

CYPRUS

Economic & Financial

Quarterly Overview

Issue No 1/2016

October 2016

Main economic indicators

	2014	2015 (e)	2016 (f)	2017 (f)
GDP (% annual change)	-2.5	1.6	2.2	2.5
Unemployment rate (%)	16.1	15.0	13.5	12.5
HICP (annual % change)	-0.3	-1.5	-0.7	0.5
Budget balance (% of GDP)	-8.9	-1.0	-0.4	-0.5
Public debt (% of GDP)	108.2	108.9	105.6	101.7

Source: Ministry of finance of Cyprus

Credit Rating Status: Republic of Cyprus

	Rating	Outlook	Last modification
Fitch	B+	Positive	3.5.2016
Moody's	B1	Stable	12.2.2016
Standard & Poor's	BB	Positive	16.9.2016

Source: Ministry of finance of Cyprus

Web site: <http://www.alpha.gr>

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Executive summary

Cyprus exited the Economic Adjustment Programme as it regained access to international capital markets, the economy returned to growth earlier than anticipated and consequently the unemployment rate entered a downward track. At the same time, a large fiscal consolidation was achieved and the banking system has been recovering. Despite the positive developments while the programme was executed, many challenges remain.

Key developments

- Cyprus ended the three-year Economic Adjustment Programme and successfully returned to international debt markets.
- Economic growth is strongly boosted by private consumption, as well as tourism.
- Deflation supports disposable income.
- Fiscal adjustment continues.
- Non-performing loans remain a major issue and constrain credit expansion.

Economic Adjustment Programme

On March 7, 2016, Cyprus exited the three-year Economic Adjustment Programme, even two months earlier the date foreseen to end the programme that started in May 2013. The financial assistance offered through the programme amounted to €10 billion with the European Stability Mechanism (ESM) providing up to €9 billion and the International Monetary Fund (IMF) contributing around €1 billion. However, there was no need to withdraw the full amount and only €7.3 billion was withdrawn (€6.3 billion from the ESM and €1 billion from the IMF). The programme contributed to ensuring financial stability, restoring sustainable public finances and economic growth.

Cyprus, following the exit from the Programme, is now subject to post-programme surveillance until at least 75% of the financial assistance received has been repaid. The surveillance may last at least until 2029 and its objective is to measure Cyprus's capacity to repay its outstanding loans to the ESM. Under this surveillance, the European Commission, together with the European Central Bank, will conduct regular review missions to assess Cyprus economic, fiscal and financial situation and will prepare semi-annual assessments of the country's economic, fiscal and financial situation and determine whether corrective measures are needed. Cyprus has yet to tackle non-performing loans, reduce public debt, and complete growth-enhancing reforms.

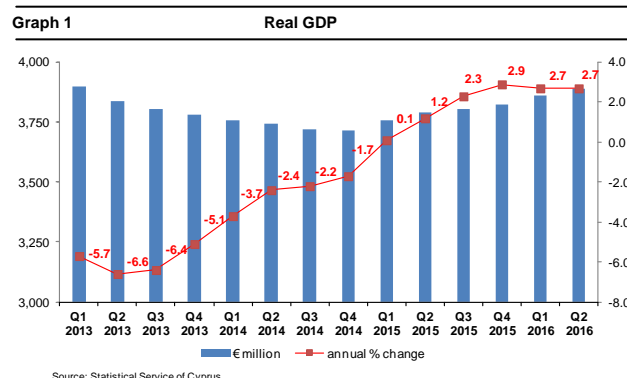
1. Economic outlook

Economic activity moved into a positive territory in Q1 2015 and demonstrated continuous acceleration.

Several consecutive quarters of positive growth readings in 2015 confirmed that the recession registered in 2012-2014 was over, with real GDP growth for 2015 reaching 1.6%. Growth was boosted by private consumption mainly due to declining prices and the restored confidence in Cyprus' economy, as well as by the tourism sector which was supported by the weaker euro, structural reforms and geopolitical tensions in the neighbouring countries. However, the contribution of net exports to growth has remained subdued.

