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Key points

- **The economy's solid performance continued into the third quarter of the year**
- **Both S&P and Fitch upgraded the long-term sovereign rating of Cyprus Republic**
- **Cyprus qualifies for further sovereign rating upgrades as long as it remains focused on reducing NPLs and is committed to structural reforms**
- **Fiscal consolidation achievements in the 2013-2015 MoU era allow for greater policy flexibility in the medium-term without compromising debt sustainability**
- **The European Commission confirmed the fiscal targets of 2017 in the Draft Budgetary Plan, yet warned Cypriot authorities of deviations from the desirable structural fiscal target of zero**

1. The flash GDP estimate of Q3-2016 demonstrates that the economy is out of the woods

According to the flash estimate, GDP expanded by +2.9%/+2.8% YoY on a non-seasonally adjusted and seasonally adjusted basis respectively in Q3-2016. Real GDP growth marked the 7th consecutive positive reading on a both quarterly and annual basis after a three-year recession, confirming the economy is finally out of the woods. On a seasonally adjusted basis, growth accelerated to +0.7% QoQ/+2.8% YoY in Q3-2016 vs. +0.8% QoQ/+2.6% YoY in Q2-2016. The GDP growth rate of Q3 is among the highest in EA-19 and EU-28, both on a quarterly and an annual basis.

From a supply side point of view, the CYSTAT press release pointed out that growth was driven by the sectors: "Hotels and Restaurants," "Professional, Scientific and Technical Activities," "Retail and Wholesale Trade," "Manufacturing," "Construction" and "Transport." In contrast, "Financial Service Activities" recorded a negative growth rate reflecting the write-offs of the bank balance sheets.

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Although the demand components of growth have not yet been released, it is highly likely that the consumption rebound continued into Q3-2016. The consumption rebound is driven by a strong sentiment improvement, mirroring the lasting progress within the economic adjustment program, a flourishing tourism sector (+18.8% YoY in tourist arrivals in 9M-2016), lower energy prices on an annual basis, lower unemployment (12.0% in September, having shown the highest decline in Euro area in the past twelve months), agents' expectations of further fiscal relaxation and a rise in real incomes. After a three-year recession during 2012-2014 and a cumulative drop of 10.5% of GDP, the economy expanded by +1.7% YoY in 2015 and is projected at +2.8% YoY in 2016.

Figure 1a: Third Quarter GDP growth (YoY) in Cyprus among the highest in EA19 & EU28

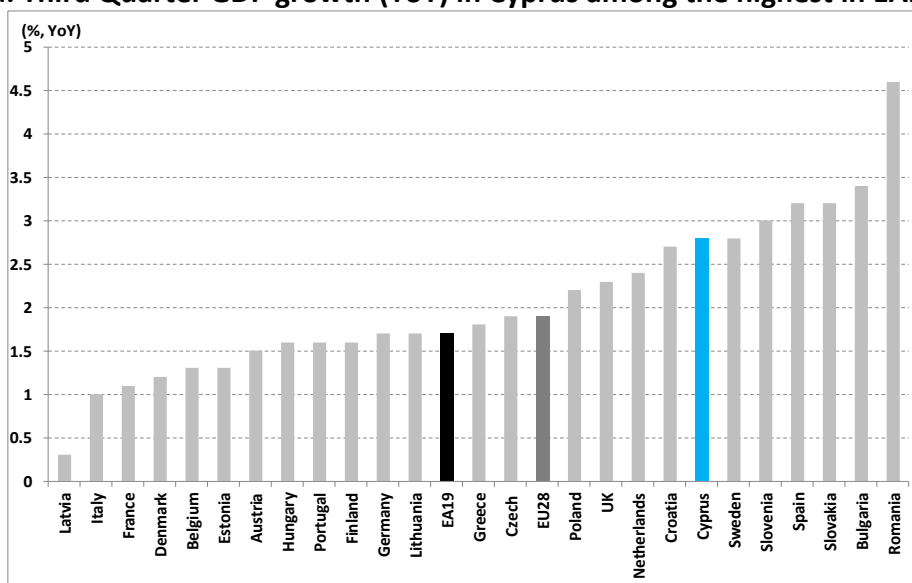
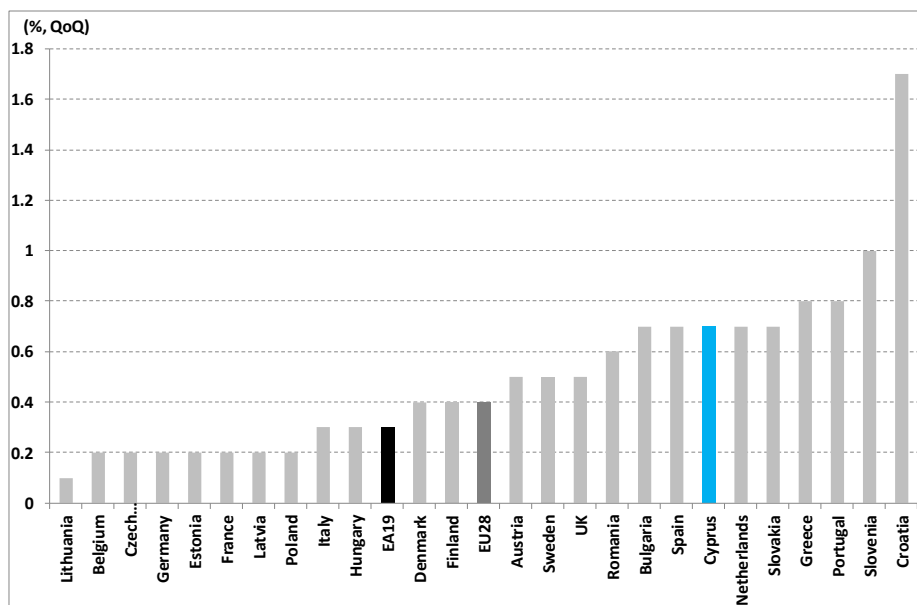


Figure 1b: Third Quarter GDP growth (QoQ) in Cyprus among the highest in EA19 & EU28



Source: Eurostat, Eurobank Research

2. The Cypriot economy has embarked on a virtuous cycle of sovereign rating upgrades: Two out of the three main rating agencies upgraded the Cypriot long term sovereign rating in their recent updates

Two out of the three main rating agencies upgraded the sovereign rating of Cyprus in their latest assessment reports. In their autumn report updates, Standard and Poors (S&P) and Fitch upgraded the long-term sovereign credit ratings of the Republic by one notch. Specifically, on September 16, S&P upgraded the sovereign credit rating of Cyprus from B+ to BB- with a positive outlook. Fitch upgraded the sovereign credit rating of Cyprus on October 21, from B+ to BB- with a positive outlook.

