

MACROECONOMIC MONITOR OF CYPRUS

Updated on 14 October 2014

- In the 2nd quarter of 2014, GDP (in seasonally adjusted terms) contracted by -2.5% compared with -3.9% in the 1st quarter of 2014 on an annual basis (see graphs 1.1-1.2). The contraction was mainly due to the continued subdued performance of the secondary sector (construction, manufacturing) and the financial sector while positive growth rates were recorded in the sectors of tourism and trade. From the expenditure side, the contraction was more pronounced in investments of construction, while net exports made a positive contribution (see graphs 3.1-3.4 and 6.1-6.2).
- The business operating environment remains constraint, given that lending to non-financial corporations is subdued and interest rates are still relative to economic conditions high. We maintain our view that growth in 2014 will remain negative, not exceeding 3% compared to a forecast of 4.2% contraction of the 5th review, and we assume a rebound in 2015 with a gradual restoration of lending at affordable rates.
- Developments are currently driven by lower domestic demand (see graphs 2.1-2.4) that compares favourably to the anticipated lower levels expected originally.
- The economic sentiment indicator by CypERC increased by 0.2 points in September 2014 compared to August 2014, but still remains in the negative territory (see graph 1.3). This increase is due to the improvement of the climate in services and retail trade.
- Exports of goods decreased by 6.3% in January-August 2014 compared to the corresponding period in 2013.
- In January-August 2014 tourist arrivals increased by 5.9% compared to the corresponding period in 2013 (see graph 6.3). An increase of 1.3% was recorded in arrivals from the United Kingdom, a 6.5% decrease in arrivals from Greece and a 16.9% increase in arrivals from Russia.
- Employment is showing an adjustment to the conditions of lower economic growth (see graphs 4.1 and 4.4). Employment in persons decreased by 2.4% in the 1st half of 2014 compared to the 1st half of 2013. The decrease was more pronounced in the construction sector, activities of households as employers, financial and insurance activities as well as public administration and defence.
- Labour market developments exhibit considerable flexibility adjusting to the new environment. This led to an increase in profitability of businesses and at the same time this allowed businesses to provide goods and services at reduced prices.
- Labour Force Survey (LFS) unemployment, in monthly seasonally adjusted figures, decreased from 16.6% in August 2013 to 15.4% in August 2014 (see graphs 4.2-4.3). The most affected segment of the population is youth. Particularly worrying is also the rapid increase in long-term unemployed. The level of unemployment is expected to be about 16% in 2014 compared to a forecast of 17.6% of the 5th review.
- Compensation per employee in the 1st half of 2014 declined by about 5.1% compared to the 1st half of 2013, contributing to a decline of nominal unit labour cost and improving cost competitiveness further (see graphs 5.3-5.5). The observed

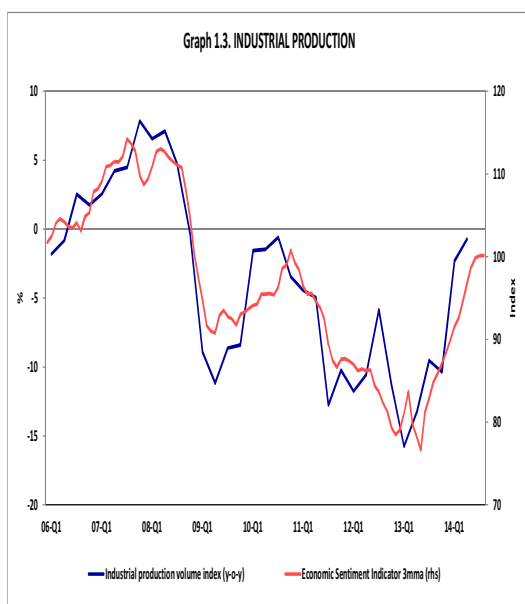
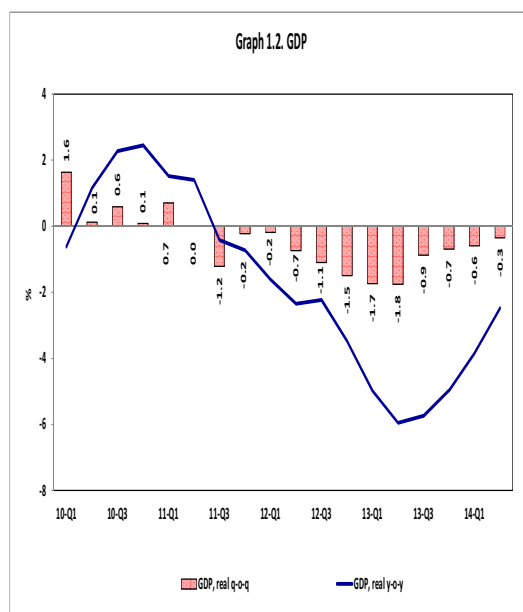
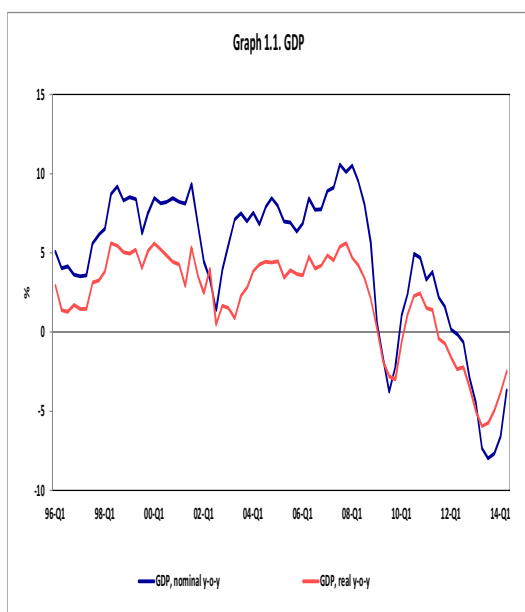
wage adjustment is expected to help containing the upward pressure on unemployment.