In Q2 2016, economic activity continued to increase at a high rate, at 2.7%, on an annual basis, while on a quarterly basis, GDP growth rate was 0.7% in Q2 2016, from 1.0% in Q1 2016. According to the Statistical Service of Cyprus, in Q2 2016 positive growth rates were recorded in the sectors of hotels & restaurants, professional, scientific & technical activities, trade, manufacturing, construction, and transport, while a negative growth rate was recorded in the financial service activities as financial institutions are negatively affected

by the writing-off of loans in the context of the consolidation of the financial sector.

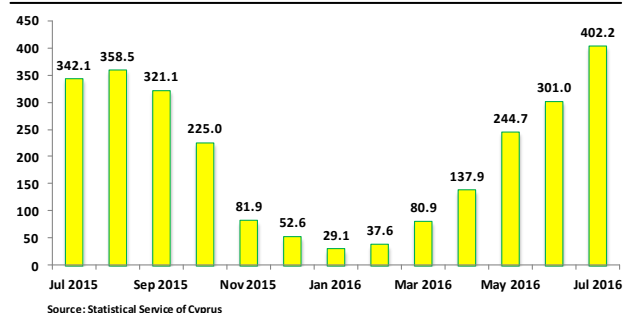


Growth prospects for 2016 are positive, according to the European Commission (May 2016), and GDP is expected to increase in 2016 by 1.7%, on an annual basis, from 1.6% in 2015, while further strengthening of the economic activity will be registered in 2017, moving above 2.0%. The main driving forces for growth in 2016 are expected to be private consumption, investment and tourism. In particular, private consumption will benefit from the increase in disposable income as a result of lower energy prices, lower interest rates and higher employment rate. Investment is expected to rise mainly due to infrastructure projects partly funded by the European Investment Bank and the European Bank for Reconstruction and Development. Infrastructure projects include two marinas, a casino resort and upgrading the existing facilities of Cyprus University. An additional boost to investment and economic activity should be given by the further exploration and exploitation of natural gas. Activity in the construction and real estate sectors is expecting to remain subdued.

1.1 Tourism

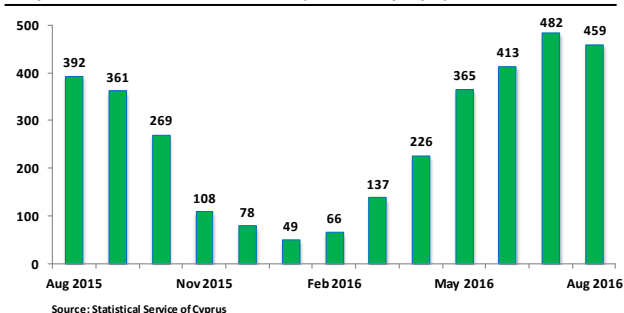
Tourism is a major contributor to economic activity in Cyprus. The total contribution of tourism in Cyprus' GDP was 19.3% of GDP in 2015 from 21.3% in 2014, according to World Travel and Tourism Council. The direct contribution of tourism in GDP was 6.4% of GDP in 2015 compared with 7.0% in 2014.

Graph 2 Revenues from tourism (in million euro)



In 2015, tourism in Cyprus benefited from geopolitical tensions in the eastern Mediterranean countries that had a negative effect in the tourism in these countries, as well as from the decreasing seasonality of tourism in the country, but also from the increase of tourist arrivals from the United Kingdom and Russia that account for 62% of total tourist arrivals in Cyprus. Revenues from tourism increased by 4.4%, on an annual basis to €2,112.1 million, in 2015, compared with a decrease by 2.8%, on an annual basis, from €2,023.4 million in 2014, while arrivals of tourists rose by 8.9%, on an annual basis, in 2015, compared with an increase by 1.5% in 2014.