The upgrade by S&P reflects the rating agency's view on the stronger than expected economic growth of the Cypriot economy and its further debt reduction, as well as the steady improvement in the banking sector's asset quality, which was in line with the earlier sovereign rating action published in late March 2016. According to S&P, the economy is now projected to grow by 2.7% in 2016, above the 2% forecast stipulated in their report last March, and is expected to average 2.5% in real terms over 2017-2019. Accordingly, the net general government debt is expected to decline to below 85% of GDP in 2019. More importantly, the positive outlook reflects S&P's view that Cyprus' rating could be further upgraded within a period of twelve months. That upgrade would depend upon a further reduction in the currently high level of non-performing loans, which would indicate further convergence of Cypriot credit and monetary conditions to those of the Euro Area, including the monetary policy transmission mechanism.

The upgrade by Fitch reflects the strong progress in the aftermath of the 2013 banking crisis, the exit from the economic adjustment program last March in the context of outperformance of fiscal and economic program targets, the success at lifting capital controls, and steps taken to restructure the banking sector. According to Fitch, the economy is now projected to grow by 2.9% in 2016, above the 1.9% forecast stipulated a year ago, and is expected to average 2.5% in real terms in 2017-2018. Among the future developments that may possibly lead to an upgrade, Fitch cited the marked improvement in the overall asset quality of the banking sector, further track record of economic recovery, a reduction in the private sector indebtedness, a decline in the government debt to GDP ratio, a narrowing of the current account deficit and reduction in external imbalances as well as sustained track record of capital market access at affordable rates.

Moody's also changed its outlook from stable to positive, yet left the rating unchanged at B1. Behind its decision to keep the previous rating, the agency cited the small and relatively undiversified economy, the ongoing weakness of the domestic banking sector and very high levels of public and private debt. Moody's cited further fiscal progress as the driver behind further upgrades. That is to say, Moody's will follow the primary surplus and whether it will be sustained at high levels, thus leading to a steady reduction in the debt burden over the coming years. Sustaining growth at current levels over the coming years plus a more rapid reversal in the previous upward trend for bank NPLs would also be credit positive.

DBRS changed its outlook (trend) from stable to positive, yet confirmed the rating at B in December. According to DBRS rationale, the rating reflects Cyprus's solid fiscal performance achieved during the program, as well as its attractiveness as a business services centre and a tourist destination, its Euro Area membership, which has ensured financial support, and its favorable public debt maturity profile. However, the rating also underlines the depth of Cyprus's challenges, given its high levels of public and private sector debt, sizable nonperforming loans, external imbalances and the small size of its service-driven economy. In the DBRS view, upward rating action will depend on Cyprus' ability to sustain economic growth and primary fiscal surpluses over the medium term. In addition, a material reduction of non-performing loans and stronger progress on the privatization plan could also put further upward pressure on the rating.

Table 1
Foreign Currency Long Term Sovereign Ratings of Euro Area Periphery

	Moody's			S&P		
	Current Rating	Date of action	Outlook	Current Rating	Date of action	Outlook
Cyprus	B1	11/11/16	Positive	BB	16/9/16	Positive
Greece	Caa3	25/9/15	Stable	B-	22/1/16	Stable
Ireland	A3	15/4/16	Stable	A+	5/6/15	Stable
Spain	Baa2	21/2/14	Stable	BBB+	25/4/14	Stable
Portugal	Ba1	25/7/14	Stable	BB+	18/9/15	Stable
	Fitch			DBRS		
	Current Rating	Date of action	Outlook	Current Rating	Date of action	Outlook
Cyprus	BB-	21/10/16	Positive	B	2/12/16	Positive
Greece	CCC	18/9/15	Stable	CCC High	10/6/16	Stable
Ireland	A	5/2/16	Stable	A High	2/9/16	Stable
Spain	BBB+	25/4/14	Stable	A Low	7/10/2016	Stable
Portugal	BB+	4/6/16	Stable	BBB Low	21/10/16	Stable

Source: Rating Agencies

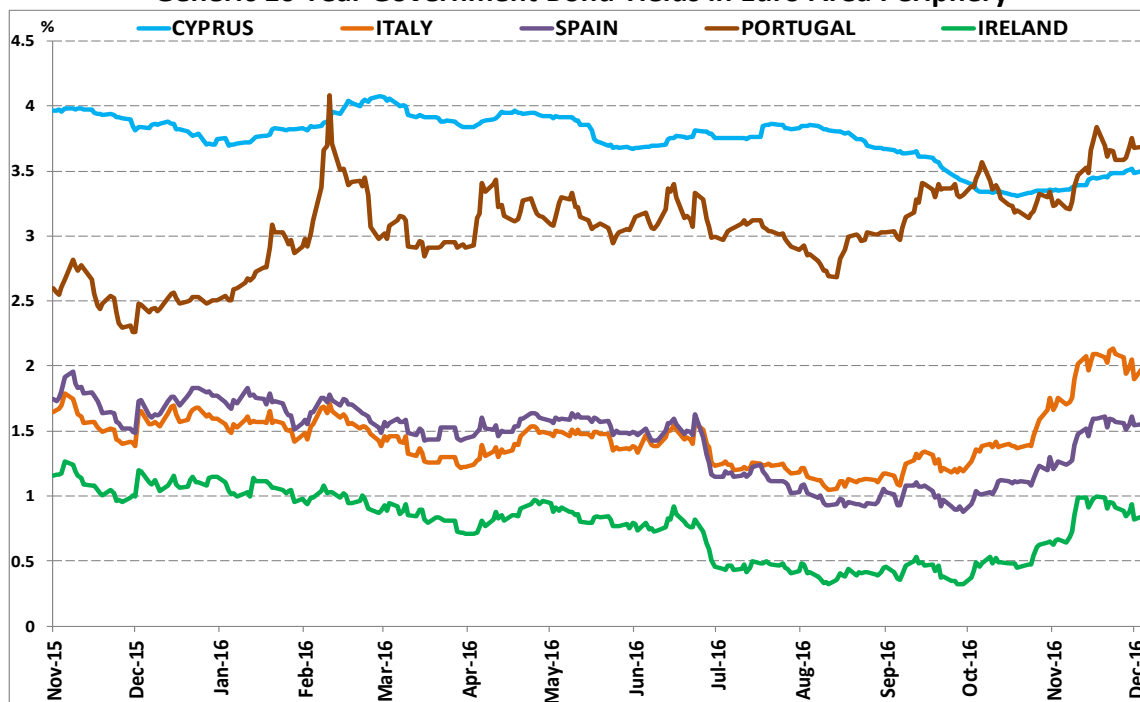
Table 2
Foreign Currency Long Term Sovereign Ratings of Cyprus

