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Key points

- **In March 2016, Cyprus became the third EMU country under surveillance to exit its Economic Adjustment Program, two months before the official expiration date, with no need to withdraw the full €10bn available credit**
- **Cyprus' success in exiting the Program was driven by the high level of ownership of the program, a timely delivery of the Program conditionalities and a prudent policy of fiscal mix, which preserved the country's comparative advantages**
- **After three years of recession over 2012-2014 and a cumulative drop of 10.5% of GDP, the economy of Cyprus expanded by +1.6% YoY in 2015 and is expected to gain momentum above +2.5% YoY in 2016, beyond recent forecasts by international organizations**
- **A new parliament after the May elections does not alter the main characteristics of the government**
- **For the economy to continue its upward momentum, reforms ought to continue hand in hand with growth preserving macroeconomic policies**
- **The main risks ahead are concentrated in the financial sector and the ability to quickly reduce the high NPL ratio. A British exit from the EU could also generate a period of uncertainty**

1. A clean Exit from the Economic Adjustment Program

Three years ago, in March 2013 and under dramatic conditions, Cyprus resorted to official borrowing from its European partners and the IMF. It was the fourth EMU country in need of financial assistance, following Greece, Ireland and Portugal. At the time, Cyprus signed a €10bn borrowing arrangement with the European Stability Mechanism and the International Monetary Fund. The agreement was accompanied by a detailed Economic Adjustment Programme (the "program" in what follows). Since March 2013, Cyprus completed successfully nine reviews according to the IMF disbursement schedule and seven reviews according to the ESM schedule.¹ Cyprus ended up borrowing only about €7.3bn out of a total €10bn available under the program. The ESM disbursed a total of €6.3bn, complemented by another €1bn by the IMF.

Cyprus' graduation from the program was finalized in the Eurogroup of March 7, 2016. The Eurogroup praised the authorities for the high degree of ownership and their important achievements and approved their decision to exit the economic adjustment program. The Eurogroup also noted that the last prior action of the last program review with respect to the approval from the parliament of the corporatization of CYTA-the telecom public utility-has not been satisfied.² Yet this did not preclude Cyprus' graduation from the program.

¹ The last ESM review (the 8th) is not considered to have been completed successfully

² <http://www.esm.europa.eu/pdf/2016-03-07%20Eurogroup%20statement%20on%20CY.pdf>

Subsequently, the Cypriot government asked to terminate the IMF portion of the program, which was scheduled to expire in mid-May. The request was approved and as a result, Cyprus became the third country after Portugal and Ireland to have made a “clean” exit from its economic adjustment program. That is to say, there was no successor program as the country already had established access to the international markets in order to re-finance its public debt.

Cyprus has made the fastest come-back to international markets among other Euro Area program countries, tapping the markets three times (June 2014, April 2015 and October 2015). The disbursement of the last ESM tranche was not absolutely necessary as market access has been restored, albeit at a comparably higher cost than that of official lending.

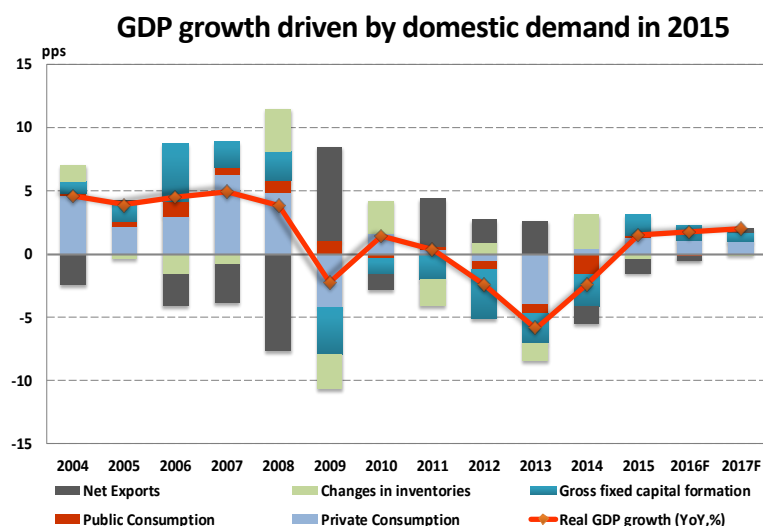
The endorsement of the review has sent a positive signal to the markets, allowing for a further improvement in the cost of funding. Moreover, Cyprus does not face any significant repayment obligations until at least 2019. The amounts to be repaid in 2016, 2017 and 2018 stand at €1.14bn, €453mn and €873mn respectively, and most of the maturing bonds are held by domestic financial institutions.

From now on, Cyprus will be subject to the usual post program monitoring from official lenders twice a year until at least 75% of the financial aid has been repaid back.

