



Gikas Hardouvelis

Professor of Finance &
Economics

University of Piraeus
+30 210 4142323
ghardouv@unipi.gr

Ioannis Gkionis

Research Economist

Eurobank Ergasias
+30 210 3337305
igkionis@eurobank.gr

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Key points

- **The economy continued to surprise positively in the second quarter of the year**
- **BREXIT doesn't entail only challenges but also presents significant opportunities for the Cypriot economy as long as authorities take the right steps**
- **New bond issuance paves the way for the streamlining of debt repayments in 2019-2020**
- **Fiscal consolidation achievements in the 2013-2015 MoU era allow for greater policy flexibility in the medium-term without compromising debt sustainability**
- **The main risks ahead are concentrated in the financial sector and the ability to quickly reduce the high NPL ratio.**
- **Another risk is complacency following the exit from the Adjustment Program: Cyprus has a political window of one year to carry on with the remaining reforms in the public sector and in privatizations**

1. BREXIT: Challenges and Opportunities for Cyprus

Cyprus is a special case in the broader region. A former colony of Great Britain, it gained independence in 1960 and maintains important ties with the United Kingdom. Those ties are illustrated by the fact that around 85,000 residents in the UK are of Cypriot origin. (See Figure 1a, around 10% of the current population of the island, UN data).¹ The Cypriot economy appears sensitive to Brexit as are the economies of Ireland, Malta, Luxemburg and Belgium. Specifically,

- Cyprus is a net recipient of remittances from UK. According to World Bank data, net remittances stood at only 0.6% of GDP in 2015 (See Figure 1b).
- The UK is the second most important trade partner of Cyprus by value of transactions (see Figure 2). Exports of goods to the UK stood at 9.6% of total goods exports in 2014 or 0.7% of GDP (the relevant numbers for 2015 were 6.9% and 0.8% of GDP). In addition, exports of

¹ <http://www.un.org/en/development/desa/population/migration/data/estimates2/estimates15.shtml>

services to the UK accounted for 20.8% of total services exports or 7.6% of GDP in 2014 (a large fraction of which originates from the flourishing tourism sector).

- Cyprus also imports a considerable amount of goods and services from UK. Yet put together, exports and imports, Cyprus currently runs a bilateral trade surplus with the U.K. of 2.6% of GDP.
- While tourism from the UK is significant, in recent years the relative importance of the British tourist market has declined as the island has diversified towards other markets (Russia, Germany, and Israel). Until 2006, UK tourist arrivals accounted for 60% of total arrivals. The respective share has now declined to 40% in 2015.² In the 1H-2016, UK tourist arrivals expanded by 16.1% YoY (to reach 465,977). The impact of BREXIT on the tourism sector, if any given the persisting geopolitical concerns in the broader region, will most probably stem from the depreciation of the British Pound vs. the Euro. In any case, any impact is expected to materialize next year.
- Net FDI ties appear relatively low: According to the Central Bank data, the incoming FDI stock from UK stood at €3,2bn in 2014 (18.4% of GDP, only 2.6% of total incoming FDI stock). On the other hand, Cypriot investment in the UK stood at €2.5bn.³ From a UK point of view, British banks had a total exposure (measured by claims on an immediate counterparty basis, BIS data) of \$1,127 mn as of Q1-2016 (3.4% of foreign banks claims in Cyprus).⁴
- Given that UK is among the largest net contributors to EU budget (3rd largest in EU-28), this appears to be one of the biggest concerns over the impact of Brexit. Cyprus has been allocated €874mn (5% of GDP or 0.2% of total ESI funds) from European Structural and Investment (ESI) Funds over the period 2014-2020. Given the additional national contribution of €246mn, the total amount will be €1.12bn.⁵ A renegotiation of the allocation of EU funding for 2014-2020 appears to be unavoidable after the Brexit vote. However, if there is no change in the designated funds for the period 2014-2020, any Brexit-related impact would be felt only after 2020.

Despite the perceived high degree of sensitivity, Brexit could post an opportunity for the island as well. Cyprus enjoys comparative advantages such as full EU and euro area membership, a legal and judicial system based on the English Common Law, low corporate tax rates, a key geostrategic position in the Mediterranean Sea, the facilitation of international businesses, and quality human capital. Cyprus could thus turn Brexit into a lasting opportunity by attracting departing businesses

² The per capita spending of UK tourists was close to the average tourist spending in 2014: €824.9 vs. €828.9, [http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/2FC7A9CCC9724451C2257E54002FA1DD/\\$file/EXP_TYP_ETRAVEL-JANDEC14-EL-080316.xls?OpenElement](http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/2FC7A9CCC9724451C2257E54002FA1DD/$file/EXP_TYP_ETRAVEL-JANDEC14-EL-080316.xls?OpenElement)

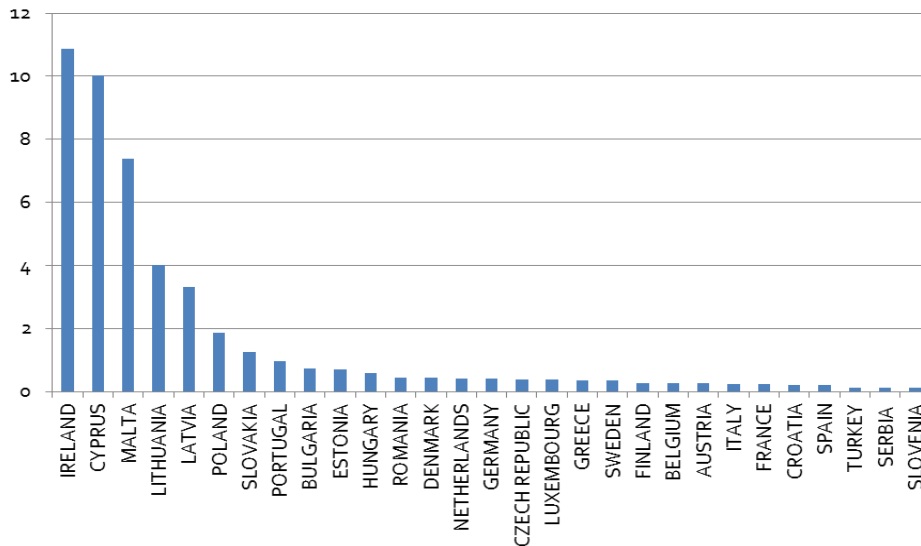
³ http://www.centralbank.gov.cy/media/xls_gr/Annual_Flow_Data_by_Country_STTBG_FDI.xls

⁴ <http://www.bis.org/statistics/b4-cy.pdf>

⁵ http://ec.europa.eu/regional_policy/en/information/publications/factsheets/2016/european-structural-and-investment-funds-country-factsheet-cyprus

from the UK or potential new entrants, which would like to operate under an environment with those characteristics.