- Inflation (HICP) stood at 0% in September 2014 compared to 0.8% in August 2014 and for 2014 so far it stands at -0.3% (see graph 5.1). Core HICP inflation stands at 0.3% in January-September 2014 (see graph 5.2). All subcategories of HICP presented a decrease except for alcoholic beverages and tobacco, clothing and footwear, transport, communication and restaurants and hotels which presented an increase.
- The current account balance in the 1st quarter of 2014 recorded a deficit of €599.3 mn compared with a deficit of €497.2 mn in the 1st quarter of 2013 (see graph 6.4). This development was mainly due to the deterioration in the balance of business and financial services.
- The income account recorded a deficit of €195.4 mn in the 1st quarter of 2014 compared with a deficit of €189.0 mn in the 1st quarter of 2013 (see graph 6.4).
- The international investment position of Cyprus (see graph 6.5) recorded a slight deterioration in March 2014 reaching -€14,361 mn compared with -€14,138 mn in December 2013.
- Developments in public finances continue to exceed expectations.
- General government budget balance (GGBB) was in surplus during the first eight months of 2014, of the order of €126 mn (0.8% of GDP) compared to a deficit of €263 mn (1.7% of GDP) during the same period of the previous year.
- General government primary balance (GGPB) was in surplus during the first eight months of 2014, of the order of €457 mn (2.9% of GDP) compared to a surplus of €135 mn (0.8% of GDP) during the same period of the previous year.
- Total revenue exhibited a positive rate of growth of about 6.7%, reaching €4,449 mn during the first eight months of 2014, compared to €4,170 mn during the same period of the year before.
- Total expenditure exhibited a negative rate of growth of about 2.5%, reaching €4,323 mn during the first eight months of 2014, compared to €4,433 mn during the same period of the year before.
- In accordance with the macroeconomic scenario agreed during the 5th review, the budget balance is estimated to exhibit an improvement with the deficit falling to 4.7% of GDP in 2014 compared to a deficit of 5.4% the year before.
- Monetary Financial Institutions (MFI) loans to domestic residents (private sector), declined with an annual rate of 2% in August 2014, affecting both households and enterprises (see graphs 8.2-8.4). This is reflecting low demand and tight lending conditions (see graphs 8.7-8.8).
- Deposits of domestic residents held with MFIs (private sector) exhibited a contraction presenting an annual decline of 2.9% in August 2014 vis-à-vis August 2013, reflecting the negative climate in confidence (see graph 8.1). From March 2014, a deceleration in the contraction of deposits was observed.
- Overall lending and deposit interest rates in Cyprus have declined compared to last year levels and the levels prevailing during the period prior to the bail-in. However, the decline in deposit rates is much bigger than the decline in lending rates (see graph 8.5). In August 2014, deposit interest rates for maturity up to 1 year and up to 3 months have decreased compared with the previous month. The lending interest

rates to households for house purchase decreased while the rate for other loans up to €1 mn for businesses increased. The rate for bank overdrafts to non-financial corporations decreased. A significant deviation of the Cypriot interest rates, compared to the euro area average is still observed.