2. Current State of the Economy

After spending three years in the program, the economy not only exited recession but also showed tangible signs of a turnaround. In year 2015, GDP growth posted the first positive growth reading after a three year recession. GDP growth expanded by +1.6% YoY, compared to -2.5% YoY in 2014, -5.9% YoY in 2013 and -2.4% YoY in 2012.

The main driver behind growth was domestic demand. Private consumption accelerated to +1.9% YoY in 2015, up from +0.6% YoY in 2014, making a contribution of +1.3pps. Gross fixed capital formation rebounded by +14% YoY in 2015 up from -18% YoY in 2014, making a positive contribution of +1.6 ppts, for the first time since 2008. Overall domestic demand contributed +3.1pps in 2015. Exports expanded by +1.9% YoY in 2015 vs. -0.5% YoY in 2014. Yet imports accelerated to +4.0% YoY in 2015 vs. +2.0% YoY in 2014. As a result, net exports had a negative contribution of -1.2pps in 2015 down from -1.4pps in 2014.



Source: European Commission Spring Forecasts, Eurobank Research

3. A new Parliament after the May 22 Elections

Despite the heightened electoral threshold (3.6% vs. 1.8% previously) and one of the lowest voters' turnouts in the history of the Republic-the abstention rate was 32.6%- eight parties entered the new Parliament. The ruling right-wing party DHSY gained 37.6% of the vote (18 seats), the main opposition left-wing party AKEL gained 25.7% (16 seats), and DHKO gained 14.5% (9 seats). Five other smaller parties, EDEK (6.2%, 3 seats), Citizens' Alliance (6.0%, 3 seats), Solidarity (5.2%, 3 seats), Green Party (4.8%, 2 seats) and far right-wing ELAM (3.7%, 2 seats) were allocated a number of 13 seats compared to only 8 in the previous elections in 2011.

The parliamentary election results are not a game changer as the system of the Republic is presidential. They have no direct impact on the formation of the government. Only indirect, affecting the ability of the government to pass legislation through parliament. Nevertheless, elections are still considered a crucial test for the popularity of the incumbent President Anastasiadis, whose term is set to expire in 2018.

At first sight, it appears that the casualties for the ruling party are low. Yet they are not negligible. Even though DHSY was first in popular support, it still lost 3.5 pts off their electoral base. Their major opponent, AKEL, performed relatively worse, as they lost more than 7 pts. A large part, if not all, of DHSY's lost votes were leaked to the Solidarity party whose leader was a former Euro parliament MP of DHSY.

From now on, the ruling party will be more dependent on smaller parties to pass legislation in the parliament. As the next Presidential elections will be approaching, it is highly likely the new parliament is going to be progressively less friendly to the ruling party than the outgoing parliament was. This is not very reassuring given that there is a number of important pending structural reforms of the Economic Adjustment Program that need to be finished in order to avoid backtracking on the economy. In any case, the reform momentum and prudent macroeconomic policies must continue in such turbulent times, for the economy not to backtrack.

From that point of view, the most recent EU assessment report³ on the national reforms program⁴ submitted by the Republic contained a number of recommendations with respect to speeding up the implementation of public sector reform plans, removing bottlenecks that impede the full functioning of the insolvency and foreclosures framework, and enhance access to EU financing tools for SMEs so as to facilitate investment.

4. Deciphering the Forces behind Success

4.1 Program Structure:

The structure of the Cypriot program resembled the previous three programs for Greece, Ireland and Portugal. The program had three major objectives: (i) to restore the sustainability of public finances (ii) to enhance growth potential by addressing structural deficiencies issues, and (iii) to improve the soundness and resilience of the banking sector.

³ http://ec.europa.eu/europe2020/pdf/csr2016/csr2016_cyprus_en.pdf

⁴ http://ec.europa.eu/europe2020/pdf/csr2016/nrp2016_cyprus_en.pdf

4.2 Program Success:

Cyprus has made significant adjustment progress within the program in a number of areas including, but not limited to, restoring the health of the banking sector, a complete lift of capital controls, the fixing of public finances and addressing of earlier macroeconomic imbalances.

Macroeconomic outcomes have so far come out better than expected in the initial and revised program forecasts. The recession of 2013-2014 has turned out milder than expected. The cumulative output losses amounted to 8.3ppts vs. 13.5ppts in the program. The full year contraction of 2013 came at -5.4% vs. -8.7% in the initial program forecast. The full year contraction of 2014 came at -2.5% vs. an initial forecast of -4.8% (in May 2013). The rebound of 2015 also surprised to the upside. The initial program forecast stood at +1.1% in 2015 and then official lenders even revised it downwards in the next reviews: In the 4th review in May 2014, the forecast of 2015 was even lowered to +0.4%).