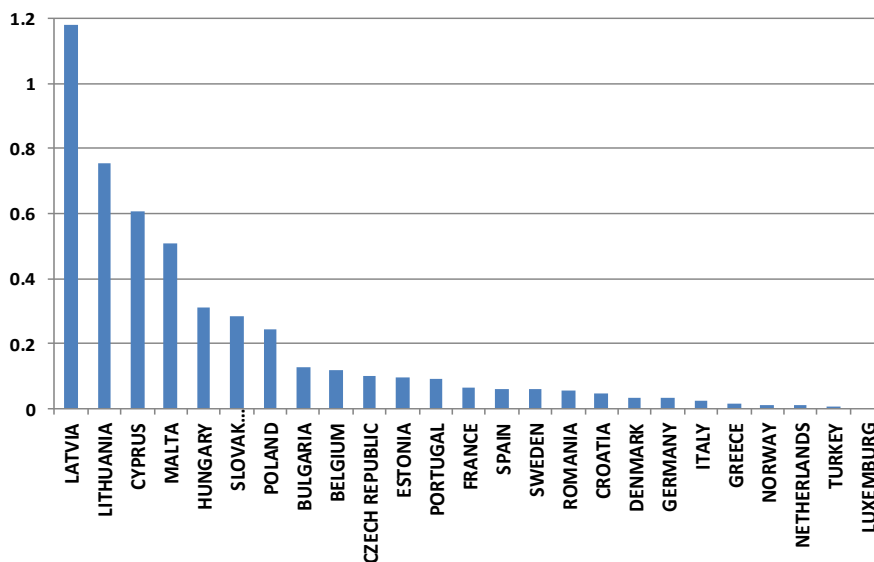
Figure 1a: Migrants in the UK as percentage of origin country population (2015, %)



Source: United Nations, Eurostat, Eurobank Research.

The total number of migrants in the UK is 8,543,120.⁶ The countries with the most migrants are: India (776,603)-Poland (703,050)-Pakistan (540,495)-Ireland (503,288)-Germany (322,220). The relevant number for Cyprus is 84,815.

Figure 1b: Net remittances from the UK (2015, % of GDP)

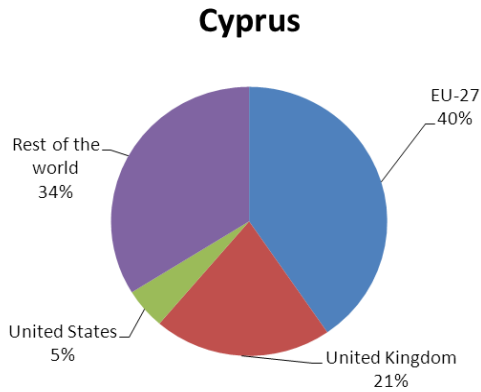


Source: IMF, World Bank, Eurobank Research

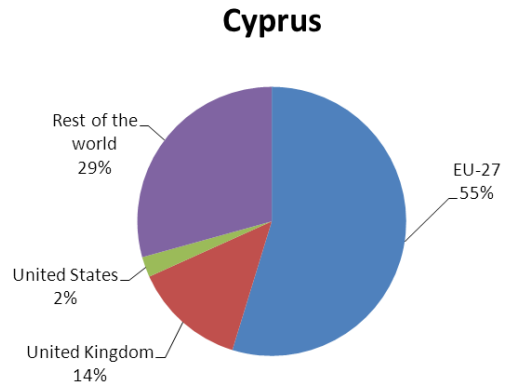
⁶http://www.un.org/en/development/desa/population/migration/data/estimates2/data/UN_MigrantStockTotal_2015.xlsx

Figure 2: Cypriot Trade of Goods & Services by geographical destination, 2014

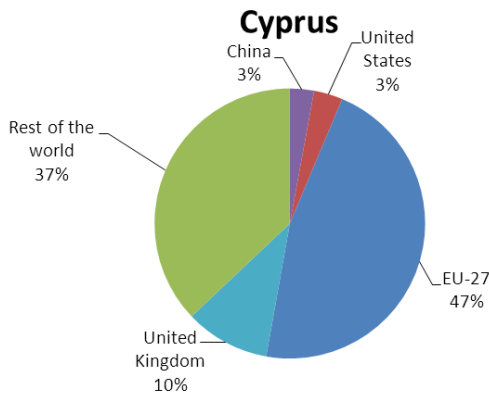
Exports of services to UK vs Rest of the World (2014)



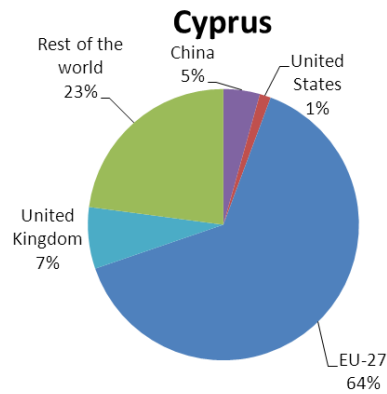
Imports of services from UK vs Rest of the World (2014)



Exports of goods to UK vs Rest of the World (2014)



Imports of goods from UK vs Rest of the World (2014)



Source: Eurostat, Eurobank Research

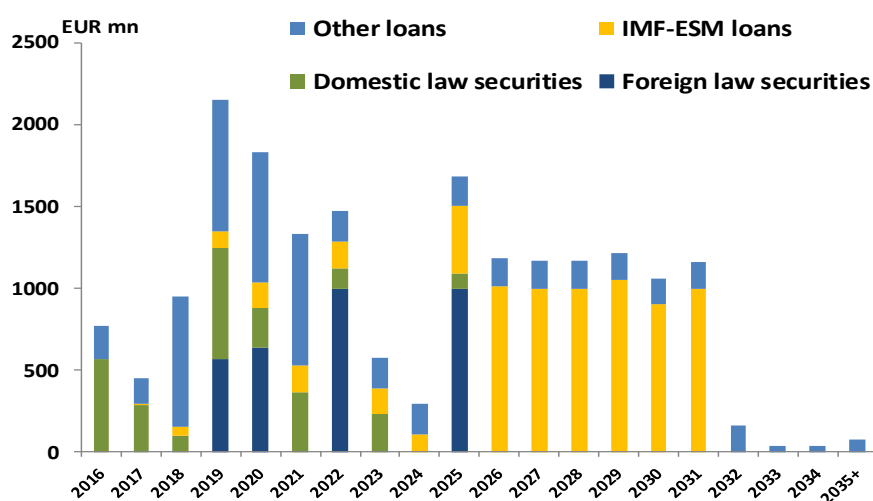
2. New bond issuance allows for streamlining of debt repayments in 2019-2020

Cyprus recently tapped international financial markets for the first time since its exit from its economic adjustment program in late March. On July 19th, the Ministry of Finance raised €1bn selling 7-year bonds with a 3.75% coupon at a 3.8% yield. From a historical point of view, this is the lowest coupon rate the Republic ever achieved in a benchmark bond debt issuance.

Investors' bids were strong. The issue was oversubscribed 2.5 times. Earlier, and within the first year of its MoU program, Cyprus was already a credible borrower and had made the fastest come-back to international markets among other Euro Area program countries. Cyprus had issued bonds three times in the international markets, once in June 2014 and then again in April 2015 and in October 2015.⁷ Specifically,

- On June 25th 2014, Cyprus raised €750mn by selling a new 5Y bond at a yield of 4.85%
- On April 28th 2015, Cyprus raised €1bn by selling a new 7Y bond at a yield of 4%
- On October 27th, 2015, Cyprus raised €1bn by selling a new 10Y bond at a yield of 4.25%

Figure 3: Maturity profile of public debt 2016-2035



Source: Ministry of Finance, Public Debt Management Office

Figure 3 shows that Cyprus does not face any significant repayment obligations prior to 2019. As of the end of March 2016, the amounts to be repaid in 2016, 2017 and 2018 stand at €767mn, €453mn and €873mn respectively, and most of the maturing bonds are held by domestic financial institutions. However, a large portion of the outstanding debt stock- around €4bn or one fifth of total outstanding public debt- is maturing within the period 2019-2020. As a result, the recent €1bn issuance will allow

