



Medium term outlook and challenges of the Cyprus economy

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I. STRONGER MACROECONOMY

II.SOUND PUBLIC FINANCES

III.REFORMED BANKING SECTOR

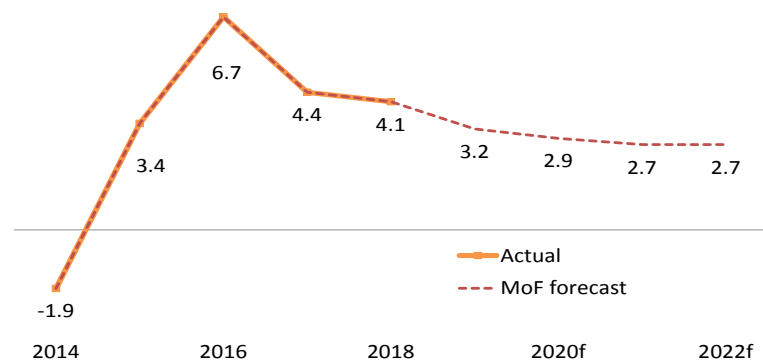
IV.LOOKING AHEAD



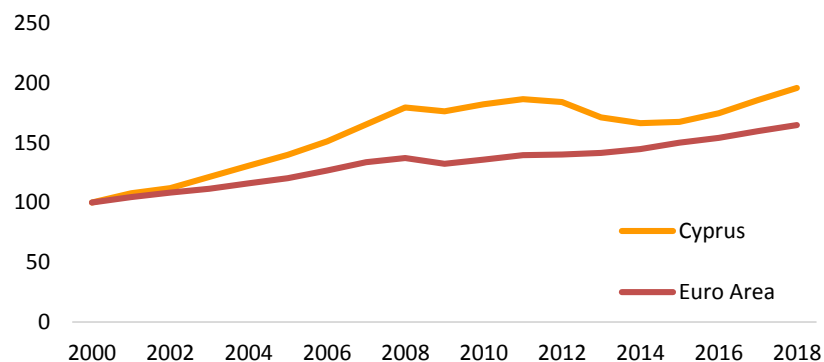
Solid near-term growth outlook

- Growth momentum of recent years has recently slowed down from 4,1% in 2018 to 3,3% over 9m-2019, albeit remaining at above eurozone levels. The deceleration is attributed to a less favourable external environment affecting the European economy.
- Growth is broad-based and derives from higher demand in the sectors of tourism, construction, business services and retail trade. The positive developments are partly attributed to the gains in price competitiveness recorded in recent years. The only sector recording negative growth rate is financial services due to its deleveraging.
- On the expenditure side, consumption has been the main driver attributed to higher employment level and disposable incomes. Additionally, mainly foreign-financed private investment has boosted growth with high value-added projects in the tourism, energy and education sectors.

Real GDP growth (% change)



GDP (Index, 2000=100)



Source: Cyprus Statistical Service, Ministry of Finance

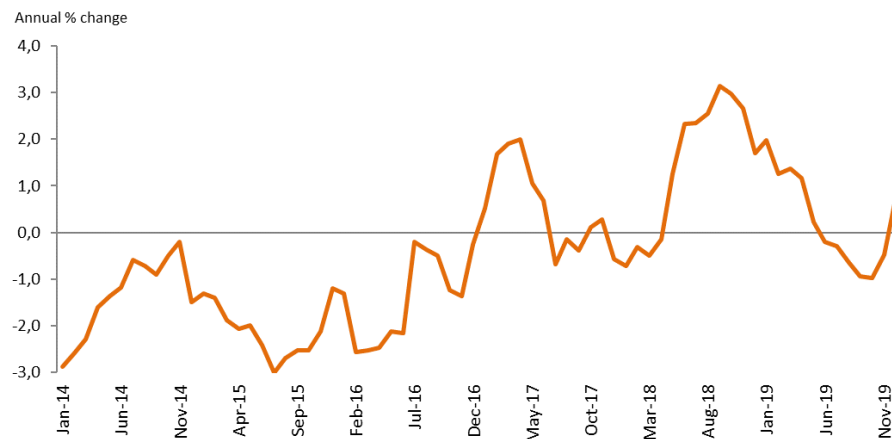
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Moderate inflation and rapid reduction in unemployment