Moody's	S&P	Fitch	DBRS	Rating Description
Aaa	AAA	AAA	AAA	Prime
Aa	AA	AA	AA	High Grade
A	A	A	A	Upper Medium Grade
Baa	BBB	BBB	BBB	Lower Medium Grade
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	
Caa	CCC	CCC	CCC	
Ca	CC	CC	CC	
Ca	C	C	C	
C	D	D	D	

Source: Rating Agencies

(Upgrade within the last review is marked with green color. Affirmation is marked with grey color)

Figure 2
Generic 10 Year Government Bond Yields in Euro Area Periphery



Source: Bloomberg, Eurobank Research

Table 3
Basic Metrics FY 2016 unless otherwise noted (autumn 2016)

Initial Conditions	Cyprus	Greece	Ireland	Italy	Spain	Portugal
GDP growth (% YoY)	2.8	0.1	4.9	0.8	3.1	1.0
Primary Balance (% of GDP)	+2.0	+0.1	+1.3	+1.3	-2.0	+1.3
General Government Balance (% of GDP)	-0.5	-3.4	-0.7	-2.5	-4.5	-3.0
Gross Public Debt (% of GDP)	106.7	183.4	74.6	133.2	100.1	128.4
Current Account ¹ Balance (% of GDP)	-0.9	0.0	+9.5	+2.2	+1.9	0.0
Total Investment (% of GDP)	10.3	10.4	22.5	16.6	21.0	15.0
Doing Business 2017 Distance to Frontier ² (best = 100)	72.65	68.67	79.53	72.25	75.73	77.40
REER ³ Q2-2016 (ULC total economy, 2005=100)	93.88	85.14	75.28	100.84	93.79	87.18
REER ⁴ Q2-2016 (CPI deflated, 2005=100)	91.66	96.19	88.91	96.36	98.49	96.63
Private Sector Indebtness (% of GDP, 2015)	354.9 ⁵	126.4	323.6	120.1	173.1	195.9
NPLs (% of Total Loans, March 2016)	49%	47%	15%	17%	6%	19%

Source: Eurostat, ECB, EBA, IMF WEO, World Bank Doing Business

¹ IMF WEO latest projection for 2016, BPM6 definition.

² World Bank (Doing Business, Distance to Frontier definition): The distance to frontier score aids in assessing the absolute level of regulatory performance and how it improves over time. This measure shows the distance of each economy to the "frontier," which represents the best performance observed on each of the indicators across all economies in the *Doing Business* sample since 2005. This allows users both to see the gap between a particular economy's performance and the best performance at any point in time and to assess the absolute change in the economy's regulatory environment over time as measured by Doing Business. An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier

³ Real Effective Exchange Rate corresponds to the trade-weighted baskets of competitor countries of the IC37 = EU28 + 9 other industrial countries (Australia, Canada, United States, Japan, Norway, New Zealand, Mexico, Switzerland and Turkey)

⁴ Real Effective Exchange Rate corresponds to the trade-weighted baskets of competitor countries of the Broad group. The underlying Broad group (42) = IC37 + 5 other industrial countries (Russia, China, Brazil, South Korea and Hong Kong). For the broad group only HICP/CPI deflated REER are available.

⁵ In the case of Cyprus, the number is inflated by the cross-border lending of non-financial foreign corporates who are registered in the island for tax-planning purposes. Anecdotal evidence brings the relevant number at 90% of GDP

Despite rating agencies' aggressive upgrading, the rating of government bonds has not yet reached investment grade status. Two and three more upward notches are required by S&P and Fitch respectively, while four notches are still required by Moody's. As a result, Cyprus cannot join ECB's QE. Earlier, when Cyprus was still in a Program, an ECB waiver allowed participation in QE. The Program and the waiver no longer exist.

Overall, Cyprus has embarked on a virtuous cycle of sovereign rating upgrades. At the moment Cyprus is the only economy in the Euro Area Periphery whose outlook is positive. The positive outlook implies that rating agencies could upgrade Cyprus in the next months, provided that the government was to stay focused on structural reforms. Yet, the risk of complacency following the exit from the Adjustment Program is material. There are a few pending important structural reforms of the economic adjustment program, which would allow the Cypriot economy not to backtrack. Particularly, the approval of the bill setting a cap on the public sector wage bill, essentially linking the expenditure expansion with the GDP growth performance, is still pending. As time moves on and the economy improves, it becomes increasingly unlikely the bill will be voted.

On a cross - Euro Area periphery comparison, it is striking that Cyprus ratings seem to be lagging behind those of Portugal. This is a country with similar macro-fundamentals, yet it is ranked above Cyprus by as much as **five** notches in the latest DBRS assessment,⁶ **three** notches in the latest Moody's assessment, **two** notches in the Fitch and only **one** in that of S&P ranking. Table 3 compiles some basic headline macro indicators from different areas of economic activity for all Euro Area periphery countries. Those economies are different in size and structure but all encounter similar challenges within the constraints of Euro Area.

The deviation of Cyprus from the rest of the Euro Area periphery can be clearly spotted in the banking sector and, especially, in the very high NPLs ratio. The fiscal metrics in the case of Cyprus are in a much better shape than its peers in the Euro Area periphery. The private and public sector indebtedness-indicators (if adjusted for the debt of foreign companies registered in Cyprus) are also close to or even better than the rest of the periphery. The competitiveness metrics-both price and quality- are still not the worst (especially when compared to Italy) in the periphery and on an improving trend. From that point of view, further progress in addressing the high NPLs ratio could act as a catalyst for further sovereign upgrades.

On a cross-Euro Area periphery comparison, we also do note that the market has priced long term Cypriot bonds at par with those of Portugal since late September (Figure 2). Even though the generic ten-year government bond yields are on a rising trend in the last two months, this trend is similar in all countries. In fact, the upward trend is smaller in Cyprus.

⁶ Interestingly, DBRS rates Portugal with investment grade.

3. The European Commission confirmed the fiscal targets of 2017 in the Draft Budgetary Plan, yet warned Cypriot authorities of deviations from the desirable structural fiscal target

The draft budgetary plan (DBP) of next year⁷ – approved by the Council of Ministers on October 17th – confirmed the revision of the fiscal targets in 2017-2019, which appeared for the first time in the Strategic Framework for Fiscal Policy (SFFP) 2017-2019 issued in May 2016. This is the first DBP after the graduation of Cyprus from its economic adjustment program in March 2016. The budgetary plan targets a headline deficit of €105.7mn, which translates into a deficit of -0.6% of forecasted GDP in 2017. This is a slightly higher deficit than the projected deficit of €52.5mn or -0.3% of projected GDP in 2016. Subsequently, the headline deficit is forecasted to decline to -0.1% of GDP in 2018 and turn into a surplus of +0.7% of GDP in 2019.