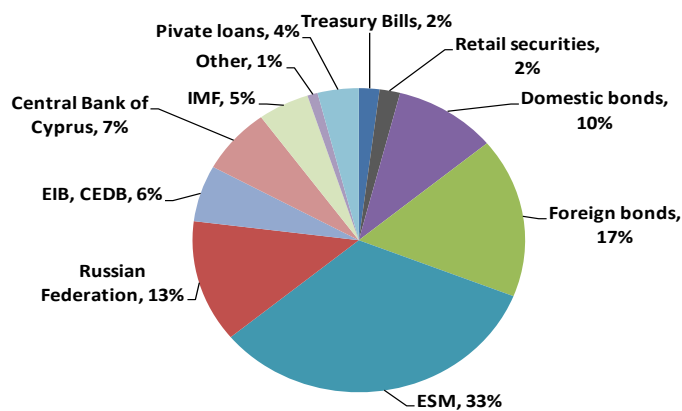
⁷ A private placement of a six year international bond for a nominal value of €100.000.000 at a coupon rate of 6.50% took place on April 30th, 2014, [http://www.mof.gov.cy/mof/mof.nsf/All/4234E193570C579AC2257CCA00446B80/\\$file/Press%20Release%20E-MTN%2030%2004%202014%20FINAL.pdf](http://www.mof.gov.cy/mof/mof.nsf/All/4234E193570C579AC2257CCA00446B80/$file/Press%20Release%20E-MTN%2030%2004%202014%20FINAL.pdf)

the Ministry of Finance to buy-back bonds of those maturities, thus reducing the required future new debt issuance of 2019-2020.⁸

The credit rating of the Republic has been on an upgrading path since mid-2013. During this 3-year period, the Republic was upgraded between 3 to 5 notches by credit rating agencies. Despite rating agencies' aggressive upgrading in the past autumn, when Cyprus' ratings went up by approximately 1-2 steps, the sovereign rating of Cyprus is still below investment grade.⁹ 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- & B1 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 Cypriot government bonds to get investment grade status. The non-investment grade status costs Cyprus an exclusion from ECB's Quantitative Easing Program (QE). Prior to April 1, 2016, Cyprus did qualify for QE but only under special circumstances through a waiver because its economy was following the specific guidelines of an EMU Adjustment Program. When Cyprus graduated from the Adjustment Program in March, it lost the earlier waiver and, given its non-investment rating, the qualification for QE.

Figure 4: Structure of public debt by instrument, March 2016



Source: Ministry of Finance, Public Debt Management Office

Figure 4 shows the composition of the public debt as of March 2016. The current debt structure is dominated by non-marketable debt in the form of loans by supranational organizations (namely ESM: 33%, IMF: 5%, and EIB-CEDB: 6%) as well as other governments (the Russian Federation: 13%) and

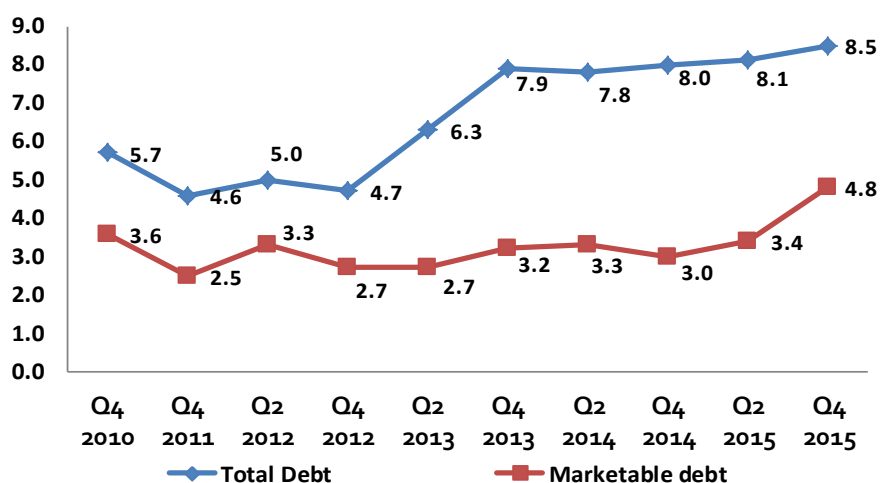
⁸ Part of the proceeds (€434 mn) from the 10Y bond issuance of October 2015 was already used to repay debt maturing in 2019-2020.

⁹ In late September S&P raised the long-term sovereign rating of Cyprus by one notch (from B+ to BB-) with a positive outlook. In late October, FITCH upgraded the sovereign rating of Cyprus by two notches (from B- to B+) with a positive outlook.

the Central Bank of Cyprus (CBC: 7%). Overall, the official sector held 65% of the outstanding debt stock in Q1-2016, up from 35% in Q4-2012, 24% in Q4-2011 and only 22% in Q4-2010.¹⁰

The second largest component of national debt is formed by marketable debt, which is split in discrete categories depending upon the market segment of investors (domestic or foreign), their sophistication (retail or institutional) and the governing law under which the securities were issued (English, Cypriot). Marketable debt comprises of several kinds of instruments of the following maturities: Treasury bills (up to 12 months), Euro-commercial paper (up to 12 months), Domestic Retail Bonds (6 years), Domestic Bonds (maturity above 12 months), Euro Medium Term Notes (EMTN, maturity above 12 months)

Figure 5: Weighted average maturity of public debt (in years)

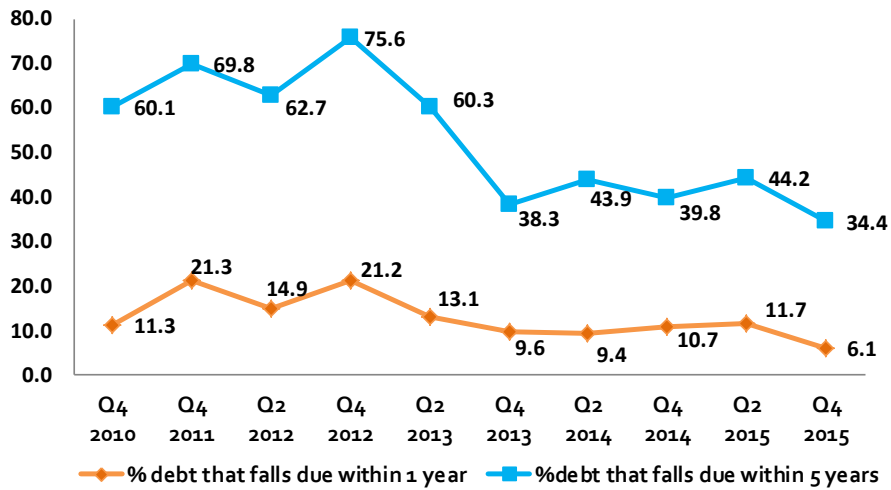


Source: Ministry of Finance, Public Debt Management Office

The faster than expected come-back to the financial markets not only reduced the dependency on programme financing, but also improved the public debt profile. Previous costlier domestic short-term borrowing has been replaced with cheaper long-term denominated external funding. As a result, the weighted average maturity increased to 8.5 years in Q4-2015 up from 8 years in Q4-2014 and 4.7 in Q4-2012 (Figure 5, blue line). The maturity of marketable debt has also gone up to 4.8 years in Q4-2015 from 2.7 years in Q4-2012 (Figure 5, red line). Interestingly, the weighted average debt servicing cost has also declined to a projected 2.7% in Q4-2015 down from 2.9% in Q4-2014, 4.2% in Q4-2012, and 3.8% in Q4-2010.