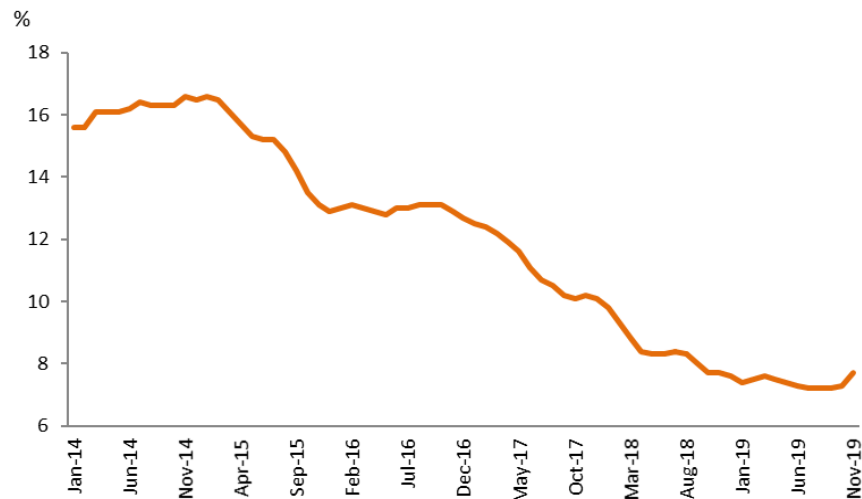
Low inflationary pressures

- Subdued inflationary pressures despite growth owing to exogenous factors. CPI inflation at 0.3% in 2019 with core inflation excluding energy and seasonal food at 0.6%. Respective figures in 2018 were 1.4% and 0.3%.
- Fast correction during crisis years reflecting the wage flexibility of the labour market which led to an internal devaluation and improvement in price competitiveness.



Rapid decline in unemployment

- Labour Force Survey unemployment in monthly seasonally adjusted terms - 7,7% in November 2019, (7,5 % in November 2018).
- Flexibility of labour market and strong economic activity contributing to normalization of labour conditions.
- Encouraging signs of de-escalation in youth unemployment while long-term unemployment is correcting faster than total.