Let us now examine the mechanics of fiscal relaxation more thoroughly, 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, with those in the DBP of 2017.⁸ As far as the fiscal target of 2017 is concerned, the fiscal relaxation is balanced between revenues and expenditures. Total revenues appear to be lower by -0.6% of GDP (from 38.7% of GDP in SFFP 2016-2018 to 38.1% in the DBP2017). Total expenditures appear to be higher by 0.6% of GDP (from 38.1% of GDP in SFFP 2016-2018 to 38.7% in the DBP2017). The combined effect of those two cumulates into a relaxation of the primary surplus target of 2017 by approximately 1% of GDP. Instead of a primary surplus of 3% of GDP initially in the (SFFP) 2016-2018, it is now expected only at 2% of GDP in the DBP2017. The overall result for FY2017 is for the general government balance to switch from a forecasted surplus of +0.6% of GDP in the SFFP2016-18 to a forecasted deficit of -0.6% of GDP in the DBP2017.

According to the DBP2017, **the target for total revenues expansion has been set at +1.8% YoY**, less than the projected nominal GDP growth. The budget is built upon the government official forecast of 2.8% for GDP growth in 2017. In addition, the nominal

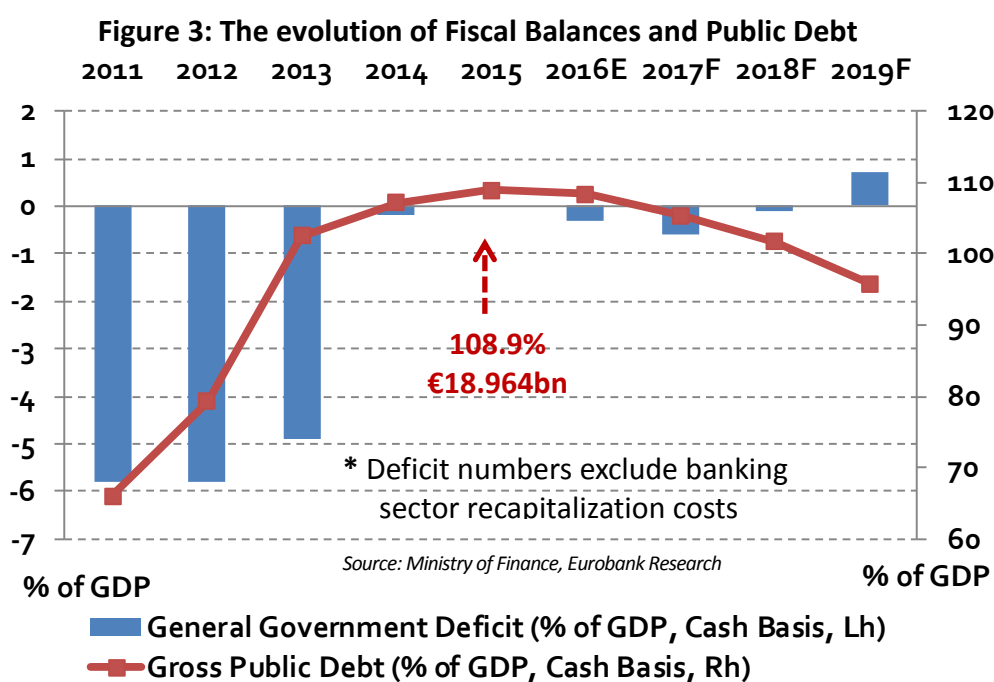
⁷ Cyprus submitted its Draft Budgetary Plan (DBP) for 2017 on 17 October 2016 in compliance with Regulation (EU) 473/2013 of the Two-Pack. Cyprus is subject to the preventive arm of the Pact and should preserve a sound fiscal position, which ensures compliance with the medium term budgetary objective (MTO). As the debt ratio was 107.5% of GDP in 2015, exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit, Cyprus is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark. During this period it should ensure sufficient progress towards compliance
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/2016-10-17_cy_dbp_en.pdf

⁸ In our previous Quarterly issue we did the comparison between the SFFP 2016-2018 and SFFP 2017-2019. For a more detailed analysis on the individual budget items please see the Fiscal Council spring report: [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).

growth rate is expected to reach 3.3% under the assumption that the consumer prices will average +0.5% in 2017, up from a projected -0.9% in 2016. As a result, total revenues are expected to reach 38.1% of forecasted GDP in 2017, down from a projected realization of 38.7% of GDP in 2016. Taxes on production and imports are foreseen to expand by +1.7% YoY, whereas current taxes on income and wealth are expected to remain broadly unchanged. The budget framework foresees the abolishment of the special contribution levied on wages of the private and public sector, the abolishment of the immovable property tax, 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.

On the other hand, **total government expenditure is expected to rise by 2.5% YoY 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. As a result, total expenditures are expected to reach 38.7% of forecasted GDP in 2017, down from a projected realization of 39.0% of GDP in 2016.

Cyprus has performed an impressive fiscal adjustment in 2013-2014, which 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).⁹



⁹ 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 faster fiscal consolidation than expected in the MoU during 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 3 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 96% in 2019 and 90% at the end of 2020. This is a drop of 19 ppts 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 goes down to a projected surplus of 2.2% in 2016, 2.0% in 2017, **and then recovers to 2.5% in 2018 and even increases to 3.4% 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.

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? As we mentioned above, Figure 3 (red line) provides a positive answer. With the new looser fiscal targets, the debt-to-GDP ratio is forecasted to decline to 96% in 2019 and 90% by the end of 2020.¹⁰

EU Commission and the fiscal stance: In a letter dated October 25th, the EU Commission expressed its concern over a significant relaxation of the fiscal stance for next year.¹¹ More specifically, the EU Commission stated that the Draft Budgetary Plan (DBP) of Cyprus for 2017 deviates from the medium-term objective (MTO) of a balanced budget in structural terms. According to the EU Commission's calculations^{12 13}, the recalculated structural

¹⁰ Calculations don't include any proceeds from the privatizations projects or the exploration of natural gas.