A large part of the better than expected performance stems from the fact that the wealth effect of the bail-in and the spillover effects to the domestic economy were widely overestimated. From a demand point of view, private consumption remained resilient as both consumers and corporates used part of their precautionary savings to smooth out consumption. On the supply side, economic activity in the sectors of tourism and professional services remained relatively resilient as both of them are less credit dependent but also more extroverted and internationally competitive.

Public finances: Cyprus has performed an impressive fiscal adjustment in 2013-2014 that outperformed initial targets. A general government primary surplus of 2.6% of GDP in cash terms was already achieved in 2014, two years ahead of schedule vs. a primary deficit of -1.8% in 2013 and -2.9% in 2012. Accordingly, the general government deficit declined on a cash basis from -5.8% of GDP in 2012 and -4.9% of GDP in 2013 to only -0.2% of GDP in 2014, and a balanced position in 2015. The aforementioned metrics don't include the use of public funds for the recapitalization costs for co-operative banks (8.7% and 1.0% of GDP in 2014, 2015 respectively).

Banking sector overhaul: The program of Cyprus contained an important innovation relative to all other programs. The concept of bail-in was applied for the first time in the history of EU. The introduction of capital controls was a necessity to secure liquidity of the banks. Capital controls were relaxed gradually in line with the agreed roadmap and were fully lifted as of April 2015.

On the eve of the crisis in 2012-2013, the banking sector was oversized. Then, following the curve out of the Greek operations and some disposal of assets overseas, the domestic banking sector size shrunk from 750% of GDP in 2012 to 420% in 2015. The current size is lower than in other well established hubs and closer to the EU-average.

The bail in of uninsured depositors was deemed necessary in order to ensure debt sustainability. The total cost of the bail in came at 9.4bn Euros, most of which was incurred by non-residents. Then the conversion of deposits to equity, additional capital injections initiatives from private investors and the use of program funds for the co-operatives, brought the core Tier I capital ratio from 4.5% in Q4-2012 to 16.5% in Q4-2015.

4.3 Reasons behind the Program's success:

Cyprus' strong performance in the program has its roots in the high level of ownership of the program by the authorities, the institutional quality of the country, and the relative high efficiency of the public sector. In addition, the Cypriot imbalances which led to the crisis, emanated mainly in the financial sector. Rectifying the problems of the financial sector did not necessitate a large fiscal austerity, which would otherwise have caused a bigger recession and may have led to population unrest. In addition, as mentioned earlier, the bail-in costs were primarily allocated to foreigners, hence negatively influencing domestic consumption by less than originally expected. The authorities were also careful not to compromise the country's growth prospects and insisted on targeting expenses instead of raising taxes. They protected the country's comparative advantages; hence the resulting relatively small recession helped Cyprus confront its financial imbalances in a more stable manner.

First, when it comes to program ownership, most political parties signed up to the program. Their differences in economic policy were relatively minor. This political agreement – which contrasts to what happened in Greece - filtered through to the population and, unlike in Greece, society was not split into two groups, for or against the MoU. Thus the political and social tensions were relatively moderate despite the painful decisions. Cypriots have shown great adaptability and willingness to compromise their living standards thanks also to the dramatic episodes in their post-war history, which has shaped a certain population psychology of sticking to each other at times of adversity.

Second, the program was executed remarkably well, and in the words of a representative of the lenders, “almost like a clock.” The authorities showed commitment to the program conditionalities and established a strong track record of timely and continued policy implementation. The quantitative targets were met ahead of time and by a wide margin.

Third, Cyprus has a relative well-functioning government sector and high administrative capacity to carry out structural reforms. The institutional and administrative capacity of Cyprus is very close to the EU average, which implies that the executive body is in a relative favorable position to carry out the necessary structural reforms. This is revealed in a number of perception indices published by world-renowned institutions which measure the quality of institutions.⁵

	Cyprus	EA-18	Greece
1. Corruption Perceptions Index 2013 (0-100)	63.0	64.7	40.0
2. Rule of Law 2012 (score -2,5 to 2,5)	1.07	1.23	0.39
3. Government Effectiveness 2012 (score -2,5 to 2,5)	1.38	1.24	0.31

Source: EUROSTAT, Transparency International, World Bank

⁵ The Government Effectiveness Index, the Corruption Perception Index and the Rule of Law, World Bank & Transparency International

Fourth, the initial size of the imbalances in the economy does matter for the subsequent evolution of economic activity. Cypriot fiscal imbalances were lower than in other program countries. And the package of fiscal measures in 2013-2014 was decided and legislated upfront, which minimized uncertainties. Also, the fiscal adjustment was front-loaded, splitting the burden almost equally between revenue enhancing and expenditure spending cuts, thus, making the policy mix of the measures balanced. As the initial IMF MoU⁶ & EU Commission program⁷ claims: *“The total package of 6.8ppts of GDP was split between 3 ppts expenditure cuts and 3.8ppts in revenue enhancing measures.”*

The speed of adjustment in only one year and the outperformance in 2014 are quite impressive. The budget-framework table contains realized vs. forecasted budget numbers in May 2014 during the time of the 4th review.⁸ Total revenues over-performed by 2.4ppts (40.3% of GDP vs. 37.9% forecast in the 4th review in May 2014) while total expenditure under-performed by 2.1ppts (40.5% vs. 42.6% forecast in the 4th review in May 2014). As a result, a primary surplus of +2.6% of GDP was achieved instead of a forecast for a -1.6% primary deficit.