Graph 3 Tourist arrivals (thousands people)



In 2016, the upward trend in the tourism sector continues. Arrivals of tourists amounted to 458,645 in August 2016 from 392,272 in August 2015. The major contribution to this increase came from tourist arrivals from Russia (26.8% of total tourist arrivals) that increased

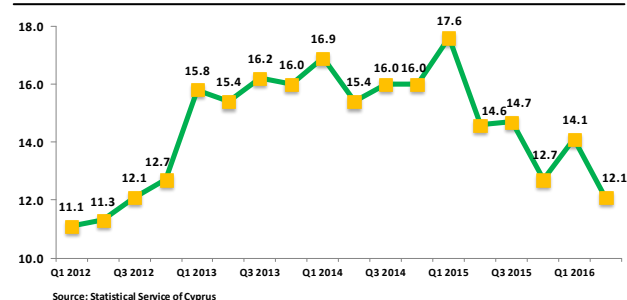
significantly by 36.8%, on an annual basis, and amounted to 122,843. Furthermore, tourist arrivals from the United Kingdom (37.6% of total tourist arrivals) increased by 9.9%, on an annual basis, to 172,236. On the other hand, a decrease was recorded in arrivals of tourists from Poland (-35.5%), Netherlands (-8.4%), Germany (-6.1%), Switzerland (-2.6%) and Finland (-1.2%). As far as revenues from tourism is concerned, they increased by 17.6%, on an annual basis, in July 2016 to €402.2 million, from €342.1 million in July 2015.

As a result of the changes in tourist arrivals and in revenues from tourism, revenues per person rose to €834.25 in July 2016 from €825.37 in July 2015, with half of the countries registering an increase while the other half presented a decrease of revenues per person. Furthermore, revenues per day increased to €86.01 in July 2016 from €80.92 in July 2015, with half of the countries registering an increase while the other half presented a decrease of revenues per day.

2. Unemployment

As a result of economic recovery after three years of recession, job creation picked up and the unemployment rate fell significantly from 15.9% in 2013 to 12.1% in Q2 2016, having reached a three-year low. In Q2 2016, unemployment rate was higher for women at 12.3% (Q2 2015: 14.4%) compared with 11.9% for men (Q2 2015: 14.8%). The number of unemployed people decreased to 51,070 in Q2 2016 from 61,537 in Q2 2015.

Graph 4 Unemployment rate (%)



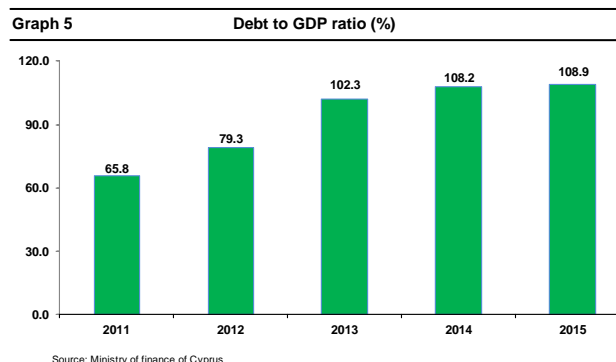
The downward adjustment of compensation per employee supported employment and secured country's external competitiveness. Although unemployment slows down, both youth and long-term unemployment remain high. The youth unemployment rate (15-24) has fallen to 26.8% compared to 31.7% in Q2 2015 but continues to be the higher amongst the age spectrum. The long-term unemployment tends to be persistent at 45.5% in Q2 2016 compared to 46.8% in Q2 2015.

According to the European Commission (May 2016), unemployment will fall to 13.4% in 2016 and further, to 12.4% in 2017 from 14.9% in 2015. Conditions in the market are expected to improve further, while more jobs are to be created by implementing growth enhancing structural reforms.

3. Fiscal policy

Public finances returned to a sustainable path as a strong fiscal adjustment was carried out on the expenditure and revenue sides. The budget process was modernized by new legislation, public spending was reduced by freezing public sector wages, tax collection was made more efficient, while the corporate tax rate increased to 12.5%, VAT increased to 19% and major state-owned companies were privatized including the Limassol Port Authority and the national telecom operator CYTA.

As a result, the budget deficit narrowed substantially in 2015 to 1.0% of GDP from 8.9% in 2014. The budget deficit as a percentage of GDP could be lower at merely 0.2% in 2015, if the recapitalization cost of the cooperative sector amounting to €175 million was not counted in.