¹⁰ The data used from the PDMA Cyprus Central Government Debt Monitor (No.21, Q1-2016) excludes intergovernmental obligations, and represents 98% of the total consolidated government debt.

Figure 6: % public debt that is due within 1 year and 5 years



Source: Ministry of Finance, Public Debt Management Office

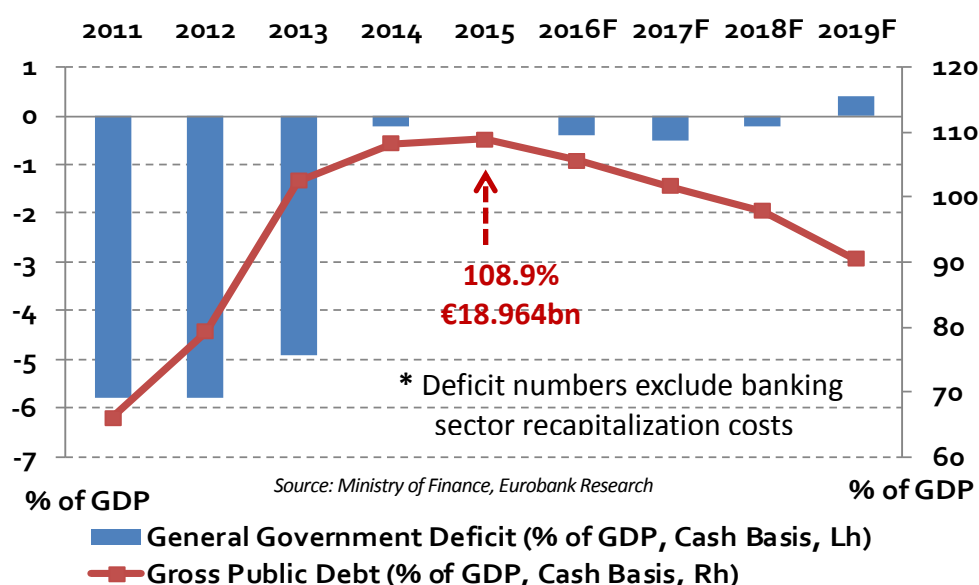
Figure 6 complements the earlier information in Figure 5. Money market debt of maturity less than one year (red line in the figure) represents only 6.1% of total debt in Q4-2015, from 9.4% in Q4-2014 and 21.2% in Q4-2012. The earlier 2011-2012 heavy dependence of short-term financing from the money market is gradually being reduced. Similarly, the dependence on debt maturing within 5 years has gone down (blue line).

Put differently, today almost two thirds of total debt matures beyond 5 years into the future. This was not the case back in 2012. *Ceteris paribus*, this maturity extension relative to 2012 makes the present value of debt a lot smaller than it used to be.

3. Fiscal consolidation

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 to a balanced position in 2015 (Figure 7, blue bars).¹¹

Figure 7: The evolution of Fiscal Balances and Public Debt



Source: Ministry of Finance, Eurobank Research

The faster than expected in the MoU fiscal consolidation in 2013-2014 allows for a looser fiscal policy in the future. Such a policy is conducive to growth, yet it does not compromise debt sustainability. This is shown in Figure 7 above. The figure includes each year's projected fiscal balances as a % of GDP (blue bars) and total public debt as a % of GDP at the end of each year (red line). Public debt is declining as a percent of GDP and reaches the level of 90% at the end of 2019. This is a drop of 19 pts from its peak of 108.9% in 2015.

The announced primary fiscal balances (that is, total true annual fiscal balances minus the annual interest rate expenses) are as follows: A primary surplus of 2.8% GDP in 2015 is expected to go down to a target of 2.2% in 2016, 1.9% in 2017, 2.3% in 2018 and 3% in 2019. By contrast, earlier Program targets for 2017-18 were in the range of 3.0%-4.0%. The difference of over one percentage point of GDP represents a boost to aggregate demand and economic activity. Put differently, because of prudent early action during the Economic Adjustment Program and early attainment of the fiscal targets, Cyprus today is rewarded with a somewhat looser fiscal path, which is conducive to growth.

¹¹ 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).

The question that immediately opens up is whether or not this slight fiscal loosening is sustainable. Can Cyprus follow a growth promoting fiscal policy without compromising its debt sustainability? Figure 7 (red line) provides a positive answer. With the new looser fiscal targets, the debt-to-GDP ratio is forecasted to decline to 90% by the end of 2019.¹²

Let us delve into the mechanics of fiscal relaxation by comparing the assumptions on government revenues and expenses for 2017 in the Strategic Framework for Fiscal Policy (SFFP) 2016-2018 issued in May 2015 compared to the SFFP 2017-2019 issued in May 2016.¹³

Fiscal Target 2017: A fiscal relaxation is stemming from the side of revenues. Total revenues appear to be lower by -1.0% of GDP while primary expenditure is expected to be higher by only +0.1% of GDP. The combined effect of those two cumulates into a substantial relaxation of the primary surplus target of 2017. **Instead of 3% of GDP initially in the (SFFP) 2016-2018, it is now expected only at to 1.9% of GDP in the SFFP 2017-2019.**

Government revenues are expected to expand by +1.8% in 2017, below the projected nominal GDP growth. This is a result of the abolishment of the special contribution levied on wages of the private and public sector, an anticipated drop in the dividends related revenues and the expected gradual decrease in VAT proceeds as a result of the amendments made in the legislative framework on the European level.

Government expenditure is expected to rise by 2.5% in 2017 driven by the lifting of the wage freeze in the public sector, the hiring of extra personnel in the areas of defense and security and an increase in the welfare benefits as a result of pension rises in the Social Insurance Fund in line with actuarial calculations.

4. Complacency risk and an untested new Parliament

The parliamentary election results were not a game changer as they have no direct impact on the formation of the government. The system of the Republic is presidential. In our previous report, we highlighted that, most probably, the new parliament was going to be less friendly to the ruling party than the outgoing. The first evidence provided by the new Parliament seems to confirm our assessment. The incoming parliament is fragmented between more parties and appears less keen to back reform friendly legislation. This was more evident in the following two cases:

1. **Immovable Property Tax:** There are disagreements between the political parties on the Immovable Property Tax bill. After intense deliberations, the Parliament voted to slash the

¹² Calculations don't include any proceeds from the privatizations projects or the exploration of natural gas.

¹³ For a more detailed analysis on the individual budget items:
[http://www.fiscalcouncil.gov.cy/fiscalcouncil/fiscalcouncil.nsf/All/C63805633109BF7CC2257FEA003B2F33/\\$file/spring%202016%20report%20ENG.pdf?OpenElement](http://www.fiscalcouncil.gov.cy/fiscalcouncil/fiscalcouncil.nsf/All/C63805633109BF7CC2257FEA003B2F33/$file/spring%202016%20report%20ENG.pdf?OpenElement) (page 25)

Immovable Property Tax (IPT) collected by the government by 75% on the 1980 property prices, and the abolishment of the IPT altogether in 2017.¹⁴ The legislation was endorsed with a majority MPs' vote of 29 for, 18 against and 5 abstentions.¹⁵

2. **Civil service reform:** The approval of the bill setting a cap to the public sector wage bill, linking the expenditure expansion with the GDP growth performance, is still pending. The Parliament has postponed for September the vote for this crucial piece of legislature, which would keep the wage bill on a sustainable level, minimizing the risk of fiscal derailment. The Minister of Finance has gently warned that unless the cap is introduced, "the current legislation stipulates that as of January 1, 2017, we return to the previous state of affairs with no ceiling in salary increments, hiring and allowances."