5. Post-MoU Challenges

After a sharp output decline in 2012-2014, it is apparent that Cyprus has entered a new growth path. The economy showed flexibility in addressing the shock of the banking crisis, yet a handful of unfinished structural reforms remain:

5.1 Privatizations:

The privatization program was an integral part of the structural reforms agenda within the economic adjustment program. The program contained the privatization of state-owned public utilities, widely known as semi government organizations: the Telecoms Utility (CYTA), the Electricity Authority (EAC) and the Port Authority (CPA) plus a number of assets including the Stock Exchange and real estate and land assets.

According to the MoU, revenues of €1.4bn were initially anticipated to lower public debt (€1bn by the end of 2016 and another €400mn by the end of 2018 at the latest). However, the privatization process had been advancing very slowly given the complex preparation work for the organizations' corporatization but also because other targets of the program have been prioritized in the previous reviews of the program. In addition, the outperformance of fiscal targets has rendered the privatization revenues less crucial for the achievement of the public debt reduction plan than initially envisaged in the first MoU. Of course, the benefits from the privatization process are not limited to sale revenues. They extend to the potential of fostering competition with multiple benefits for the domestic economy (attracting FDI inflows, creating jobs etc.)

⁶ Page 19, <http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf>

⁷ Table 4, Page 47: contains the consolidation measures in 2012-2014

http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp149_en.pdf

⁸ Page 15:

[http://www.mof.gov.cy/mof/mof.nsf/All/6AE32BCE964A0450C2257E5A003E41EF/\\$file/%CE%A3%CF%84%CF%81%CE%B1%CF%84%CE%B7%CE%B3%CE%B9%CE%BA%CF%8C%20%CE%A3%CF%87%CE%AD%CE%B4%CE%B9%CE%BF%20%CE%94%CE%B7%CE%BC%CE%BF%CF%83%CE%B9%CE%BF%CE%BD%CE%BF%CE%BC%CE%B9%CE%BA%CE%AE%CF%82%20%CE%A0%CE%BF%CE%BB%CE%B9%CF%84%CE%B9%CE%BA%CE%AE%CF%82%202016%20-2018.pdf](http://www.mof.gov.cy/mof/mof.nsf/All/6AE32BCE964A0450C2257E5A003E41EF/$file/%CE%A3%CF%84%CF%81%CE%B1%CF%84%CE%B7%CE%B3%CE%B9%CE%BA%CF%8C%20%CE%A3%CF%87%CE%AD%CE%B4%CE%B9%CE%BF%20%CE%94%CE%B7%CE%BC%CE%BF%CF%83%CE%B9%CE%BF%CE%BD%CE%BF%CE%BC%CE%B9%CE%BA%CE%AE%CF%82%20%CE%A0%CE%BF%CE%BB%CE%B9%CF%84%CE%B9%CE%BA%CE%AE%CF%82%202016%20-2018.pdf)

The privatization process is politically highly sensitive, not only because multiple stakeholders (government, parliament, political parties, and unions) are involved. So far, only the privatization of CPA (the Port Authority) has been carried out. Legislation of the unbundling of EAC (Electricity Authority) has been approved only on the ministerial level. Finally, legislation for CYTA (Telecoms Utility) corporatization has been rejected by the outgoing parliament ahead of the elections and it remains to be seen if and how this privatization will proceed. Yet, by resisting privatization, CYTA risks becoming marginalized in a highly competitive international market.

5.2 Public sector reform:

The wage setting bill mechanism for the public sector, which introduces a rule for total spending as a percentage of GDP has not yet been endorsed. If legislated, it would protect future fiscal outcomes from sidetracking.

5.3 Health sector:

The introduction and implementation of the National Health System, which is envisaged to allow private and public sector regulated competition for health services, is progressing but is not complete yet.