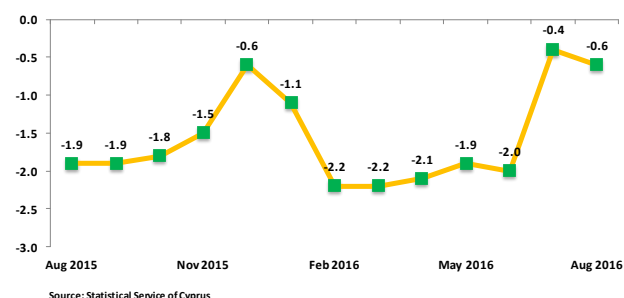


Fiscal adjustment continues in 2016 and in the first seven months of 2016, the general government budget balance posted a deficit of €92.2 million (-0.6% of GDP) compared to a surplus of €38.5 million in the first seven months of 2015 (0.4% of GDP). This was the result of the total revenues decrease by 3.5%, on an annual basis, while total expenditure remained almost unchanged. In 2016, the general government budget deficit is estimated to fall to 0.4% of GDP from 1.0% in 2015, supported by economic growth which is expected to increase revenues and by the continued freeze of pensions and wages.

Public debt peaked at 108.9% of GDP in 2015 from 108.2% in 2014, but is expected to follow a downward path reaching 105.6% in 2016, positively affected by the favorable growth prospects and the fall in the general government budget deficit. The above downward trend is subject to risks, arising from delays in implementing the privatisation agenda and the public administration reforms.

4. Prices

Negative inflation has supported private consumption and economic activity in 2015 and 2016. Inflation turned negative in 2015 as a result of the fall in energy prices and the lower wages, while in 2016 inflation was also affected by lower prices of air tickets as the competition between airline companies increased. In 2015, Cyprus registered the higher negative inflation among the Euro zone countries.

Graph 6 HICP (annual % change)


In August 2016, headline inflation stood at **-0.4% y/y** from **-0.2% y/y** in July 2016, as the prices of food and non-alcoholic beverages were higher by 5.7%, while the fall persisted in the prices of transport (-5.5%) and of housing, water, electricity, gas and other fuels (-3.6%). In the first eight months of 2016, headline inflation averaged **-1.7% y/y**. Harmonized inflation (HICP) was **-0.6% y/y** in August 2016 from **-0.4%** in July 2016, as food and non-alcoholic beverages prices increased (5.0%), while prices continued to decline for transport (-8.2%) and housing, water, electricity and gas (-4.8%). In the first eight months of 2016, harmonized inflation averaged **-1.6% y/y**.

According to the latest projections of the European Commission (May 2016), harmonized inflation will remain negative for the whole year 2016 at **-0.7%**, compared with **-1.5%** in 2015, as energy prices will continue to remain low. Harmonized inflation is expected to turn positive in 2017 at **1.0%** as domestic price pressures increase and energy prices halt to decline.

5. External balance

Current account recorded a deficit of **€634.2 million (3.6% of GDP)** in 2015, lower than **€791.5 million in 2014 (4.6% of GDP)**. This was the result of a surplus in the primary income balance, as income from foreign direct investment increased. On the other hand, the deficit in the trade balance was higher in 2015 compared with 2014 due to the decrease of exports, while imports remained almost stable.

Table 1 Current account balance

(€ million)	Q1 2016	Q1 2015	%Δ
Exports	852.2	617.1	38%
Imports	1,144.5	1,413.7	-19%
Trade Balance	-292.3	-796.6	-63%
Services Balance	490.7	235.7	108%
Income Balance	-133.5	24.6	
Current Transfers Balance	-104.0	-107.5	-3%
Current Account Balance	-39.1	-643.8	-94%

Source: Central Bank of Cyprus

In Q1 2016, the current account deficit decreased by **93.9%**, on an annual basis, to **€39.1 million** from **€643.7 million in Q1 2015**. This decrease was the result of a lower trade deficit as exports increased by 38%, while imports fell by 19%, as well as of a higher surplus in the services balance. The services balance surplus was positively affected by higher revenues from financial services, from telecommunications & information services, reflecting the restoration of confidence in the banking system and other services, as well as by higher tourism receipts. On the other hand, a deficit in primary income balance had a negative effect on the current account balance.