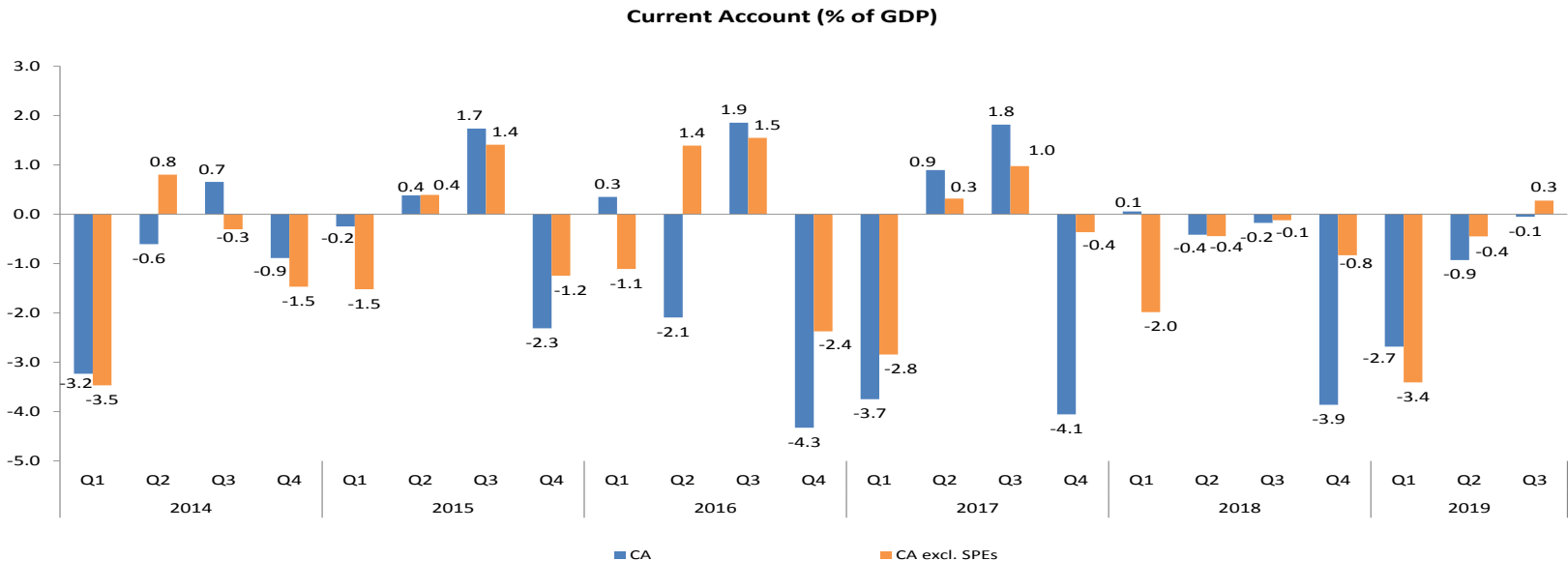
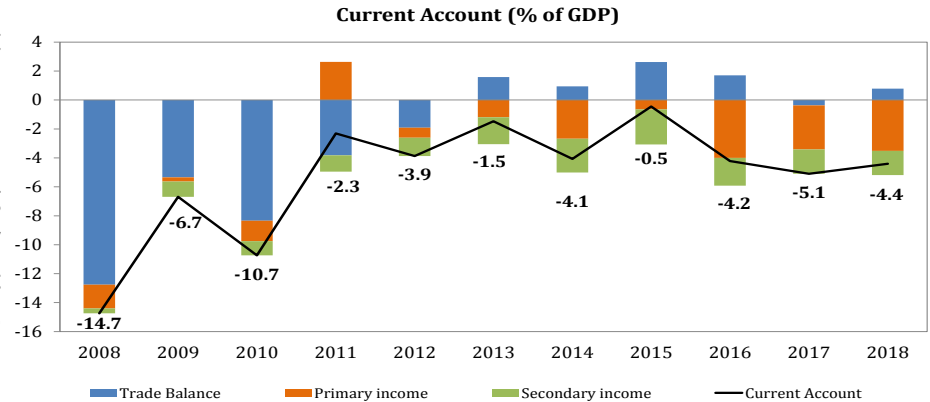


Source: Cyprus Statistical Service, Eurostat



Current Account Trends

- Cyprus presents small to moderate current account deficits, within sustainable levels.
- Companies statistically registered as Special Purpose Entities (SPEs) in Cyprus, have strong balance sheets relative to the size of the economy but minor real economic activity in the domestic economy. Exclusion of SPEs provides a more accurate picture of the external position.





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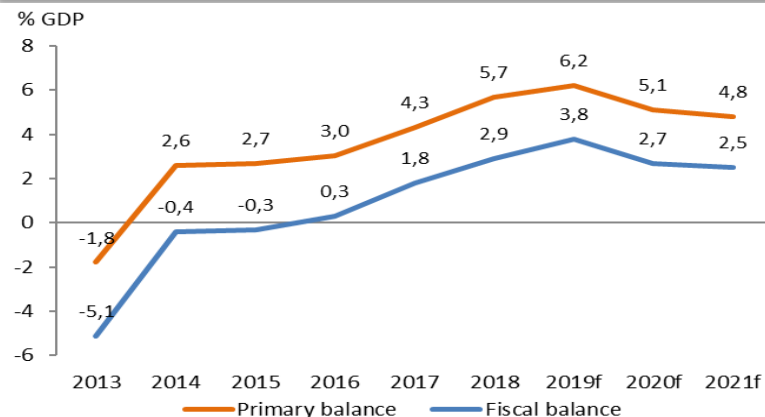
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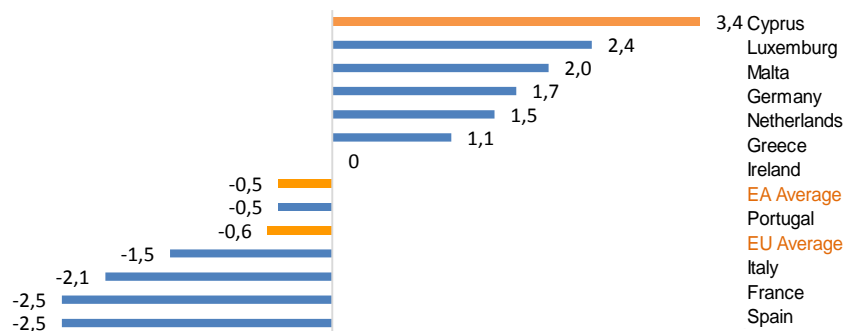
Public finances in a solid surplus position