5.4 Banking crisis legacies:

- **Asset Quality:** NPLs are “the elephant in the room” of the Cypriot economy, as they remain extremely high, the highest among all EMU countries. Addressing the high NPL ratio remains a key challenge for the banking sector. European authorities follow the banking system-wide NPE ratio. According to EBA methodology, this is a more conservative asset quality measure than the NPL ratio, as it inflates the NPL numbers by including restructured loans for a probation period of at least 12 months. The NPE ratio edged up to 48.9% in February 2016, up from 45.8% in December 2015, compared to 47.8% in December 2014. The recent deterioration in the ratio does not mirror a further rise in the non-performing loans but rather the ongoing private sector deleveraging, which impacts the size of total loans in the denominator of the NPL ratio. Nevertheless, the ratio remains extremely high, among the highest worldwide, when following a banking crisis.
- **ELA exposure** has declined substantially, yet it remains at very high levels (€3.2bn in April 2016 or 18.1% of projected GDP down from €11.4bn in March 2013).
- **LAIKI resolution:** the resolution of the Legacy Laiki unit is not yet complete. The legacy unit⁹ still contains some remaining overseas assets (the most prominent is IBG in Greece) that ought to be disposed of, non-performing assets, the uninsured deposits and a 9% stake in the Bank of Cyprus.¹⁰

⁹ http://www.centralbank.gov.cy/media/2013-08-13_qa_english_comments.pdf & www.esm.europa.eu/pdf/FAQ_Cyprus_180920131.pdf

¹⁰ The resolution of LAIKI entailed the split into a good and bad bank. The good bank which assumed Laiki performing assets at fair value, insured deposits and ELA funding was folded into Bank of Cyprus in exchange for 18% equity given to the bad bank. After the €1bn capital raise in September 2014, the stake came down to 9%.

5.5 Looking ahead:

Overall, on the fiscal front, the better than anticipated fiscal performance reduces the financing needs of the government, which, in turn, erases the necessity of additional adjustment measures in 2017-18 in order to achieve the revised medium term primary surplus targets.

The key question is whether Cyprus will be able to achieve sustainable growth rates in the medium term.¹¹ To do so, there is still need for a comprehensive post-MoU growth strategy for which policymakers ought to make a diligent preparation. The program describes the necessary but not sufficient conditions for medium and long-term growth.

The new growth strategy should rely on the key comparative advantages of the island. Cyprus enjoys comparative advantages such as low corporate tax rates, the key geostrategic position of the island in the Mediterranean Sea, the facilitation of international business, and quality human capital. From that point of view, Cyprus could turn the recent crisis into a lasting opportunity. Authorities should define and rigorously implement reforms that are compatible with this new growth paradigm.

¹¹ For an extensive analysis on the future growth model and the long-term economic policies of Cyprus see the Eurobank report by Hardouvelis (2014): “Overcoming the crisis in Cyprus”, available at: <http://www.eurobank.gr/Uploads/Reports/20January2014Q.pdf>

Interpreting Cypriot Economic News (January-May 2016)

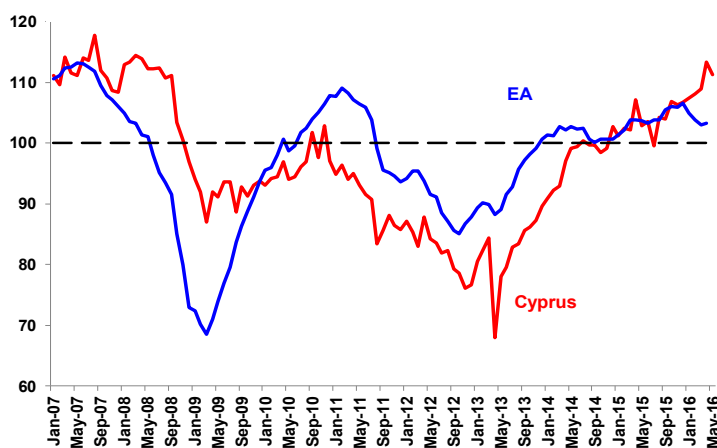
Economic Sentiment Index (ESI Index)

The ESI Index trajectory spurs optimism for short-term economic activity prospects

The ESI Index fell by 2.0 points to 111.3 in May compared to 113.3 in April vs. 108.9 in March. With the exception of industry, which improved for a second month in a row moving further up in positive territory, all other sub-components of the index deteriorated. The more pronounced decline in expectations came from construction (by 9.6 points) and consumer sentiment (by 4.1 points). Despite the small decline, the ESI index still stands close to its post-Lehman peak recorded in last April. Overall, the ESI index has been on an improving trend in the past three years. In fact, the improvement recorded – a total of 43.4 points since April 2013- is the highest in EU-28 over the same period.

As of May, the ESI index stands only 6.5 points below its pre-crisis level recorded at 117.8 in August 2007. The distance to the pre-crisis peak is the shortest among any other EU-28 members. Overall, the sentiment improvement is illustrative of the progress of the Cypriot economy in the past three years within the economic adjustment program. Cyprus has made significant adjustment progress within the program in a number of areas including, but not limited to, restoring the health of the banking sector, a complete lift of capital controls, the fixing of public finances and addressing earlier macroeconomic imbalances. Sentiment improvement is one of the key drivers of the consumption rebound taking place and feeds into output growth.