The risk of complacency following the exit from the Adjustment Program is material for Cyprus. Firstly, there is a number of pending important structural reforms of the economic adjustment program that will allow the Cypriot economy not to backtrack. The incumbent government has a political window of one year to carry on with the remaining reforms, mainly in the public and health sectors as well as to conclude key privatization projects. Secondly, fiscal policy achievements may lead to spending pressure, which is going to increase ahead of the Presidential Elections, scheduled for February 2018.

5. Non-Performing loans

NPLs, a side effect of the Cypriot banking crisis, are "the elephant in the room" of the Cypriot economy, as they remain extremely high, the highest among all EMU countries. As of end-2014, the Central Bank of Cyprus has adopted the EBA methodology, which follows 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.

Despite the improvement in the economic conditions, the system wide NPE ratio is still standing close to 50%. According to the latest data, the NPEs ratio had reached 49.7% in May 2016 up from 48.1% in April and 48.4% in March 2016, still higher than a 45.9% recorded in December 2015, and 47.7% in December 2014. The recent deterioration in the ratio does not mirror a further rise in the size the euro value of non-performing loans but rather the ongoing private sector deleveraging, which impacts the size of total loans in the denominator of the NPE ratio.

The NPL ratio in Cyprus is among the highest recent ratios, which tends to occur following a banking crisis, as in Ukraine (1998) or Iceland (2008). More importantly, it is not entirely justified by the deterioration in economic activity, the subsequent rise in unemployment, or the decline in disposable incomes. It appears that a number of strategic defaulters have emerged, most probably as a result of

¹⁴ The IPT tax due in 2016 will be at 25% of the amount calculated with the existing provisions in place provided that it is paid until October 31st 2016, 27.5% if paid between November 1st-December 31th and a 10% penalty imposed on 27.5% if settled thereafter. The local authorities will continue to collect IPT which amounts to €30 million in revenue.

¹⁵ The legislative proposal was jointly submitted by ruling party DISY and major opposition parties DIKO, EDEK and the Solidarity Movement. AKEL and ELAM MPs voted against the proposal while MPs of Citizen Alliance and Greens-Citizen Cooperation abstained.

the bail-in event of March 2013. High levels of NPLs deter banks from extending new lending, thus leading to a more prolonged period of limited credit supply, hindering economic recovery. They also create distortions in the economy, as resources are trapped in unproductive assets. Most of the NPLs originate directly or indirectly from the downturn of the real estate market (mortgage or construction loans).

To mitigate the impact on the banking sector balance sheets, banks increased their provisions. However, the increase of provisions failed to keep up with the rise of NPLs, so that the provisions coverage ratio stood at 37.2% in May 2016, much lower than the EU average (see Figure 8).

To address the issue of NPLs from a structural point of view, the right incentives for banks and borrowers ought to be in place. Banks are now equipped with the appropriate new legal framework, a subject of intense political deliberations and a prior action in the earlier Economic Adjustment Program.¹⁶ The new legal framework provides banks the necessary tools for addressing strategic defaulters and allows for effective debt-restructuring, essential for the resolution of NPLs. The insolvency framework, a set of bills complementary to the foreclosures legislation, is designed to balance borrowers' rights with their obligations to lenders, offering them protection from foreclosure under certain circumstances. Finally, legislation to facilitate the sale of bank loans to foreign institutional investors and private funds through securitization has also been put in place. The creation of a new market for non-performing assets could allow banks to dispose some of those assets, thus cleaning up their balance sheets more quickly and efficiently.

The result of the new legal framework is a pick-up in the pace of loan restructurings, an essential tool for the resolution of NPLs. The amount of loans restructured has been 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 €1.9bn in Q1-2016.¹⁷ As a result, a large fraction of the restructured loans falls into the 12-month probation period and are still classified in NPEs (41.3% in March 2016 vs. 40.8% in February 2016). On a more positive note, according to the Central Bank data, 78% of the fixed-term loans which were restructured between 1 January 2014 and 31 March 2016 abide by the new repayment schedule, agreed as part of the restructuring process.

In its latest assessment on the Cypriot banking system on August 1, Moody's changed its outlook from stable to positive, reflecting the rating agency's view that the country's economic recovery will restore banks to profitability and improve their weak asset quality. Moody's is forecasting asset quality to improve for domestic Cypriot banks as a result of strengthening operating conditions - driven by a revival of tourism, the strengthening business services sector and increased consumer spending. Moody's is also forecasting the ratio of NPEs continuing to decline to 43%-45% by year-end 2016, still high but below their peak of 55% in September 2015.¹⁸ Moody's notes that the process of balance sheet rehabilitation for the Cypriot banks will be long, given the long cure periods for

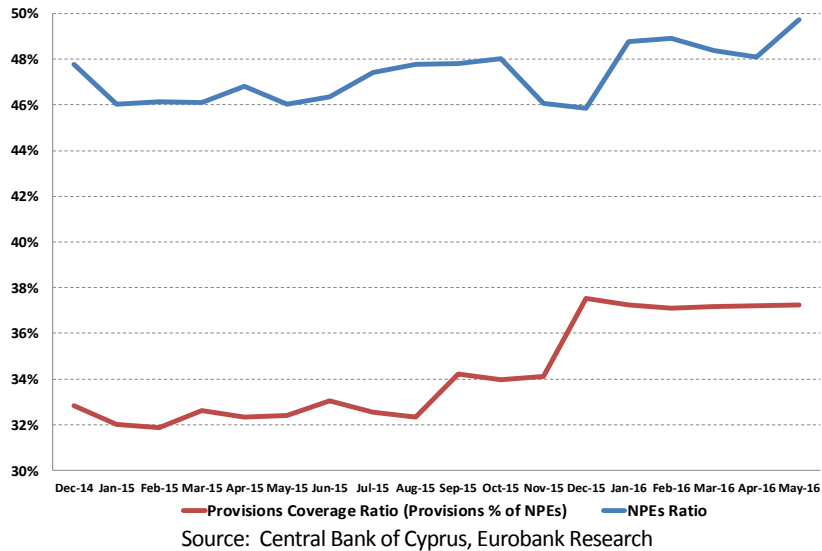
¹⁶ The completion of the first auctions under the new legal framework governing auctions of foreclosed assets took place in late June 2016.

¹⁷ As of May 2016, the stock of restructured loans increased to €13.95 bn from €12.9 bn as of December 2014: http://www.centralbank.gov.cy/nqcontent.cfm?a_id=13029&lang=gr

¹⁸ Moody's calculations: As of March 2016 the domestic banks' NPL ratio was around 51% according to our estimates, down from a peak of 55% in September 2015. The central bank's assessment of troubled loans, using the European Banking Authority's (EBA) broader Non Performing Exposure (NPE) definition, is higher at around 60% for core domestic banks and 48% for the wider banking system.

restructured loans before they are reclassified as performing, the still sizeable amounts of distressed debt banks must tackle, and the relatively limited volumes of real estate transactions.