- The government policy is for a growth-friendly fiscal stance safeguarding the maintenance of robust primary surpluses supporting a sustained reduction of public debt. The budget reflects a continuation in the employment policies adopted by the government and places emphasis on reallocation of expenditure towards growth-enhancing activities.
- Over the past few years the fiscal position has been positive and is expected to peak in 2019 at a surplus of 3,8% of GDP. In the years 2020-22 the budget surplus is expected to follow a declining trend, mostly due to increased expenditure associated with the gradual abolition of wage cuts. Excluding the methodological treatment of the CCB - Hellenic Bank deal, Cyprus recorded the largest fiscal surplus in the EU during 2018.
- The budget is designed to achieve the medium term objective of a balanced fiscal position in structural terms.

Evolution of main fiscal indicators, % of GDP



Budget balance 2018, % of GDP



Source: Ministry of Finance

Note: The budget outcomes of 2014-15 and 2018 exclude government contributions for the Cyprus Cooperative Bank

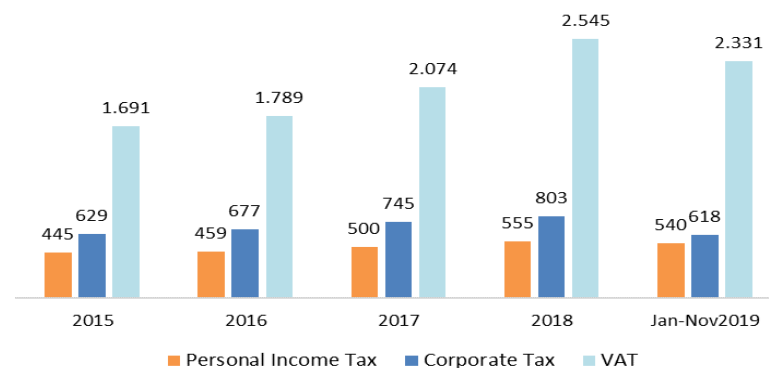
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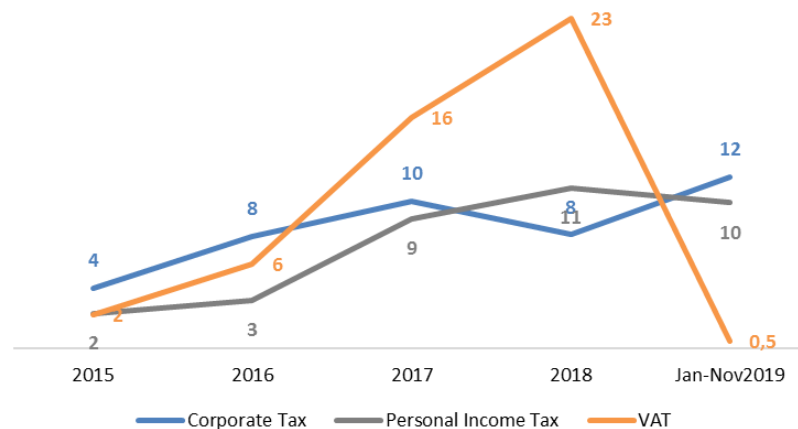
Budget revenue reflects strong economic activity

- Corporate tax revenue in steady increase over the past years reflecting corporate profitability and recovery of nearly all sectors of the economy.
- Personal income revenue has recorded increases, albeit at lower levels than corporate tax revenue, relating to the improvement in the labour market both in terms of higher employment and wage increases.
- VAT collections record strong increases primarily from trade and construction sectors.
- Budget revenue at 39.2% of GDP with EU average being 45% in 2018.