Figure 1: ESI index close to its post-Lehman peak



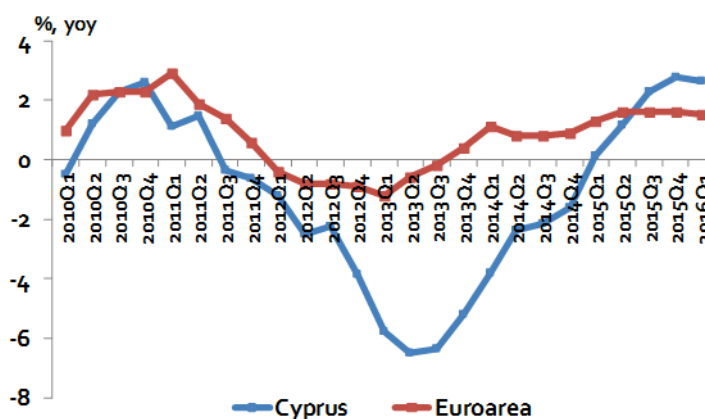
Source: Eurostat, Eurobank Research

Q1-2016 GDP growth (Flash estimate)

The economy started the year on good foot

A number of national statistics offices across the region, among them CYPSTAT, released earlier this month flash estimates of GDP growth for the Q1-2016. The flash estimate of the first quarter- *the fifth consecutive positive on both quarterly and an annual basis after a three year recession*- proves that the economy is finally out of the woods. On a seasonally adjusted basis, GDP growth expanded by +0.9% QoQ/+2.7%YoY in Q1-2016 compared to +0.4% QoQ/+2.8% YoY in Q4-2015, up from +0.5% QoQ/+2.3% YoY in Q3-2015 vs. +1% QoQ/+0.1% YoY in Q1-2015. The reading came above that of EA-19 for a third consecutive quarter. Although the components of growth are not known yet, it is highly likely that the consumption rebound has continued in Q1-2016, driven by strong sentiment improvement (a result of compliance with program's conditionalities), a flourishing tourism sector, lower energy prices on an annual basis, lower unemployment and a rise in real incomes.

Figure 2: GDP growth impressed in Q1-2016



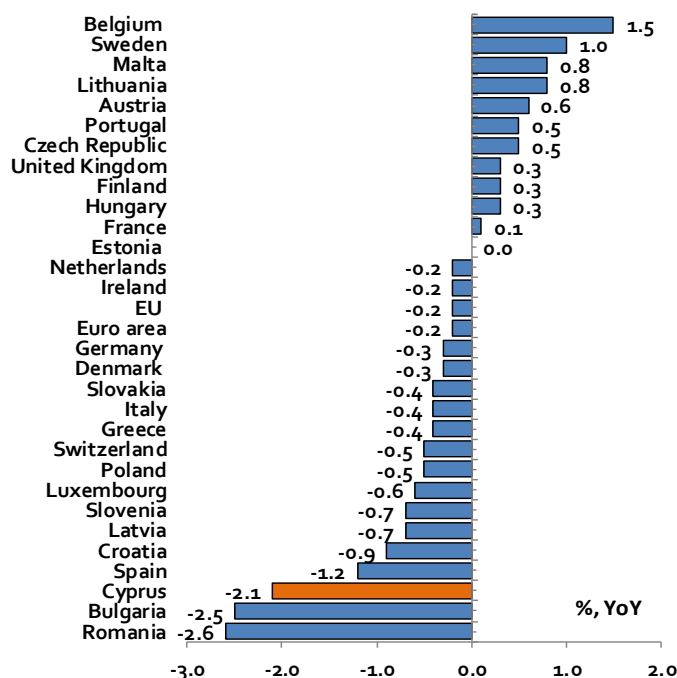
Source: CYPSTAT, Eurobank Research

Consumer prices in April (HICP)

Cyprus recorded the third highest deflation in April among EU-28

Consumer prices, measured by HICP, edged up to +0.4 MoM/ -2.1% YoY in April up from +0.7% MoM/-2.2% YoY in March compared to +0.7% MoM/-1.7% YoY in April 2014. The biggest declines were observed in the categories of transportation (+0.9% MoM/-9.1% YoY) and utilities (-2.5% MoM/-10.5% YoY), which reflect the pass through of lower energy prices. In addition, the volatile component of food and non-alcohol prices declined by +0.2% MoM/-3.7% YoY in April. On the other hand, the clothing and footwear component among other categories-in April (+3.71% MoM/+1.8% YoY). As a result, the average annual HICP came at -2.1% yoy in the first 4 months of the year up from -1.7% YoY in FY2015 and -0.4% YoY in FY2014.