¹¹ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/dbp_2017-17-18_letter_to_cyprus-final.pdf

¹² In the Table 2 (page 7) of the EU Commission Staff working document (SWD2016 502 final) dated 16.11.2016, which contains the analysis of the draft budgetary plans of Cyprus, accompanying the EU Commission Opinion, the relevant numbers of the structural position are +1.7 of GDP in 2015, +0.2% of GDP in 2016 and -1.3% of GDP in 2017
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/cy_2016-11-16_swd_en.pdf

¹³ The Eurogroup (of 05.12.2016) endorsed the EU Commission assessment and issued the following statement in the case of Cyprus: We agree with the Commission's assessment that the budget is at risk of non-compliance with the requirements of the SGP. We note that according to the latest Commission assessment, Cyprus's structural fiscal effort in 2017 will be -1.4% of GDP, whereas Cyprus is required to remain at the MTO of a structural balance of 0.0% of GDP. Following that assessment, significant additional measures would be needed. We welcome the commitments of Cyprus, in such circumstances, to implement the measures necessary to ensure that the 2017 budget will be compliant with the rules of the preventive arm of the SGP.

position is expected to deteriorate from a surplus of 1.5% of GDP in 2015 to a deficit of -0.1% of GDP in 2016 and to a bigger deficit of -2.0% of GDP in 2017.

The structural position is an estimated magnitude, which is cleaned from the influence of the business cycle on the revenues and expenditures. A fast growing economy can achieve a fiscal surplus a lot easier than a stagnating economy. This differential influence on the budget is eliminated when examining the structural budget. In the calculations of the structural budget, instead of using actual GDP to generate forecasts of revenues and expenditures, the level of potential GDP is used, which is clean of cyclical fluctuations. Clearly, the calculation of the structural budget becomes sensitive to the assumption of the level of potential GDP, or the so called output gap, that is, the difference of actual from potential GDP.

The MoF submitted a Draft Budgetary Plan (DBP) based on the estimations of potential GDP of the EU Commission Spring forecasts. Based on the EU Commission estimates of potential output of spring 2016 for Cyprus, the DBP puts the structural deficit target for 2017 at -1% of GDP vs. a projected surplus of +0.4% of GDP in 2016. The corresponding forecasts for 2018-2019 were -0.4% of GDP and +0.5% of GDP respectively. Thus the MoF had already admitted early on, in October, that it will not manage to deliver a structural deficit of zero. This admission seems to have generated the EU Commission's response.

According to the DBP, MoF targets a headline fiscal deficit of -0.6% of GDP in 2017 vs. a projected -0.3% in 2016. **The EU Commission is more optimistic on the headline number of the deficit in the most recent Autumn Forecasts.** According to the latter, the headline deficit is expected to outperform the MoF forecast by 0.2 ppts and inch up to -0.4% of GDP in 2017, driven by lower forecasts compared to the DBP of revenues and expenditures. Revenues are expected to be lower by -0.4 ppts of GDP than in the DBP but also expenditures would be lower by -0.6 ppts of GDP.

More importantly, in its response to the EU Commission on October 27th, the MoF rebuts the Spring 2016 forecasts calculations of the output gap.¹⁴ In the MoF view, the **discussion is theoretical** and the output gap estimates cannot be considered as acceptable. The use of a common methodology across the Euro Area on the calculation of output gap, indicates the presence of a positive output gap of +0.9% of potential output in Cyprus. Yet, this result is counter intuitive and is driven mainly by a very conservative (too high) estimate of NAWRU¹⁵, which is projected at 12.8% in 2017, whereas the actual unemployment rate has already declined to 12.5% and will further decline to 11.0% in 2017. Thus the EU Commission

http://www.consilium.europa.eu/en/meetings/eurogroup/2016/12/20161205-Draft-EG-statement-DBPs-EG-final_pdf/

¹⁴ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/dbp_2017_reply_cyprus.pdf

¹⁵ NAWRU stands for "Non-accelerating wage rate of unemployment."

calculations imply that the economy is overheating,¹⁶ something which cannot be economically justified by the fundamentals exhibited in the labor market and the capacity of the economy at large. According to the new MoF estimates of the structural balance, which are based on their own NAWRU-anchored methodology, Cyprus is running a structural surplus of 1% of potential output in 2016, and is expected to run a structural deficit of only -0.2% of potential GDP in 2017, something which obeys the Stability & Growth Pact (SGP) rules.

¹⁶ An economy is in a condition of overheating when aggregate demand is increasing at a faster pace than the productive capacity of the economy.

4. Interpreting the latest Cypriot Economic News (September-November 2016)

The real economy continues to surprise positively

Economic Sentiment Index (ESI Index)

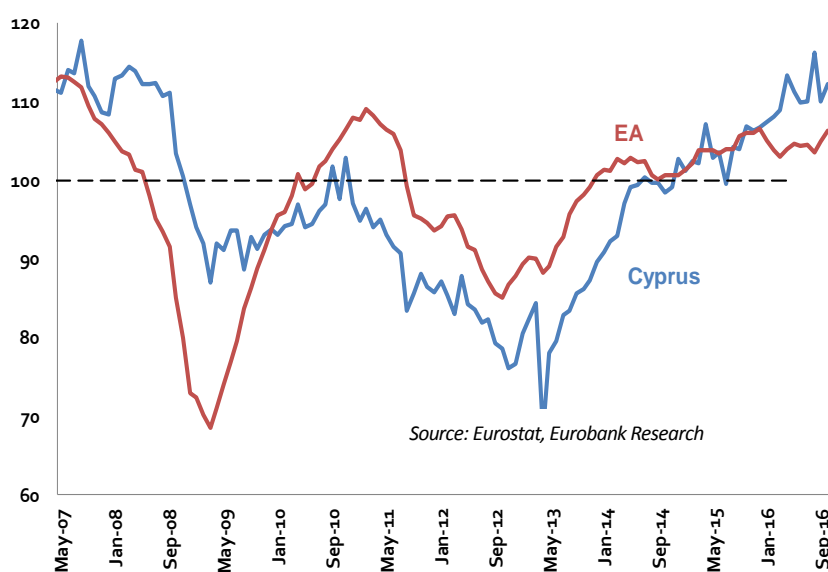
Confidence on an upward trend in early Q4-2016, close to its pre-Lehman peak

The ESI Index increased by 2.2 points to 112.3 in October, compared to 110.1 in September vs. a multi-month peak of 116.2 in August. The more pronounced improvement in expectations came from retail trade (3.8 points), consumer sentiment (by 3.2 points) and services (by 1.5 points). On the other hand, industry edged down by 0.1 points and construction declined by 2.3 points respectively.

The ESI Index stands above its long-term average. Despite the small decline vs. the August reading, the ESI index still stands close to its post-Lehman peak, which was recorded in last August. The improvement recorded in the past three years – a total of 44.4 points since April 2013- is the highest in EU-28 over the same period. 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 the short-term economic activity prospects.