Budget revenue, EUR million



Budget revenue, % change y-o-y



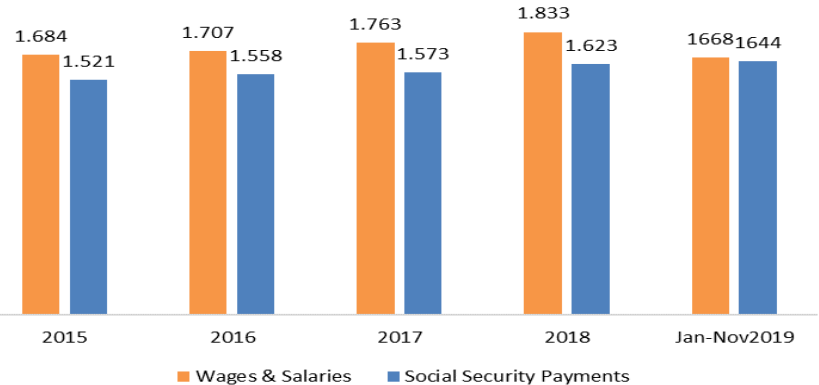
Source: Cyprus Statistical Service, Eurostat, Ministry of Finance



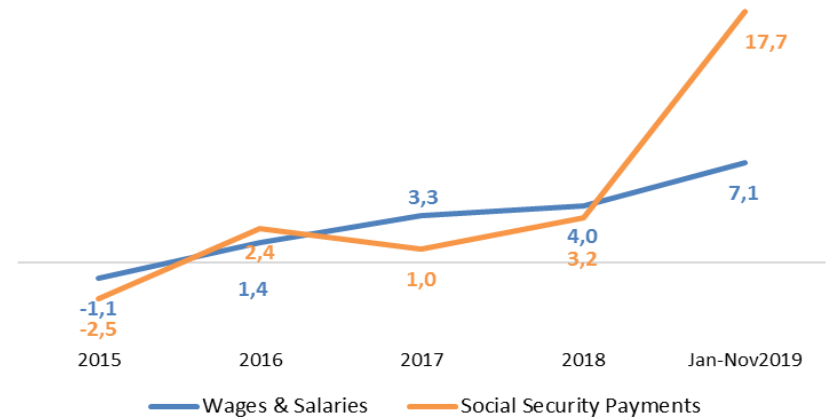
Budget expenditure grows moderately

- Expenditure growth has remained below the medium term GDP growth rate.
- Wages and salaries have been increasing at contained rates, and less than the increase in nominal GDP. The year 2018 marked the start of the reversal of wage cuts imposed during the crisis with a view to restoration by 2023.
- Interest payments are expected to evolve broadly stable in 2019 vis-à-vis 2018 despite the increase in the public debt recorded in 2018 owing to debt refinancing at lower interest rates.
- Despite expenditure increases, budget expenditure as a share of GDP was 36% in 2018, below the EU average of 45,6%.

Budget expenditure, EUR million



Budget expenditure, % change y-o-y



Source: Cyprus Statistical Service, Eurostat, Ministry of Finance

Note: The budget outcomes of 2014-15 and 2018 exclude government contributions for the Cyprus Cooperative Bank.