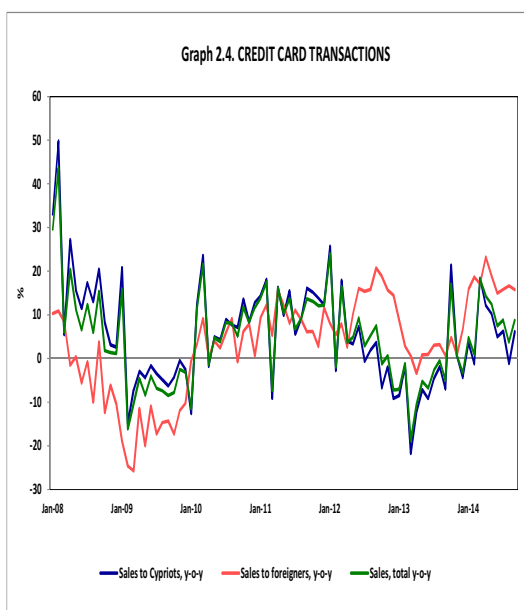
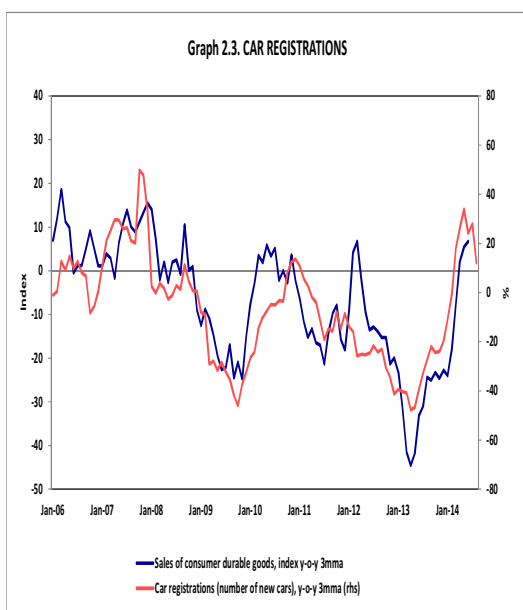
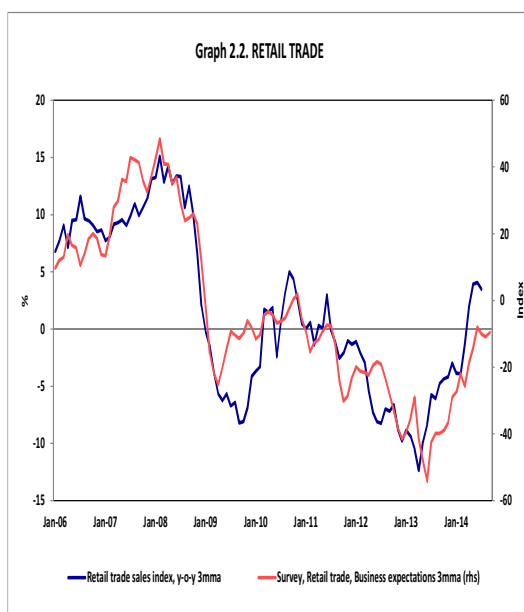
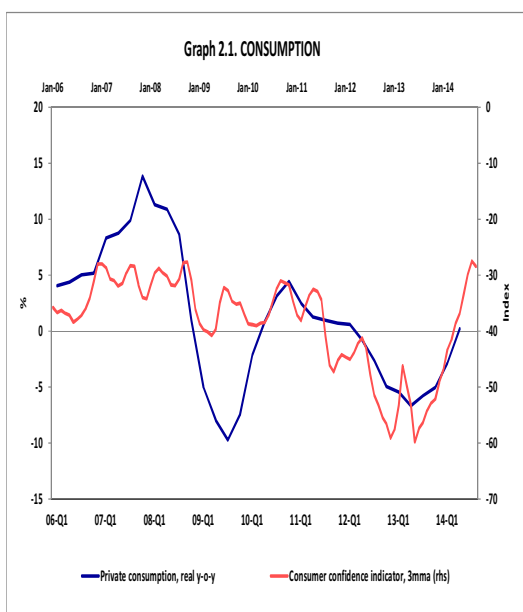
- The CBC's residential property price index declined by 9.1% in the 2nd quarter of 2014 compared to the 2nd quarter of 2013. Cumulative from the 1st quarter of 2008 it has declined by around 25.6% (see graph 7.1), revealing a modest adjustment to the conditions of lower domestic and foreign demand.
- According to the Department of Lands and Surveys, new sale contracts were up by 24% while, transfers of property were up by 17.4% in January-September 2014 compared to the corresponding period in 2013 (see graph 7.3). MFI loans to domestic residents for housing declined with an annual rate of 3.4% in August 2014 (see graph 7.2).
- The Cyprus Government bond spread compared to the German Government bond, increased in mid-October 2014 compared to September 2014 to around 508 basis points above the German bond on 14/10/2014 from around 490 basis points above on 30/09/2014 (see graph 8.6, yields refer to the bonds maturing in 2020).
- The Republic of Cyprus issued a EUR 750 million benchmark bond due 25 June 2019. The transaction pays an annual coupon of 4.750% and was priced at a yield of 4.850% implying a spread of 414.1bps over the mid-swap reference. Joint bookrunners were Deutsche Bank, Goldman Sachs International, HSBC, UBS and VTB Capital.
- By geography, the Republic of Cyprus has achieved a broad distribution dominated by international investors, across Europe, the UK, and other international investors. By investor type, the quality of the orderbook was very high with very strong granularity. Real-money demand dominated the orderbook, at around two thirds, with Fund Managers the largest investor class at 51%, and well supported by Hedge Funds and Bank interest.