According to the European Commission (May 2016), current account deficit is expected to reach **-4.2% of GDP** in 2016 and **-4.6%** in 2017 from **-3.5%** in 2015.

6. Money & Financial Markets

Cyprus resumed accessibility to the international capital markets in June 2014, for the first time since October 2010. Since then it proceeded with four bond issues. The success of the bond issues reflected the restoring confidence of international lenders to the economy of Cyprus while the same time enhanced country's liquidity.

In July 2016, Cyprus proceeded with a bond issuance for the first time following the successful exit from the Economic Adjustment Programme on March 7, 2016 and the abolition of the restrictive measures on financial transactions on April 5, 2016. Since March 2016, the Ministry of Finance (MoF) had under consideration the diversification of its funding sources and the further development of the benchmark sovereign bond credit curve. To this end the MoF has been monitoring the conditions in the international capital markets and the economic developments in the country.

In particular, on July 19, 2016, Cyprus proceeded with a 7-year bond issue of €1 billion at a nominal rate of 3.75% and yield of 3.80%, which both were the lowest ever, with demand standing at €2.5 billion. Previous to that issue, on October 27, 2015, Cyprus proceeded with a 10-year bond issue of €1 billion at a nominal rate and a yield of 4.25%. Earlier in 2015, on April 28, 2015, Cyprus proceeded with a 7-year bond issue of a nominal value of €1 billion at a nominal rate of 3.875% and a yield of 4.0%, and collected €1 billion while its demand stood at €1.9 billion. This issue followed the bond issuance on June 18, 2014, which was the first since October 2010.

6.1 The banking sector

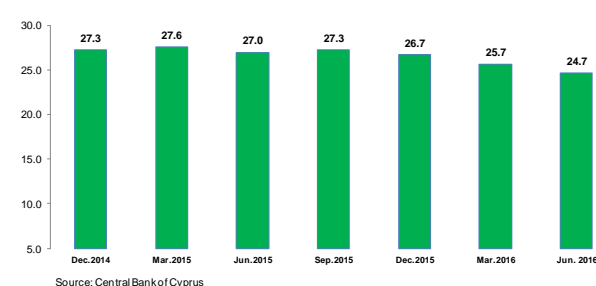
The banking sector in Cyprus shows signs of gradual recovery after having gone through significant changes in the last three years. The banking sector is structured around four categories : i) domestic banks, ii) cooperative banks, iii) subsidiaries of Greek banks, and iv) foreign banks.

Since 2015 non-performing loans (NPLs) continue to improve and deposits stabilized, while banks were recapitalized through state aid and foreign investment.

Following the recapitalization of banks, the Common Equity Tier 1 Capital ratio (CET 1) rose to 15.7% in June 2016 from 14.2% in December 2014, which is higher than 9% which is set by the Central Bank of Cyprus and the overall solvency ratio increased to 16.7% in June 2016

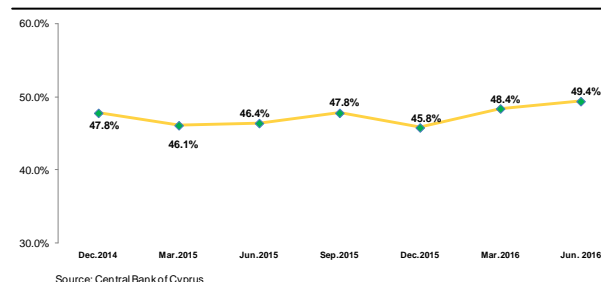
from 15.3% in December 2014. As a result banks' financing from ELA and ECB funding has been gradually diminishing from €11.8 billion in April 2013 (ELA: €11.4 billion, ECB funding: €0.4 billion) to €4.3 billion (ELA: €3.4 billion, ECB funding: €0.9 billion) in February 2016.