Figure 8: Banking Sector Asset Quality Metrics in 2014-2016



4. Interpreting the latest Cypriot Economic News

(May-August 2016)

Current State of the Economy: The real economy continues to surprise positively

Economic Sentiment Index (ESI Index)

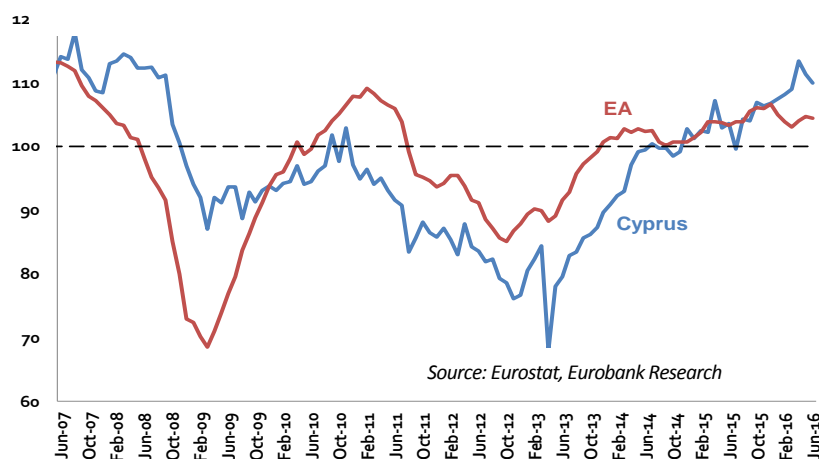
CYPRUS: Confidence edged up in July in the aftermath of the Brexit vote in late June

The ESI Index inched up by 0.2 points to 101.1 in July compared to 109.9 in June and 111.3 in May vs. a multi-month peak of 113.3 in April. The more pronounced improvement in expectations came from services (by 4.5 points), retail trade (by 4.8 points) and construction (by 3.6 points). On the other hand, both industry and consumer sentiment edged down by 1.8 points and 1.6 respectively. In any case, the ESI Index stands above its long-term average. Despite the small decline in the last two months, the ESI index stands still close to its post-Lehman peak recorded in last April. The improvement recorded in the past three years – a total of 42 points since April 2013 – is the highest in EU-28 over the same period.

The sentiment improvement is the first in the post-Brexit period and suggests that economic agents have started to look beyond it. We will be looking for more evidence in the next months for this. Sentiment improvement is one of the key drivers of the consumption rebound taking place and feeds into output growth. All in, the ESI Index trajectory spurs optimism for short-term economic activity prospects.

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 9: ESI index close to its post-Lehman peak

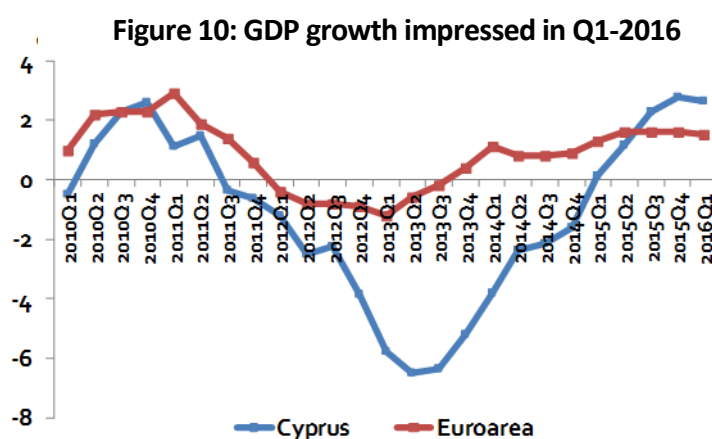


Q1-2016 GDP growth (Second estimate)

The economy started the year on good foot

The second estimate of the first quarter- the fifth consecutive positive reading on both a quarterly and an annual basis- 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 and +1% QoQ/+0.1% YoY in Q1-2015. The reading came above that of EA-19 for a third consecutive quarter.

After a three year recession in 2012-2014 and a cumulative drop of 10.5% of GDP, the economy expanded by +1.6% YoY in 2015 and is expected to further gain momentum to +2.5% YoY in 2016. This forecast stands above the most recent EU Commission Spring forecast of +1.7%, as lower energy prices, strong sentiment improvement, the lagged effect from Euro depreciation, the lack of additional fiscal austerity measures and a flourishing tourism sector are expected to provide more support to consumption's recovery and net exports



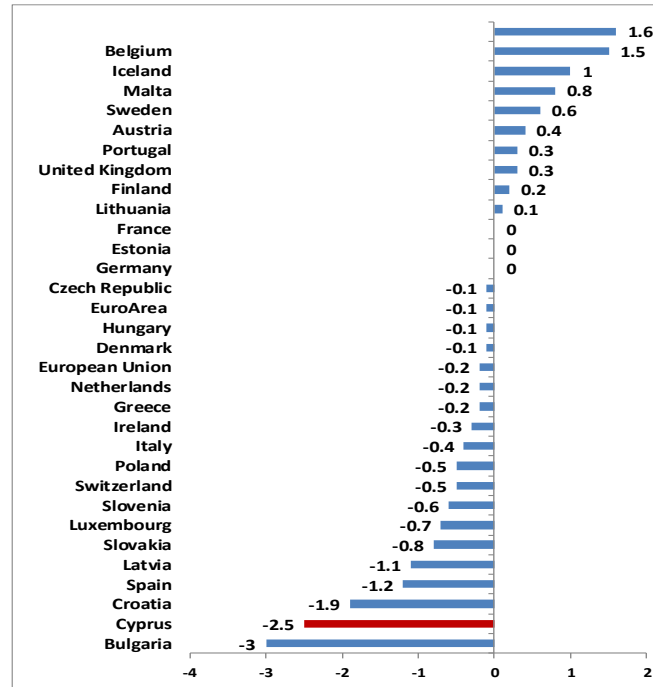
Source: CYPSTAT, Eurobank Research

Consumer prices (HICP)

Cyprus recorded the second highest deflation in June among EU-28

Consumer prices, measured by HICP, edged up to +0.28 MoM/ -2.0% YoY in June, down from +0.7% MoM/-1.9% YoY in May, compared to (or with) +1.32% MoM/-2.1% YoY in June 2014. The biggest declines were observed in the categories of transportation (+2.4% MoM/-11% YoY) and utilities (-0.3% MoM/-8.8% YoY), which reflect the pass through of lower energy prices. In addition, the volatile component of food and non-alcohol prices increased slightly by -0.96% MoM/+0.1% YoY in June. On the other hand, the clothing and footwear component among other categories-in June (+1.52% MoM/+0.6% YoY). As a result, the average annual HICP came at -1.9% YoY in the first 6 months of the year down from -1.4% YoY in 2015 and -0.7% YoY in 2014.