1. OUTPUT



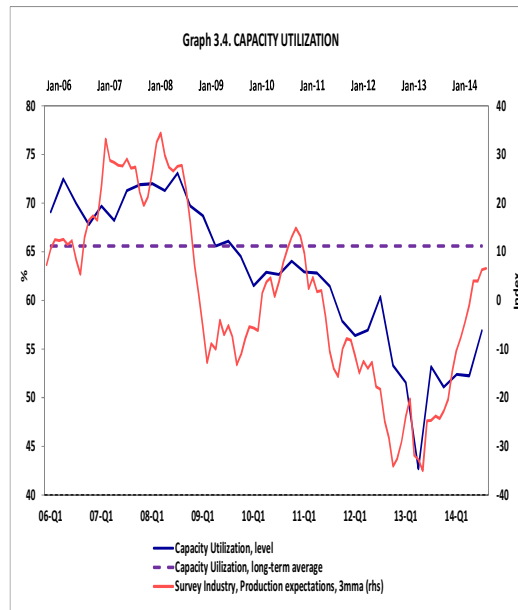
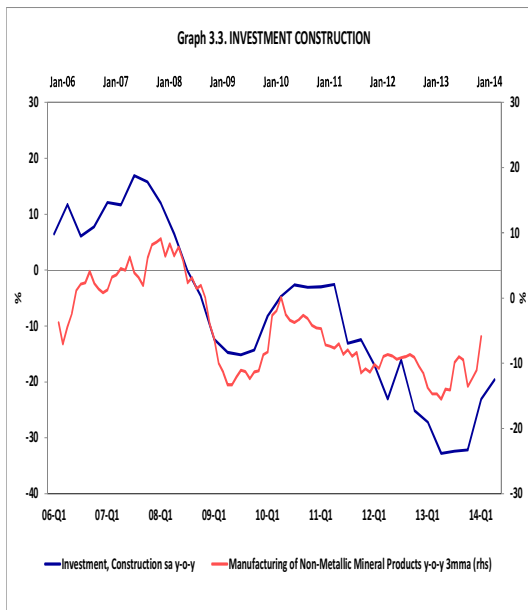
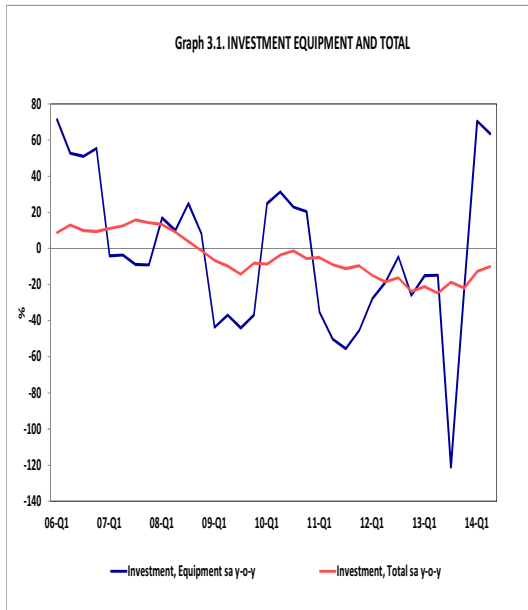
Sources: Eurostat, DG ECFIN, Cystat

2. CONSUMPTION



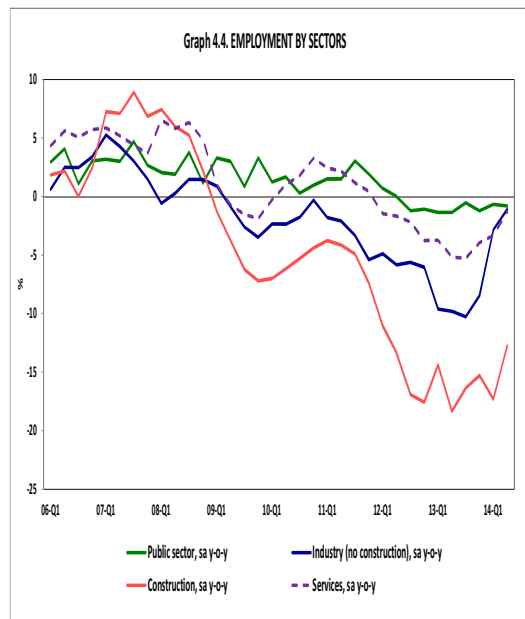
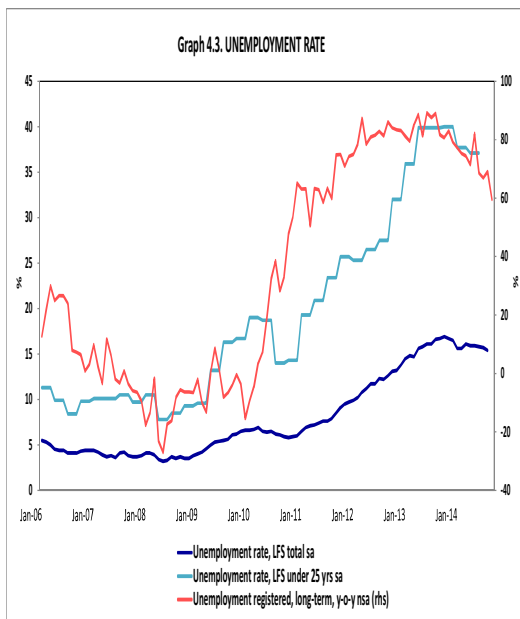
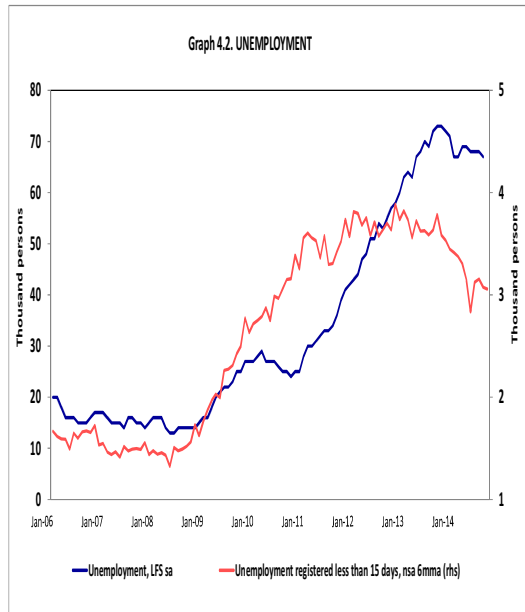
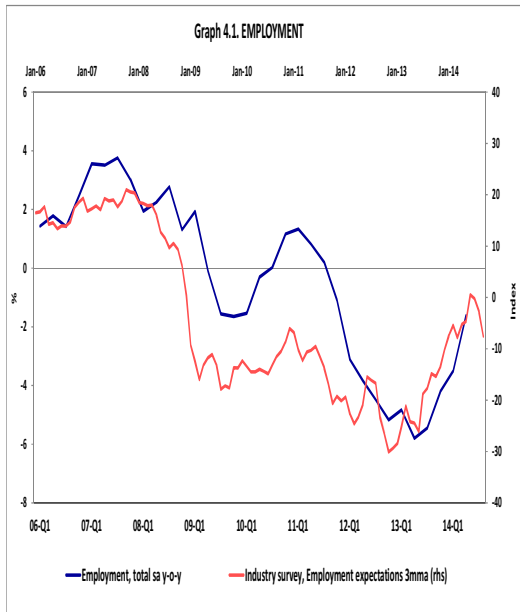
Sources: Eurostat, DG ECFIN, Cystat, JCC Payment Systems Ltd