The sentiment improvement is illustrative of the progress of the Cypriot economy in the past three years within the economic adjustment program. This progress is evident 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.

Figure 4: Index of Economic Sentiment

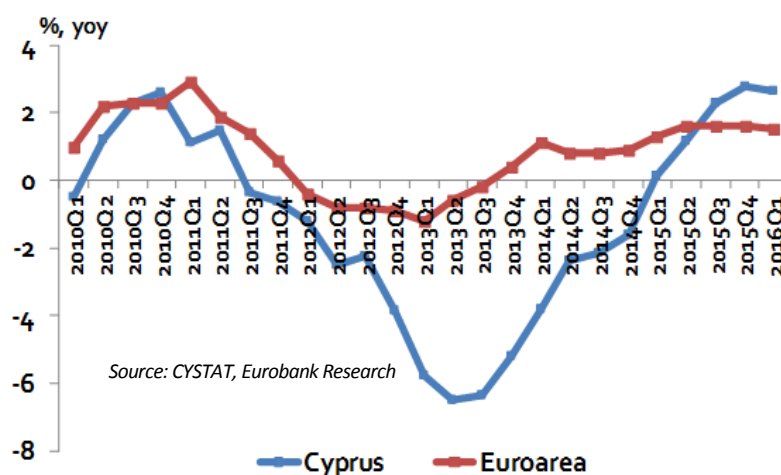


Q2-2016 GDP growth (Second estimate)

The Q2 GDP growth reading confirmed the economy is on a fast growth recovery track

The second estimate of CYPSTAT on the seasonally adjusted Q2 GDP reading matched the flash estimate of +0.7% QoQ/+2.7% YoY. The strong reading, the sixth consecutive positive one on both a quarterly and an annual basis, compares to +1.0% QoQ/+2.7% YoY in Q1-2016 vs. +0.8% QoQ/+1.2% YoY in Q2-2015. Final consumption expanded by +0.8% QoQ/+1.9% YoY in Q2-2016, up from +0.1% QoQ/+1.4% YoY in Q1-2016 vs. +0.3% QoQ/+1.0% YoY in Q2-2015, making a +1.6ppts contribution to growth. The consumption rebound is driven by the strong sentiment improvement mirroring the lasting progress within the economic adjustment program, a flourishing tourism sector (+19.8% YoY in tourist arrivals in 7M- 2016 and +13.8% YoY in tourism revenues in 1H-2016), lower energy prices on an annual basis, lower unemployment (11.6% in July 2016 vs. 15% a year ago, the highest decline in EU-28 in the past twelve months), agents' expectations of further fiscal relaxation and a rise in real incomes. Moreover, investments skyrocketed by 104.7% YoY in Q2-2016, driven entirely by transportation equipment purchases, which most probably could be attributed to ship imports. As a result, the hefty contribution of investments was largely offset by the negative contribution of net exports (imports: +18.9% YoY vs. exports: - 3.3%YoY), so that both components added another 1.1ppts.

Figure 5: GDP growth

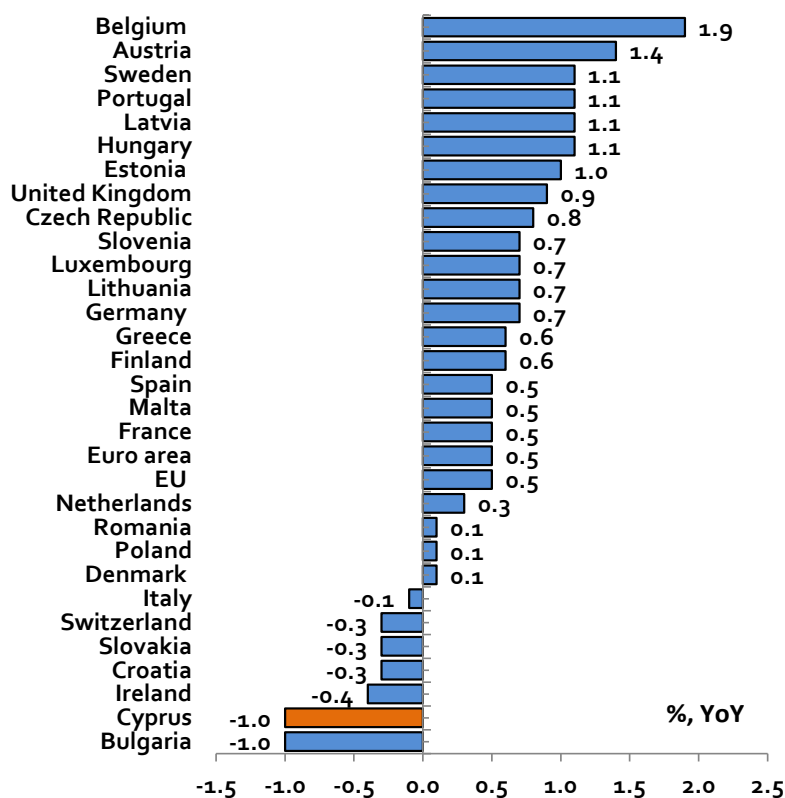


Consumer prices (HICP)

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

Consumer prices, measured by HICP, remained in negative territory in October. HICP dipped again to -0.9% MoM/-1.0% YoY in October, down from -0.4% MoM/-0.4% YoY in September vs. a twelve-month low at -0.6% MoM/-2.2% YoY in last February and -0.2% MoM/-1.8% YoY in October 2015. The biggest declines on an annual basis were observed in the categories of transportation (+0.2% MoM/-5.2% YoY) and utilities (+0.6% MoM/-2.7% YoY), which reflect the pass through of lower energy prices. In addition, the volatile component of food and non-alcohol prices contracted by -2.9% MoM /-1.6% YoY in October. On the other hand, the clothing and footwear component was that category with the highest monthly increase during October (+7.0% MoM/-2.1% YoY). As a result, the average annual HICP came at -1.4% YoY in the January-October 2016, down from -1.4% YoY in 2015 and -0.7% YoY in 2014.