Fiscal risks

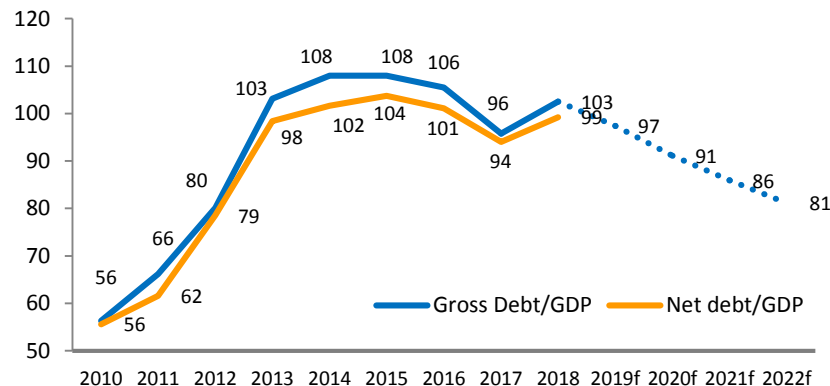
- **Introduction of the NHS:** in the first years of the system the government is expected to cover the deficits of autonomised public hospitals until a level of productivity and cost efficiency is reached so that their expenditure is covered through revenues from NHS participation. Expenditure pressure on the government budget is mitigated by the global budget of the NHS structure with frequent changes in unit prices allowed to absorb fluctuations in demand.
- **Judicial proceedings** pending before the courts and relating to the Law on the reduction of emoluments and pensions that was deemed unconstitutional by the Administrative Court in March 2019. The Government submitted an appeal before the Supreme Court. In the event of ratification of the original decision, the total net payments are estimated at EUR 0,8 bn for a period of four years.
- **Upside risk:** revenues from the state-owned asset management company.



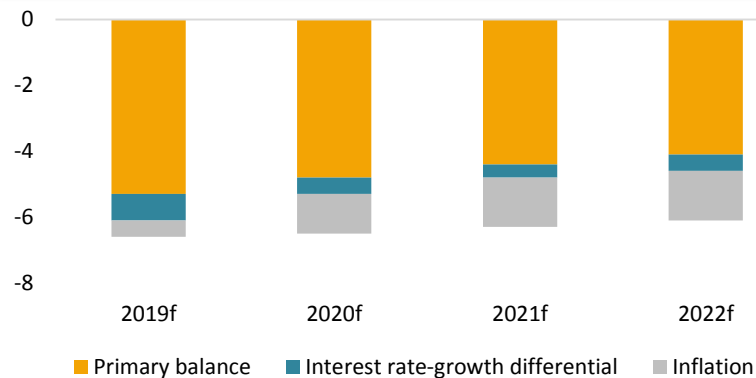
Positive public debt dynamics

- Public debt peaked over 2014-2015. After a one-off increase in 2018 due to the placement of government bonds as part of the partial sale of Cyprus Cooperative Bank, the decline is expected to resume and progress steadily to 81% by 2022.
- Debt dynamics are favourable due to growth, positive fiscal balance and low interest burden.
- The debt sustainability analysis, introducing various shocks to the macroeconomic parameters, indicates that the debt declining rate remains resilient albeit at a slower pace.
- The current policy followed is for liquid assets to cover gross financing needs of the following 9-month period on a rolling basis.

Evolution of gross and net general government debt, %



Debt dynamics, % of GDP



Source: Cyprus Statistical Service, Ministry of Finance

Note: "f" denotes forecasts by the Ministry of Finance as of September 2019. All forecasts are based on assumptions and there can be no assurance they will be realised.



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A consolidated, capitalised and liquid banking system

The banking system has refocused its operations and renewed its corporate governance. The regulatory framework has been reformed and modernised. Decisive actions have been undertaken for the tackling of NPEs .

