary Income Net Balance (%GDP)	BMP6	Eurostat					-2.5	-1.3	-3	0	-3	-4.7	-3.6	0.6	-1.6	-2.5
Current Account, Secondary Income Net Balance (%GDP)	BMP6	Eurostat					-0.3	-1.0	-1.0	-1.1	-1.4	-2.1	-2.7	-2.9	-2.5	-2.2
Imports of Goods (%GDP)	BMP6	Eurostat					42.2	34.7	36.8	35.5	33.6	31.2	31.9	33	35.5	36.4
Exports of Goods (%GDP)	BMP6	Eurostat					12.0	13.1	13.9	15.3	15.6	15.0	15.9	16.2	14.2	12.9
Imports of Services (%GDP)	BMP6	Eurostat					20.7	19.4	20.7	20.4	21.3	25.7	28.1	30.8	30.0	30.1
Exports of Services (%GDP)	BMP6	Eurostat					38.1	35.7	36.3	37.6	37.8	43.7	46.1	48.3	50.5	51.7
Financial Account (%GDP)	BMP6	Eurostat					-18.5	-8.4	-8.6	-1.2	-2.1	-1.9	-7.1	-1.6	-7.4	-2.1
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
General Government Debt EDP Procedure (% GDP)		Cyprus Statistical Service	64.1	62.8	58.7	53.5	45.1	53.8	56.3	65.7	79.7	102.6	107.5	107.5	106.6	97.5
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
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
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
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
Market Indicators																
10Y Gov Bond Yield Rate	%, EMU criterion series	Eurostat	6.3	4.1	4.3	4.6	4.6	4.6	4.6	7.0	7.0	6.0	6.0	3.9	3.6	1.6
Cyprus Stock Exchange Index	EoP, Composite Index		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