Figure 3: HICP in EU-28 countries in April-2016



Source: Eurostat, Eurobank Research

Deposits & Loans (MFS)

Deposit growth was positive on an annual basis for a seventh consecutive month in April

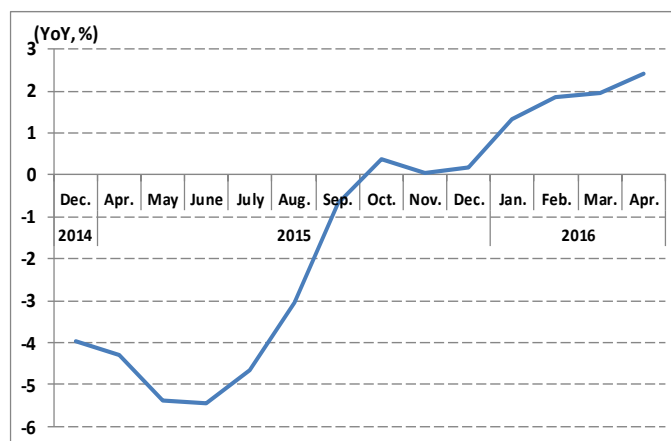
The Central Bank of Cyprus published on May 31st the Monetary and Financial Statistics (MFS) of April¹². From a flow point of view, total deposits recorded a net increase of €144.9 mn in April 2016, compared with a net decrease of €95.6 mn in March 2016. The annual growth rate of expansion¹³ - the seventh positive consecutive in a row - increased to 2.4% YoY, up from 2.0% YoY in March 2016. The outstanding amount of total deposits reached €45.89 bn in April 2016 down from €45.97bn in December 2015.

Total loans in April 2016 exhibited a net decrease of €86.7 million, compared with a net decrease of €613.1 million in March 2016. The annual growth rate stood at -7.3% YoY in April 2016, compared with -7.5% YoY in March 2016. The outstanding amount of loans reached €57.43 bn in April 2016 down from 57.52bn in March 2016.

¹² http://www.centralbank.gov.cy/media/xls_gr/MFS2_May2016_GR.xls

¹³ The Central Bank is using ECB methodology to calculate the annual growth with a special formula taking into account the monthly transactions

Figure 4: Annual growth of deposits



Source: Central Bank of Cyprus, Eurobank Research

Non Performing Exposures (NPEs)

The pace of loan restructuring has picked up in recent months

The pace of loan restructuring, an essential tool for the resolution of NPLs, has picked up speed. The amount of loans restructured is on a continuous climbing trend from €1bn in Q1-2015 to €1.2bn in Q2-2015, to €1.4bn in Q3-2015, further up to €2.3bn in Q4-2015 and close to €1bn in the two month period January-February 2016. As a result, a large fraction of the restructured loans falls into the 12-month probation period and are still classified as NPEs (41% in Feb2016, compared to 40% in Dec2015 vs.33% in Dec2014). On a more positive note, according to the Central Bank data, 76% of the fixed-term loans which were restructured between 1 January 2014 and 29 February 2016 abide by the new repayment schedule agreed as part of the restructuring process.

The pace of restructuring is anticipated to accelerate in the coming months, now that more incentives are in place for borrowers and lenders, namely the foreclosures and insolvency framework are in full force. Yet NPEs remain the major risk factor the economy faces as we move along. Another source of uncertainty ahead is the possibility that the UK chooses to exit the European Union. The UK is a major trading partner of Cyprus and an exit choice will bring a period of uncertainty.

Sovereign rating agencies updates

In April 22nd, Fitch became the third rating agency to affirm Cyprus' Republic long term rating at B+ with a positive outlook. The rating agency cited further banking sector stabilization, including a pick-up in loan restructurings, further track of economic recovery, reduction in private sector indebtedness and continued fiscal adjustment among the factors that could lead to an upgrade.