Figure 6: HICP in EU-28 countries in June-2016



Source: Eurostat, Eurobank Research

Deposits & Loans

Deposit growth was positive on an annual basis for a twelfth consecutive month in September

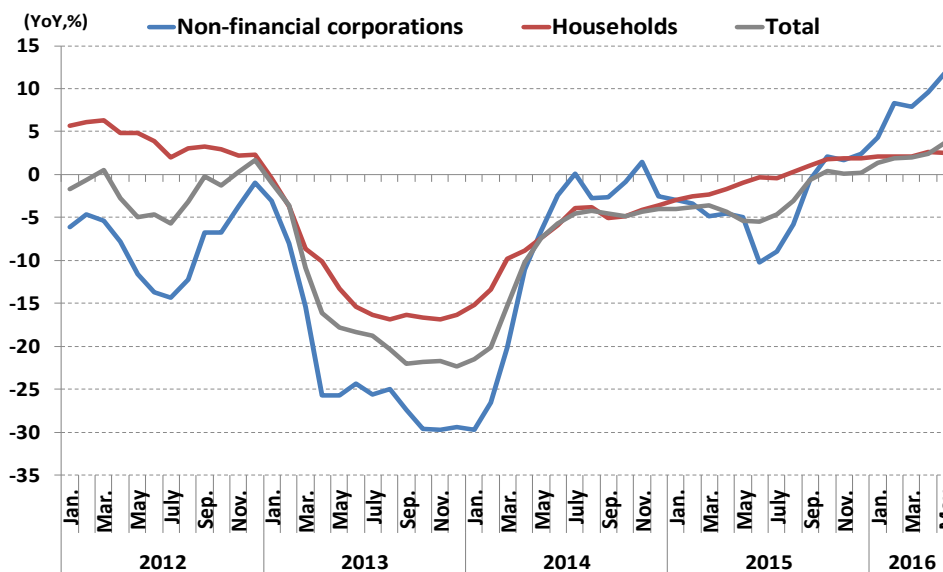
The Central Bank of Cyprus published on October 27th the Monetary and Financial Statistics (MFS) of September.¹⁷ From a flow point of view, total deposits recorded a net increase of €131.3 mn in September 2016, compared with a net increase of €872.7mn in August 2016. The annual rate of expansion- the twelfth positive consecutive in a row - came at 5.5% YoY in September compared to 6.4% YoY in August and 3.7% YoY in May vs. only +0.2% YoY in December 2015. The outstanding amount of total deposits reached €47.7bn in September, up from €45.89 bn in May 2016 and from €45.97bn in December 2015.¹⁸

Total loans in September 2016 exhibited a net decrease of €316.1 mn, as a result of loan repayments, compared with a net increase of €476.2 million in August 2016. The annual growth rate stood at -11.0% YoY in September and -10.8% YoY in May 2016 vs. only -3.4% YoY in December 2015. 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 €53.9bn in September, down from €54.5bn in August, down from €55.34bn in May and down from €62.7 bn in December 2015.

¹⁷ http://www.centralbank.gov.cy/media/xls_gr/2ndMFSOctober2016gr.xls

¹⁸ The Central Bank is using ECB methodology to calculate the annual growth with a special formula taking into account the monthly transactions

Figure 7: Annual growth of deposits



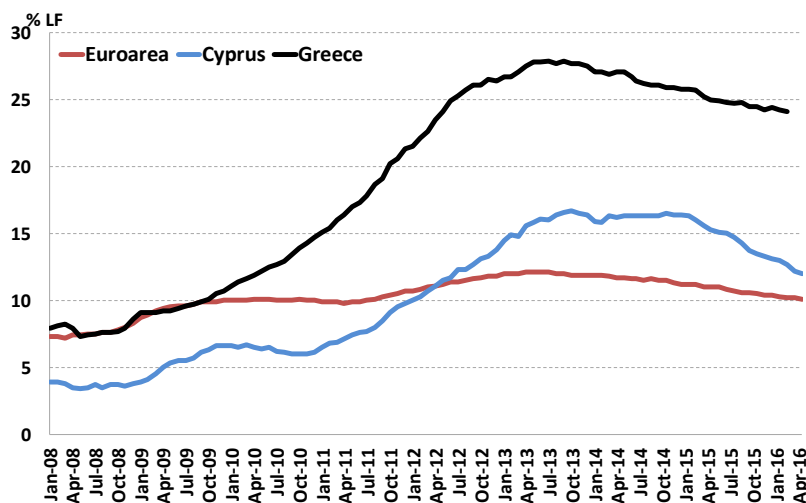
Source: Central Bank of Cyprus, Eurobank Research

Unemployment

Unemployment continues its downward trend

According to the latest Labor Force Survey (LFS), unemployment came down to 12.0% in September 2016 on a seasonally adjusted basis, down from 12.1% in August 2016, compared to 14.3% in September 2015 and 17% at its peak in October 2013. Cyprus recorded the highest unemployment decline in the Euro Area (the second highest EU-28 after Croatia) in the past twelve months. The decline keeps being faster than in the Euro Area or Greece (See Figure 8). Yet, despite the improving 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 8: Unemployment rate



Source: Eurostat, Eurobank Research

Jan-Sep 2016 Budget execution (cash basis)

The budget was in surplus during the first 9 months

In the near term, the budget switched to a surplus in 9M-2016. The consolidated government surplus came at €72.3mn in 9M-2016, up from a deficit of €31.2mn in 1H-2015. As a percentage of GDP, the consolidated government surplus came at +0.8% in 9M-2016, switching from a beginning deficit of -0.2% in Q1-2016, and compared to a surplus of +0.6% of GDP in 9M-2015. The primary surplus stood at +2.9% of GDP in 9M-2016 almost unchanged from the level during the same period a year ago. Total revenues improved by +2.1% YoY, driven by higher indirect tax and social contributions. On the other hand, total expenditure inched up by +0.4% YoY driven by higher subsidies and spending on pensions. Nevertheless, key spending items such public wages and current transfers remained well contained.

Table 4: General Government Budget Execution

General Government Adjusted Budget Balance on cash basis (January-September 2016)		
in % GDP	January-September 2015	January-September 2016
<u>I. Government Budget and SSF</u>		
Total Revenue	26.40%	26.50%
Current revenue	26.10%	26.31%
Direct Taxes	8.26%	8.33%
Indirect Taxes	10.38%	10.52%
of which, VAT	6.14%	6.20%
Social security contributions	4.11%	4.24%
Non-tax revenue	3.36%	3.22%
Capital Revenue	0.00%	0.00%
Grants	0.29%	0.19%
Total Expenditure	26.44%	26.10%
Current expenditure	25.70%	25.23%
Wages and Salaries	6.65%	6.59%
Goods and services	1.51%	1.45%
Subsidies	0.33%	0.47%
Social Security payments	6.12%	6.19%
Pensions	2.42%	2.22%
Social Pensions	0.27%	0.27%
Current transfers	5.91%	5.70%
Non-allocated	0.23%	0.11%
Interest payments	2.25%	2.24%
Capital expenditure	0.74%	0.87%
Balance (I)	-0.04%	0.40%
<u>II. Other General Government Bodies</u>		
including		
Local Authorities	0.01%	-0.01%
Semi-public Entities	0.10%	0.06%
Other Entities	0.05%	0.01%
Balance (II)	0.10%	0.08%
<u>III. ESA 2010 adjustments</u>		
Balance (III)	0.51%	0.31%
<u>III. General Government Balance</u>		
Budget Balance (I+II+III)	0.57%	0.80%
Primary Balance (excl. interest)	2.84%	2.92%
Cyprus GDP (Mrd EURO-CYP)	17,640.0	17,940.0