3. INVESTMENT



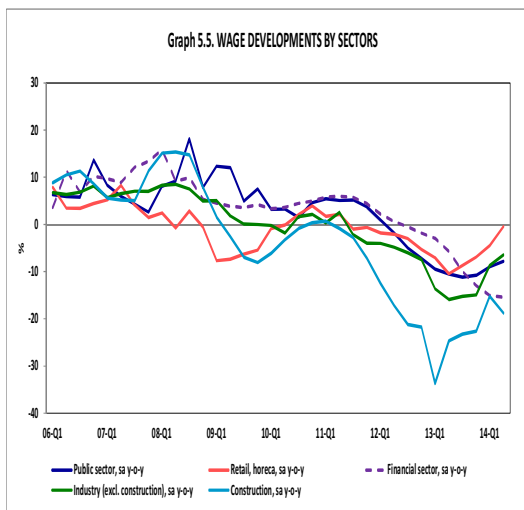
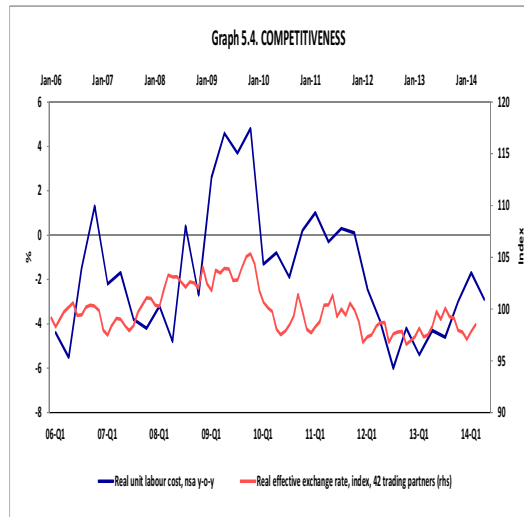
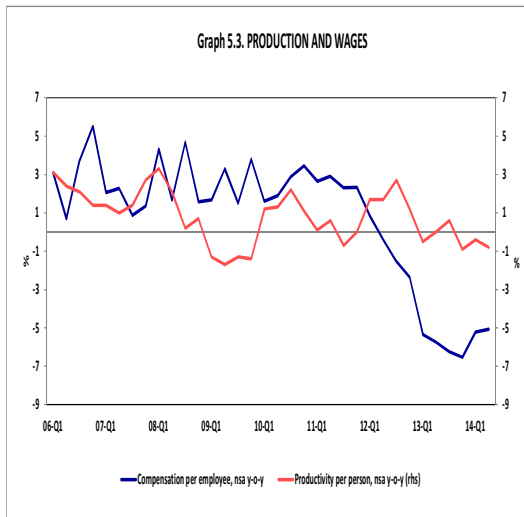
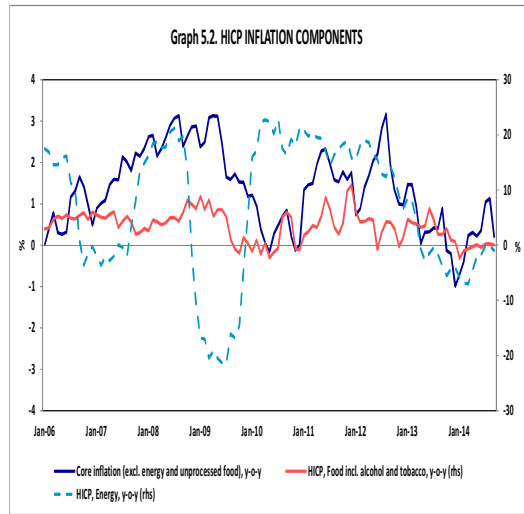
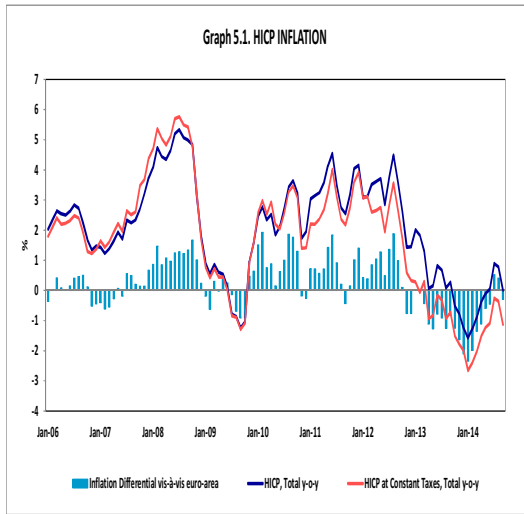
Sources: Eurostat, DG ECFIN, Cystat