Graph 7 Non-performing loans (€ million)



Structural weaknesses in the banking sector and the highest NPLs ratio amongst banks supervised by the Single Supervisory Mechanism (SSM) affected credit conditions and constrained investment. Credit conditions in the banking system remain tight as the poor quality of the Cypriot banks' loan portfolio, which was the result of the economic crisis in the country, remains a major issue. Non-performing loans ratio (NPLs ratio), although being reduced through loan restructuring, remains high, but there are positive prospects for its further decrease. The fall in unemployment rate should help improve households' solvency, while new foreclosure and insolvency rules should encourage banks and borrowers to restructure NPLs. According to the Governor of the Central Bank of Cyprus, 3 to 5 years is the horizon for the non-performing loans' issue to start to be resolved.

Graph 8 Non-performing loans to GDP



In June 2016, NPLs ratio rose to 49.4% from 45.8% in December 2015 as a result of the decrease of total

loans to €50.0 billion in June 2016 from €58.2 billion in December 2015. The decrease of loans is due to weak new lending as banks try to further deleverage and correct their balance sheets. NPL ratio was higher for corporates' loans standing at 58.3% in June 2016, compared to 56.3% for households' loans while it was higher for loans to small and medium sized corporates at 60.6%.

The local authorities have taken significant actions to improve the resilience of the banking system. One of these actions is the improvement of banks' balance sheets in order to support the credit expansion of the real economy.

NPLs continued to fall in 2016 as a result of increasing loan restructuring and amounted €24.7 billion in June 2016, down from €26.7 billion in December 2015, having reached a record high in February 2015 (€27.8 billion). There are indications that there will be a downward trend since in June 2016 out of the total amount of €24.7 billion an amount of €10.2 billion refers to exposures that have been restructured and will be classified as performing if they exhibit capital repayments for at least twelve months. The coverage of NPLs with provisions increased during 2015 and the coverage ratio was 38.1% in June 2016 compared with 32.8% in December 2014.

Table 2 Financial strength indicators

	Dec.2014	Dec.2015	Mar.2016	Jun.2016
Total loans (€ million)	57,2	58,2	53,1	50,0
Non-performing loans (€ million)	27,3	26,7	25,7	24,7
Non-performing loan ratio (%)	47,8	45,8	48,4	49,4
Enterprises (%)	58,0	56,0	55,1	58,3
Households (%)	52,7	56,2	56,4	56,3
Coverage ratio (%)	32,8	37,5	37,2	38,1
Overall solvency ratio (%)	15,3	16,6	16,3	16,7
Common Equity Tier 1 capital ratio (%)	14,2	15,6	15,4	15,7