Figure 11: HICP in EU-28 countries in June-2016



Source: Eurostat, Eurobank Research

Deposits & Loans

Deposit growth was positive on an annual basis for an eighth consecutive month in May

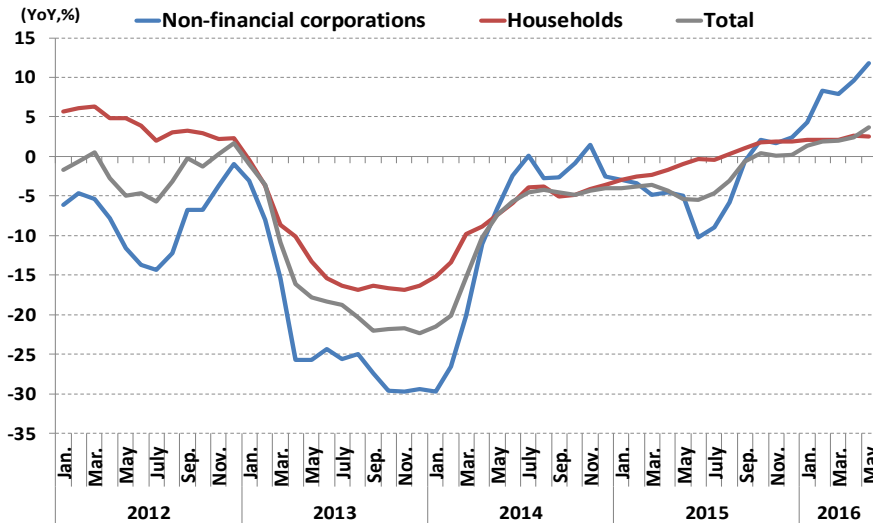
The Central Bank of Cyprus published on May 31st the Monetary and Financial Statistics (MFS) of May.¹⁹ From a flow point of view, total deposits recorded a net increase of €377.2 mn in May 2016, compared with a net decrease of €144.9mn in March 2016. The annual rate of expansion- the eighth positive consecutive in a row - increased to 3.7% YoY in May compared to 2.4% YoY in April, up from 2.0% YoY in March 2016. The outstanding amount of total deposits reached €46.47bn in May up from €45.89 bn in April 2016 down from €45.97bn in December 2015. 20

Total loans in May 2016 exhibited a net decrease of €2147.4 mn, as a result of loan repayments, compared with a net decrease of €114.1 million in April 2016. The annual growth rate stood at -10.8% YoY in May2016 vs. -7.3% YoY in April2016, compared with -7.5% YoY in March 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 €55.34bn in May2016 down from €57.40 bn in April 2016 down from 57.52bn in March2016.

¹⁹ http://www.centralbank.gov.cy/media/xls_gr/2ndMFSJune2016gr.xls

²⁰ The Central Bank is using ECB methodology to calculate the annual growth with a special formula taking into account the monthly transactions

Figure 12: Annual growth of deposits

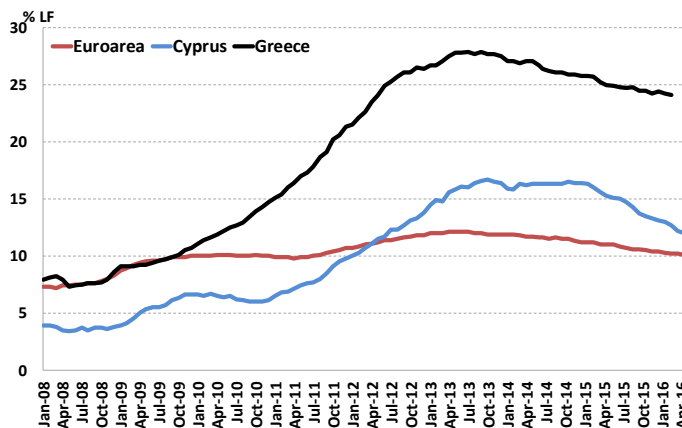


Source: Central Bank of Cyprus, Eurobank Research

Unemployment

According to the latest Labor Force Survey (LFS), unemployment on a seasonally adjusted basis came down to 11.7% in June 2016 down from 11.9% in May 2016 compared to 15.1% in June 2015 and 17% at its peak in October 2013. Cyprus recorded the highest unemployment decline in EU-28 in the past twelve months. Yet, despite the improvement trend, the unemployment in Cyprus is still the fourth largest in EU-28. Youth & Long-term unemployment are a source of concern and necessitate more attention

Figure 13: Unemployment in Cyprus is on a declining trend



Source: Eurostat, Eurobank Research

Jan-June 2016 Budget execution (cash basis)

In the near term, the budget switched to a deficit in 1H-2016. The consolidated government deficit came at €43.7mn in 1H-2016, up from a deficit of €31.2mn in 1H-2015. As a percentage of GDP the consolidated government deficit came at -0.25% in 1H-2016, switching from a surplus of up from a deficit of -0.2% in Q1-2016. The primary surplus stood at +1.0% of GDP in 1H-2016 up from +1.2% a year ago. Total revenues improved by only +1.2% YoY driven by higher indirect tax and social contributions. On the other hand, total expenditure was lower by -0.8% YoY driven by lower debt servicing, current transfers and spending on pensions.

Table 1: General Government Budget Execution

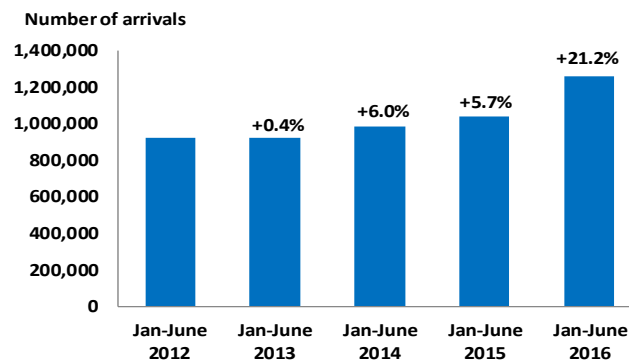
General Government Adjusted Budget Balance on cash basis (January-June 2016)		
in % GDP	January-June 2015	January-June 2016
<u>I. Government Budget and SSF</u>		
Total Revenue	17.01%	16.98%
Current revenue	16.85%	16.88%
Direct Taxes	4.82%	4.82%
Indirect Taxes	6.66%	6.80%
of which, VAT	4.01%	3.99%
Social security contributions	2.80%	2.89%
Non-tax revenue	2.57%	2.36%
Capital Revenue	0.00%	0.00%
Grants	0.16%	0.11%
Total Expenditure	17.81%	17.43%
Current expenditure	17.42%	16.91%
Wages and Salaries	4.49%	4.46%
Goods and services	0.91%	0.87%
Subsidies	0.25%	0.40%
Social Security payments	4.24%	4.39%
Pensions	1.67%	1.48%
Social Pensions	0.18%	0.18%
Current transfers	4.13%	3.81%
Non-allocated	0.18%	0.05%
Interest payments	1.36%	1.27%
Capital expenditure	0.39%	0.53%
Balance (I)	-0.80%	-0.45%
<u>II. Other General Government Bodies</u>		
including		
Local Authorities	0.02%	-0.01%
Semi-public Entities	0.17%	0.01%
Other Entities	0.05%	0.01%
Balance (II)	0.26%	0.05%
<u>III. ESA 2010 adjustments</u>		
Balance (III)	0.38%	0.19%
<u>III. General Government Balance</u>		
Budget Balance (I+II+III)	-0.18%	-0.25%
Primary Balance (excl. interest)	1.16%	1.02%
Cyprus GDP (Mrd EURO-CYP)	17420.6	17663.26

Source: Ministry of Finance, Eurobank Research

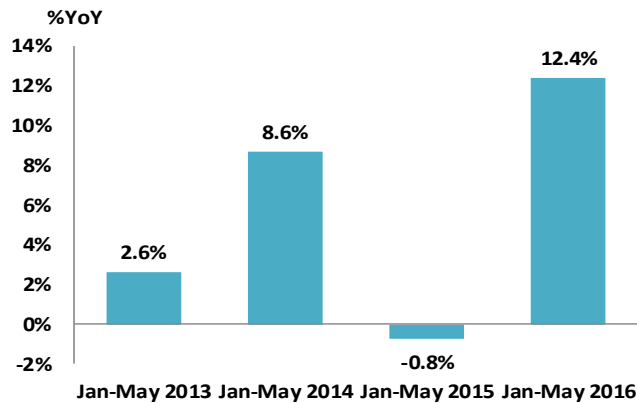
Tourism arrivals & revenues (January-June 2016 & January-May 2016)

The positive momentum for the tourism sector continued in the 1H-2016. Tourist arrivals increased by +21.2% YoY (1,255,240 vs. 1,035,898) in Jan-June 2016. A sharp increase of + 47.7%YoY, +46.5% YoY, +34.8% YoY and + 36.4% YoY was recorded in tourist arrivals from Russia, Israel, Ukraine and Lebanon in the same period. Tourist arrivals from traditional markets such as Germany (+9.4% YoY) and UK (+16.1% YoY) fared also relatively well. In addition, tourism revenues expanded robustly by +12.5% YoY in Jan-May 2016 to €530mn, up from €472mn compared to the same period last year.