4. LABOUR MARKET



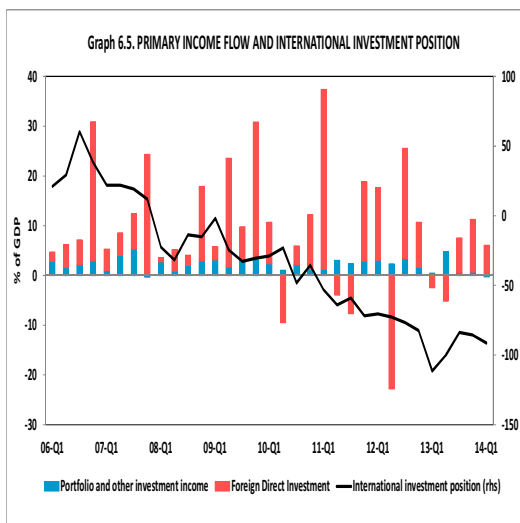
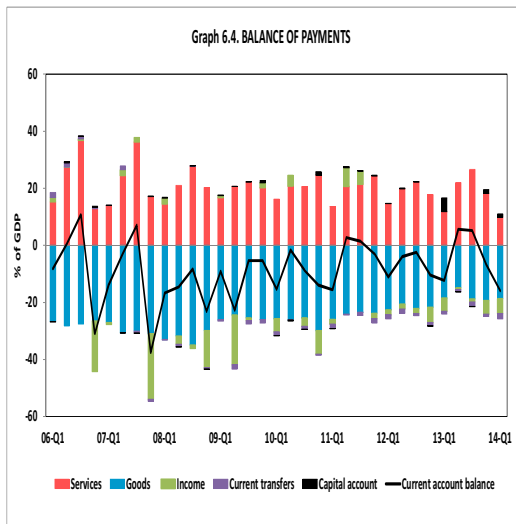
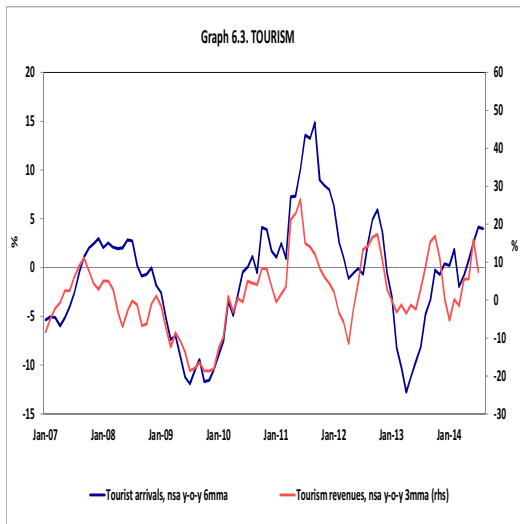
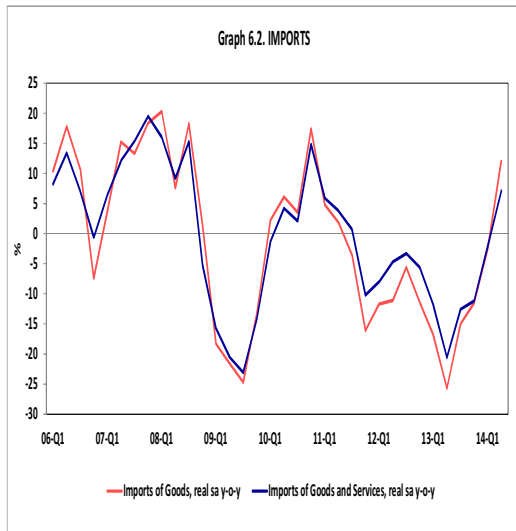
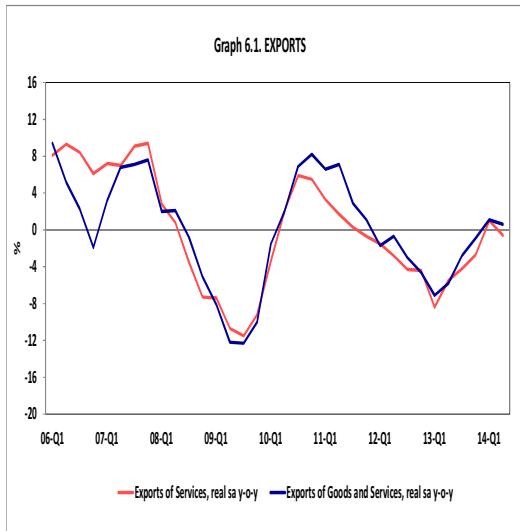
Sources: Eurostat, DG ECFIN, Cystat