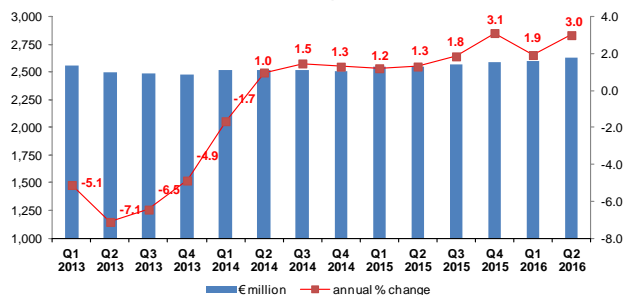
Source: Central Bank of Cyprus

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APPENDIX

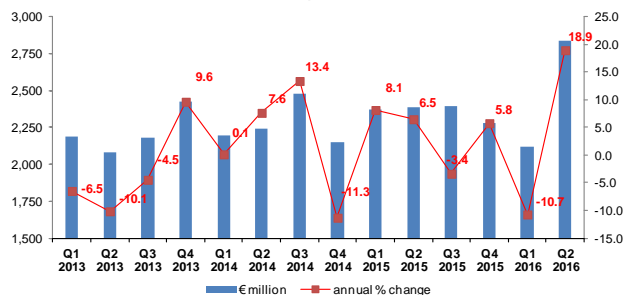
Trends of GDP components

Private consumption



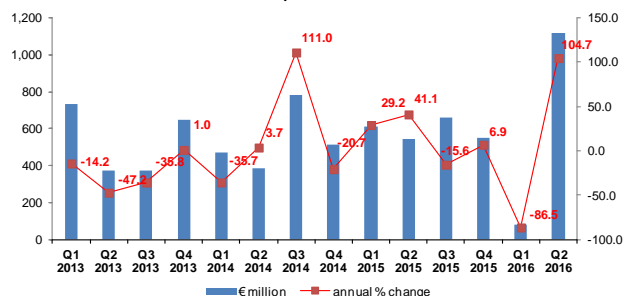
Source: Statistical Service of Cyprus

Imports



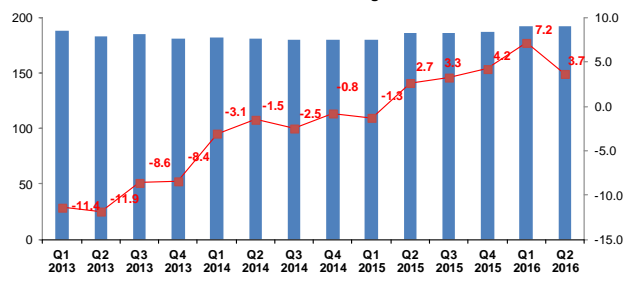
Source: Statistical Service of Cyprus

Gross capital formation



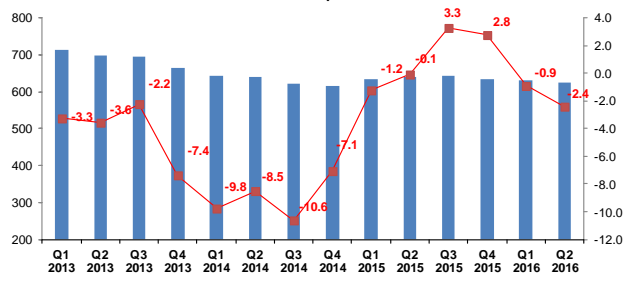
Source: Statistical Service of Cyprus

Manufacturing



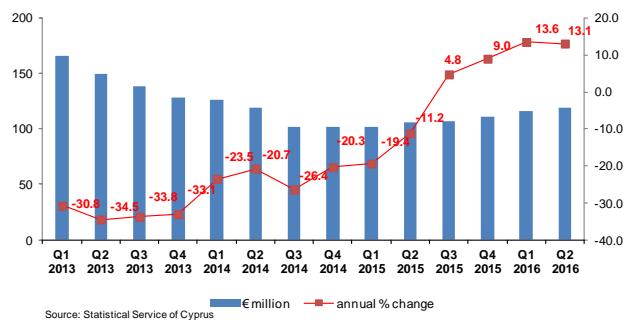
Source: Statistical Service of Cyprus

Public consumption



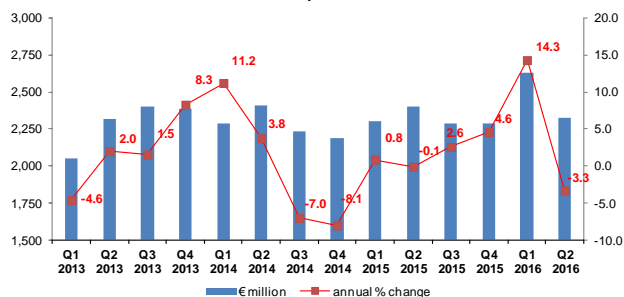
Source: Statistical Service of Cyprus

Construction



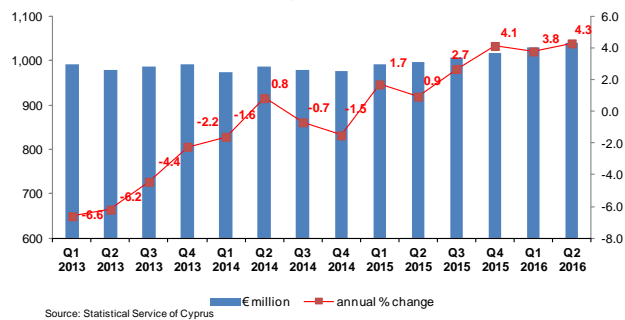
Source: Statistical Service of Cyprus

Exports



Source: Statistical Service of Cyprus

Trade, transport, hotels & restaurants



Source: Statistical Service of Cyprus