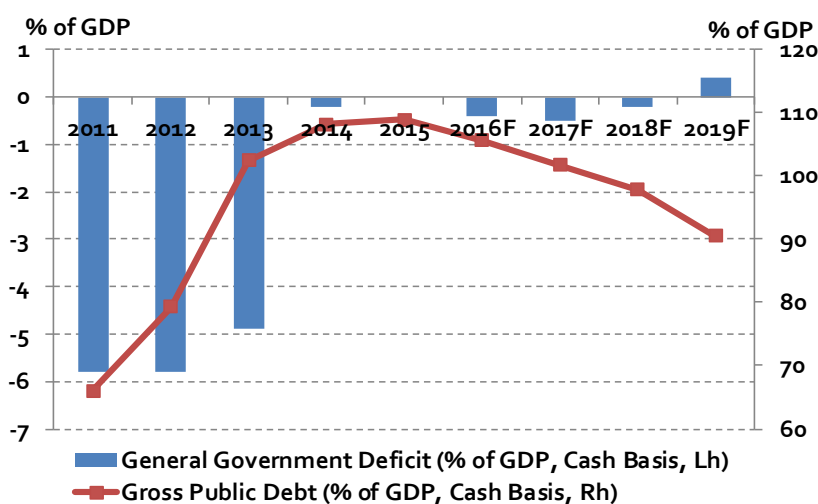
Despite rating agencies' aggressive upgrading in the past autumn, the sovereign rating of Cyprus is still below investment grade. Only recently, in late March, Standard and Poor's and Moody's affirmed their respective long-term - below investment grade - sovereign ratings for Cyprus. Currently, the sovereign rating stands at BB- & B3 by S&P and Moody's respectively. An upgrade by 3 and 4 notches in their

respective grading system would be required in order for the Cypriot government bonds to get investment grade status.

The next update on sovereign rating assessment of Cyprus from Moody's and S&P is scheduled for mid-July and mid-September respectively. As a result, ECB's waiver for government bonds eligibility for Euro system financing has been lifted as of April 1st and Cyprus no longer qualifies for QE. The waiver allowed these instruments to be used in Euro system monetary policy operations despite the fact that they did not fulfill minimum credit rating requirements.

In the latest report on BREXIT, S&P ranked Cyprus among the most hit economies in case a BREXIT materialized after the referendum on June 22nd.

Figure 5: Fiscal performance 2011-2019



Source: Ministry of Finance, Eurobank Research

Q1-2016 Budget execution (cash basis)

Figure 5 above shows the fiscal picture from 2011 all the way to 2019. Cyprus has made an impressive fiscal adjustment in the last three years. The government accomplished a balanced budget in 2015 – excluding the recapitalization costs of the domestic banking sector compared to -0.2% of GDP deficit in 2014 down from -4.9% in 2013 and -5.8% in 2012. Accordingly, the public debt to GDP ratio peaked at 108.9% of GDP in 2015 up from 108.2% in 2014 and is projected to decline below 100% by 2018.

In the near term, the budget was in surplus in the first three months of the year. The consolidated government surplus came at €147mn in Q1-2016, up from a deficit of €19mn in Q1-2015. As a percentage of GDP the consolidated government surplus came at +0.8% in Q1-2016, up from a deficit of -0.1% in Q1-2016. The primary surplus stood at +1.4% of GDP in Q1-2016 up from +0.5% a year ago. Total revenues improved by +8.4% YoY driven by higher non tax revenue and social contributions. On the other hand, total expenditure contracted by -2.7% YoY driven by lower debt servicing, public sector wage bill and other current expenditure.

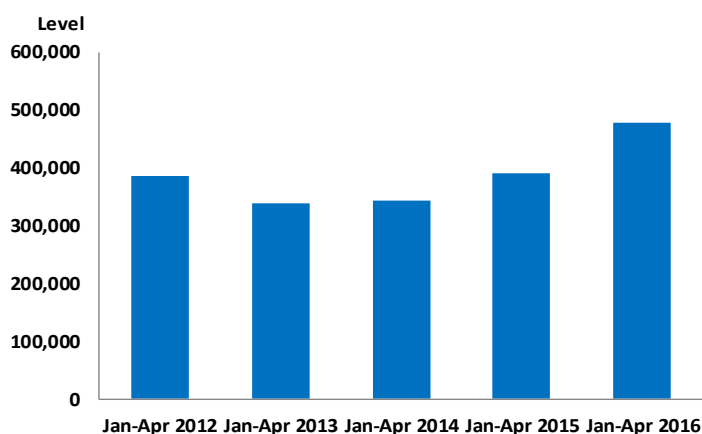
Unemployment

According to the latest LFS survey, unemployment on a seasonally adjusted basis came down to 12.1% in April 2016 vs. 16.2% in April 2015. The decline recorded was the largest in the EU-28. Despite the improvement trend, the unemployment in Cyprus is still the fourth largest in EU-28.

Tourism arrivals & revenues (January-April 2016 & January-February)

The positive momentum for the tourism sector continued in the first months of 2016. Tourist arrivals increased by +23.9% YoY (477,183 vs. 391,483) in Jan-April 2016. A sharp increase of + 54.6%YoY, +19.2%YoY and + 21.6%YoY was recorded in tourist arrivals from Russia, Germany and UK in the same period. In addition, tourism revenues expanded by +12.5% YoY in Jan-Feb 2016 to 67mn €, up from 59mn € compared to the same period last year.

Figure 6: Sharp increase in tourism arrivals



Source: CYPSTAT, Eurobank Research