Figure 14 a,b: Sharp increase in tourism arrivals & revenues



Source: CYSTAT, Eurobank Research



Source: CYSTAT, Eurobank Research

Residential Property Price Index (RPPI)- Q1-2016

The RPPI Index recorded the lowest decline on an annual basis since Q3-2010.

The Central Bank of Cyprus published in August the residential property price index (RPPI) for Q1-2016. The RPPI declined by -0.8% on a quarterly basis in Q1-2016 reflecting the combined effect of a rise in the flat

apartments by +0.6% and a decline by -1.3% for house prices. On an annual basis, the RPPI declined by a further -1.6% YoY in Q1-2016 up from -1.8% YoY in Q4-2015, -3.7% YoY in Q3-2015 and -5.0% YoY in Q2-2015. The annual RPPI decline of Q1 was the lowest since Q3-2010. Overall, residential property prices have either remained flat or declined marginally in the past four quarters. The RPPI trajectory in the past quarters, in combination with other high frequency data from the construction industry and real estate transactions, point to stabilization in the real estate sector. According to CYSTAT, the construction output index rose by 7.6% YoY in the first three months of the year, having still remained 60% below the 2010 average.

Eurobank Cyprus Research

Economic Indicators	Description	Source	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
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
GDP (%YoY)	Constant Prices	Eurostat	4.6	3.9	4.5	4.9	3.7	-2	1.4	0.4	-2.4	-5.9	-2.5	1.6
Households and NPISHs Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	7.6	3.4	4.8	10.3	7.6	-6.2	2.6	0.5	-0.8	-5.9	0.6	1.9
General Government Final Consumption Expenditure (YoY%)	Constant Prices	Eurostat	1.2	2.8	7.0	3.3	5.7	6.4	-2.1	1.3	-3.7	-4.1	-9	1.1
Gross Fixed Capital Formation (YoY%)	Constant Prices	Eurostat	4.3	6.8	21.1	7.9	9.0	-13.7	-5.1	-9.3	-20.5	-15.2	-18	14
Exports of Goods and Services (YoY%)	Constant Prices	Eurostat	2.5	2.1	1.3	5.3	-0.7	-4.3	4.3	4.1	-1.1	1.8	-0.5	1.9
Imports of Goods and Services (YoY%)	Constant Prices	Eurostat	6.9	1.6	5.7	10.5	12.5	-15.0	6.2	-3.1	-4.4	-3.0	2.0	4.0
GDP	Current Prices, SA, mil	Cyprus Statistical Service	13,767	14,731	15,879	17,375	18,822	18,482	19,118	19,547	19,469	18,065	17,394	17,421
GDP (%YoY)	Current Prices, SA, mil	Cyprus Statistical Service	7.8	6.9	8.6	9.6	4.7	-2.5	5.3	0.5	-0.9	-8.9	-1.3	0.9
Labour Market														
Unemployment Rate	NSA	Cyprus Statistical Service		5.3	4.6	3.9	3.7	5.3	6.2	7.9	11.8	15.9	16.1	15.0
Labor Productivity	Per hour worked, % Change	Eurostat	2.6	2.2	3.2	-0.7	0.0	-1.2	1.1	0.7	1.1	1.6	0.4	0.9
Unit Labor Costs	Index, 2010=100	Eurostat	84.2	86.1	88.0	90.6	94.5	99.7	100.0	101.7	101.7	98.3	95.0	93.4
Unit Labour Cost Growth Total Economy	YoY%	Eurostat	1.5	2.3	2.2	3.0	4.3	5.5	0.3	1.7	0.0	-3.3	-3.3	-1.7
Short-term business statistics														
Economic Sentiment Index (ESI)	EoP, SA	EU Commission	106.3	99.8	108.1	108.4	97	93.8	97.1	85.7	76.6	89.6	102.7	106.7
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	
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
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
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
Industrial Production General Index	NSA	Cyprus Statistical Service	103.2	102.7	103.5	111.0	109.9	102.8	100.3	92.5	75.2	69.9	72.8	77.3
Industrial Production General (%YoY)	NSA	Cyprus Statistical Service	3.7	-0.5	0.8	7.2	-1.0	-6.5	-2.4	-7.8	-18.7	-7.0	-9.6	7.8
European Commission Capacity Utilization Cyprus SA	SA	Cyprus Statistical Service	70.0	72.6	66.8	71.3	69.4	63.0	63.9	58.1	53.7	50.8	54.5	61.1
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	
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	
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	
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	
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
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
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
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
Gross Household Saving Rate	% of Gross Disposable Income	Eurostat	8.7	9.7	10.0	6.3	6.0	9.4	7.3	5.4	0.6	-4.1	-10.8	
International Trade & Balance of payments														
Current account balance (%GDP)	BMP6	Eurostat					-15.6	-7.7	-10.7	-4.0	-5.6	-4.5	-4.5	-3.6
Current Account, Goods & Services Net Balance (%GDP)	BMP6	Eurostat					-12.9	-5.4	-6.6	-3.1	-1.1	1.1	0.7	-1.4
Current Account, Primary Income Net Balance (%GDP)	BMP6	Eurostat					-2.5	-1.3	-3.0	0.3	-3.1	-3.5	-2.8	0.3
Current Account, Secondary Income Net Balance (%GDP)	BMP6	Eurostat					-0.3	-1.1	-1.0	-1.1	-1.4	-2.1	-2.4	-2.6
Imports of Goods (%GDP)	BMP6	Eurostat					42.6	35.0	37.1	35.8	33.7	31.3	32.3	32.5
Exports of Goods (%GDP)	BMP6	Eurostat					12.2	13.2	14.0	15.5	15.6	15.0	16.1	14.3
Imports of Services (%GDP)	BMP6	Eurostat					20.9	19.6	19.9	19.6	20.4	25.9	27.0	28.9
Exports of Services (%GDP)	BMP6	Eurostat					38.4	36.0	36.4	36.8	37.4	43.2	43.9	45.7
Financial Account (%GDP)	BMP6	Eurostat					-18.7	-8.5	-9.2	-0.7	-2.9	-3.4	-4.6	0.5
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	-5.5	-4.8	-5.7	-5.8	-4.9	-8.9	-1.0
General Government Debt EDP Procedure (% GDP)		Cyprus Statistical Service	64.7	63.4	59.3	54.1	45.3	54.1	56.3	65.8	79.3	102.5	108.2	108.9
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
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
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
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
Market Indicators														
10Y Gov Bond Yield Rate	%, Middle Rate	Bloomberg	5.8	5.2	4.1	4.5	4.6	4.6	4.6	5.8	7.0	6.5	6.0	4.5
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	85.7	67.75