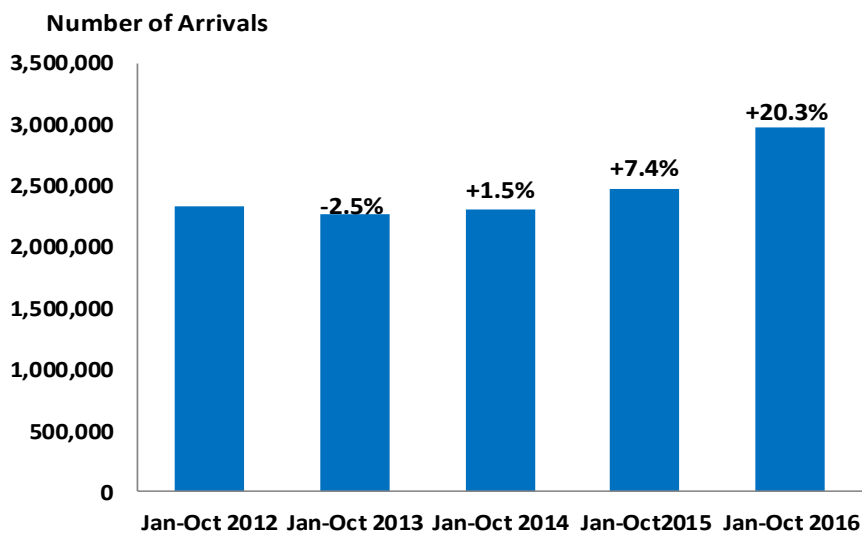
Source: Ministry of Finance, Eurobank Research

Tourism arrivals & revenues (January-October 2016 & January-September 2016)

Sharp increase in tourism arrivals & revenues

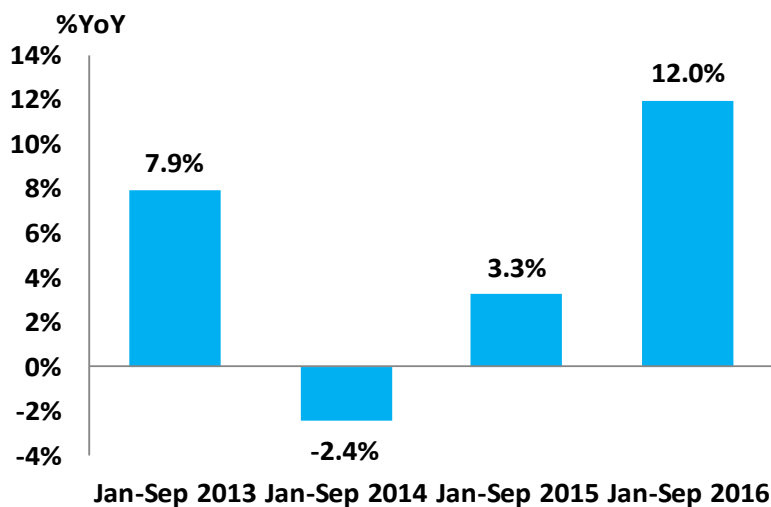
The positive momentum in the tourism sector continued in the 10M-2016. Tourist arrivals increased by +20.3% YoY in Jan-Oct2016 (2,974,412 vs. 2,472,963, see Figure 9a). A sharp increase of + 50.7%YoY, +48.0% YoY, +26.4% YoY and + 37.9% YoY was recorded in tourist arrivals from Russia, Israel, Ukraine and Lebanon in the same period. Tourist arrivals from traditional markets such as Germany (+6.7% YoY) and UK (+16.1% YoY) fared also relatively well. In addition, tourism revenues expanded robustly by +12.0% YoY in January-September 2016 to €1,626mn, up from €1,431mn compared to the same period last year. This expansion is much larger than a year earlier (Figure 9b).

Figure 9a: Tourism Arrivals



Source: CYSTAT, Eurobank Research

Figure 9b: Tourism Revenues



Source: CYSTAT, Eurobank Research

Residential Property Price Index (RPPI)- Q2-2016

The RPPI Index stabilized further in Q2-2016

The Central Bank of Cyprus published in mid-November the residential property price index (RPPI) for Q2-2016. On a quarterly basis, the RPPI declined by -0.5% in Q2-2016, which is less than -0.8% in Q1-2016, reflecting the combined effect of a negligible decline in the flat apartments by -0.2% and by -0.6% for house prices. On an annual basis, the RPPI declined by a further -1.7% YoY in Q2-2016, almost unchanged compared to -1.6% YoY in Q1-2016, and smaller in absolute terms than -1.8% YoY in Q4-2015, -3.7% YoY in Q3-2015 and -5.0% YoY in Q2-2015.

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 a gradual stabilization of the real estate sector. According to CYSTAT, the construction output index rose by 10.9% YoY in Q2-2016, up from 4.6% YoY in the first three months of the year, yet still remaining 53.4% below the 2010 average.

Non-Performing Exposures (NPEs)- Data as of August 2016

The volume of NPEs declines but the ratio to total loans rises

According to the Central Bank of Cyprus, the stock of non-performing exposures (NPEs) declined by only €145mn in July-August on top of the €1bn decrease in Q2-2016, bringing the stock of NPEs down by 10.2% from December 2014 to August 2016. The decline in NPEs reflects three main factors: (i) increased repayments, (ii) the migration of successful restructurings to performing facilities after the completion of the one year observance period, plus (iii) write-offs and settlements through immovable property exchange.

The decrease in the volume of NPEs is not visible in the ratio statistics as total loans decreased by a much larger amount, €3.2 billion during the same period. The net effect was an increase in the ratio of NPEs to total loans, from 47.8% in December 2014 to 48.4% in March 2016 and further up to 49.0% in June 2016.

Recall that based on the EBA conservative definition, a restructured loan is still classified as an NPE for a probation period of at least 12 months, even if it is serviced without incurring new arrears. As a result, a very large fraction of the restructured loans are still classified as NPEs (€10.3bn out of €13.7bn in August 2016). In any case, the NPE ratio remains extremely high, the highest in the Euro Area. From that point of view, the Central Bank of Cyprus noted that there is a long road towards the eventual resolution of NPEs.

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