5. INFLATION, WAGES



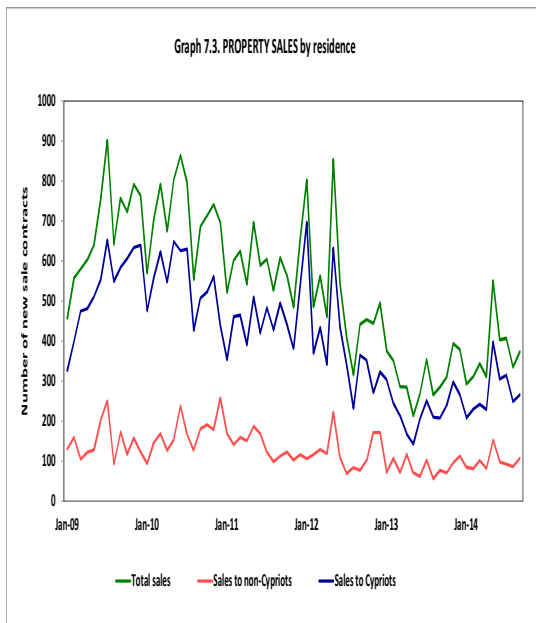
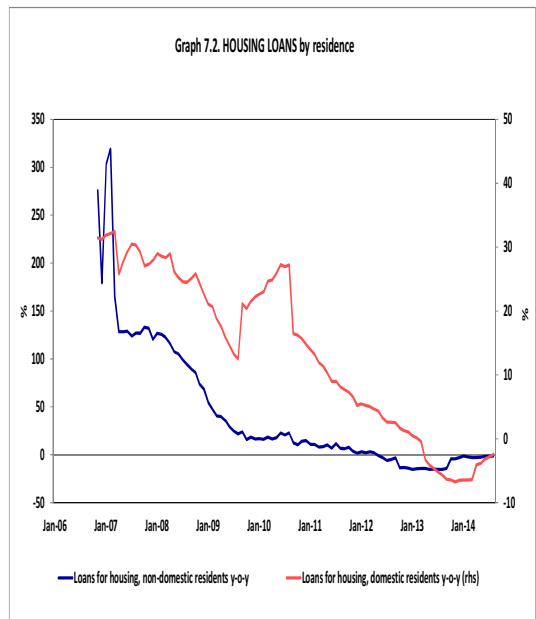
Source: Eurostat

6. EXTERNAL SECTOR



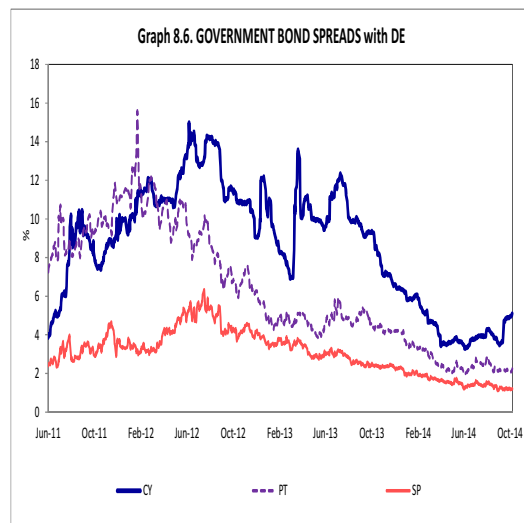
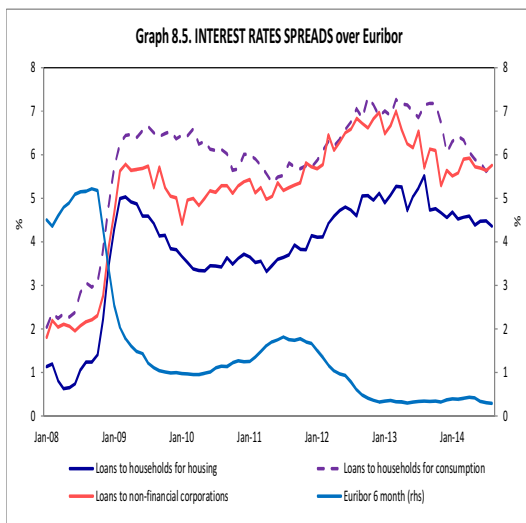
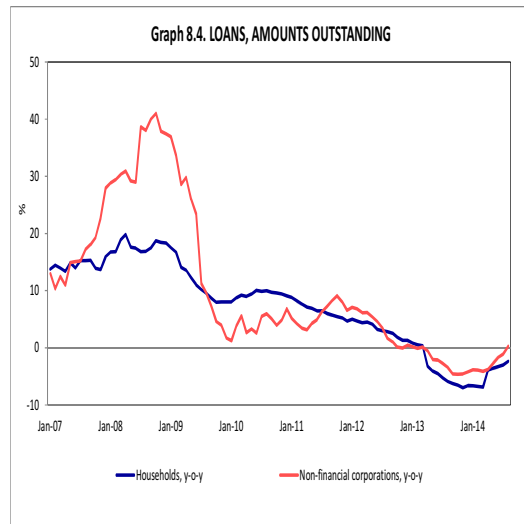
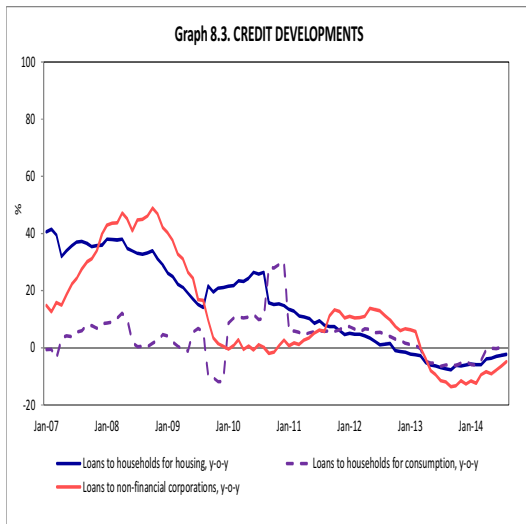
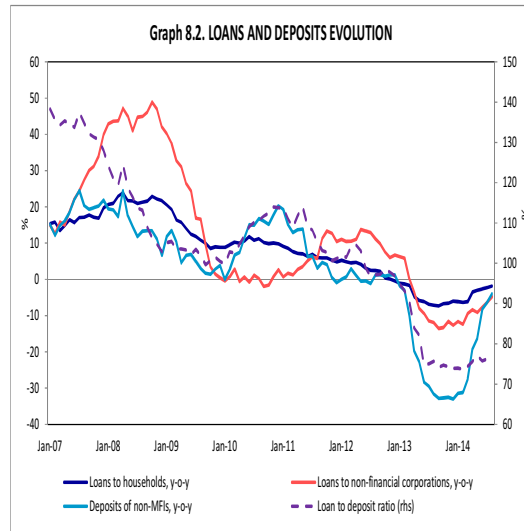
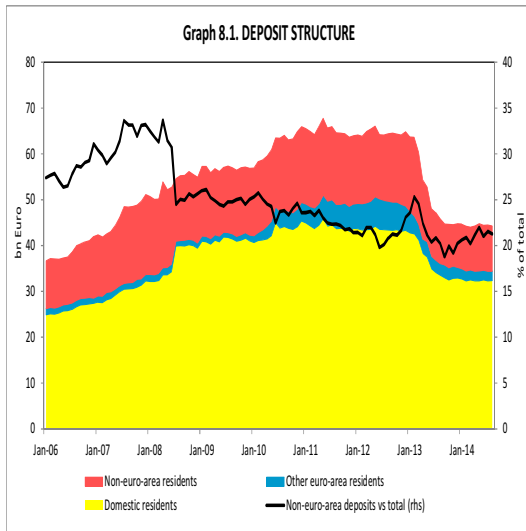
Sources: Eurostat, Cystat, ECB, CBC

7. HOUSING



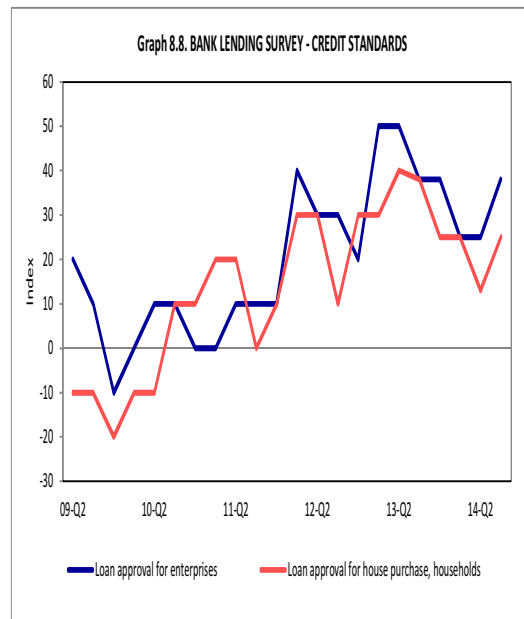
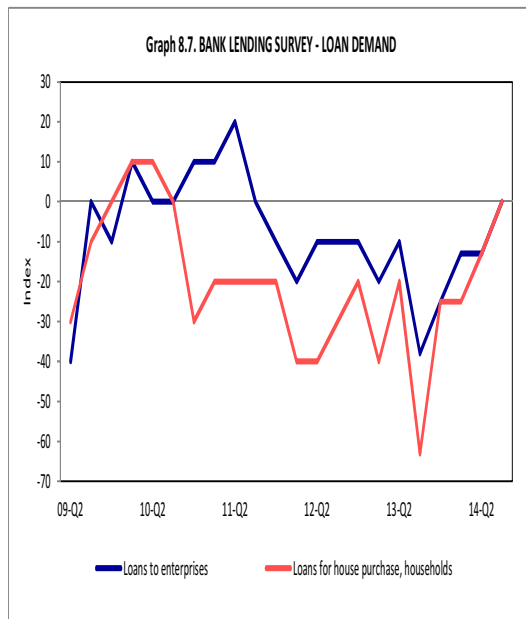
Sources: ECB, CBC, Dep. of Lands and Surveys

8. FINANCIAL SECTOR



Sources: ECB, CBC, Bloomberg

8. FINANCIAL SECTOR – cont.



Source: ECB