- Banking sector shrinks by half to 4x the GDP and reaches EU average
- International investors obtain majority holding of Hellenic Bank and Bank of Cyprus
- Capital controls lifted
- Successful stress test results
- ECB assumes supervision of systemic banks

2013-2014

- Legislation on Foreclosures, Insolvency and Sale of Loans enter into force
- Emergency Liquidity Assistance repaid
- Deposits on upward path
- Decline in interest rates
- Provision of new credit increases
- Non performing exposures mark first reduction

2015-2016

- Bank of Cyprus listed in London Stock Exchange and returns to bond capital markets
- Hellenic Bank and Bank of Cyprus outsource management of NPEs and real estate portfolios to independent servicing companies
- Sales of non-performing exposures
- Partial sale of the Cyprus Cooperative Bank to Hellenic Bank; state owned AMC for residual entity
- Banking sector at 3x the GDP
- Enhancement of laws on foreclosure, insolvency and sale of loans; Introduction of Securitisation law
- Introduction of scheme for NPE burden sharing among state, banks and borrowers

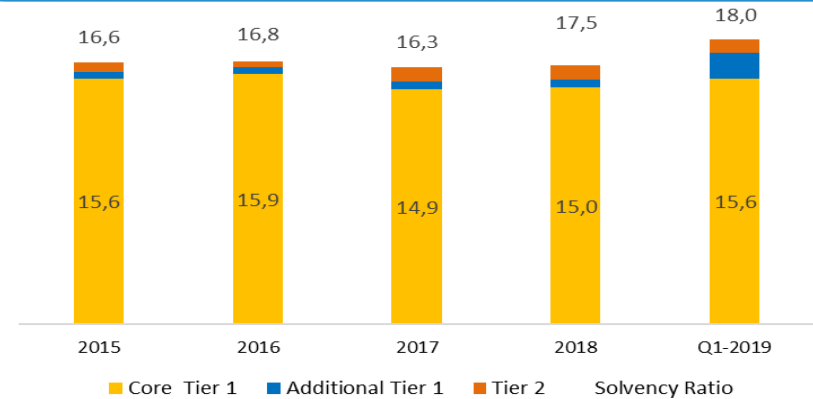
2017-2019



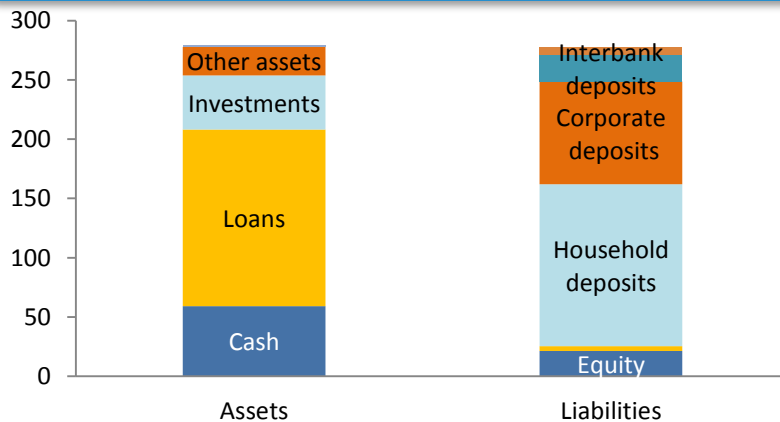
Solid capital base

- International investors hold majority of shareholding and board composition in systemic banks.
- Since 2013 the banks' capital position has been consistently strengthened, due to increase in common equity and deleveraging, resulting in key ratios of systemic banks to be above the thresholds specified by the supervisor.

Aggregate banking sector capital position, %

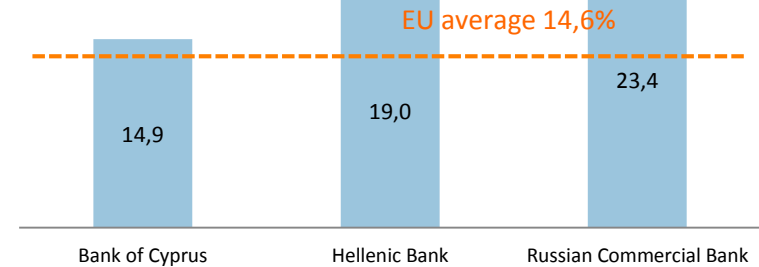


Banking system balance sheet (% GDP), Q2-2019



Source: EBA, Central Bank of Cyprus, systemic banks publications.

Systemic Banks CET1 capital ratio, %



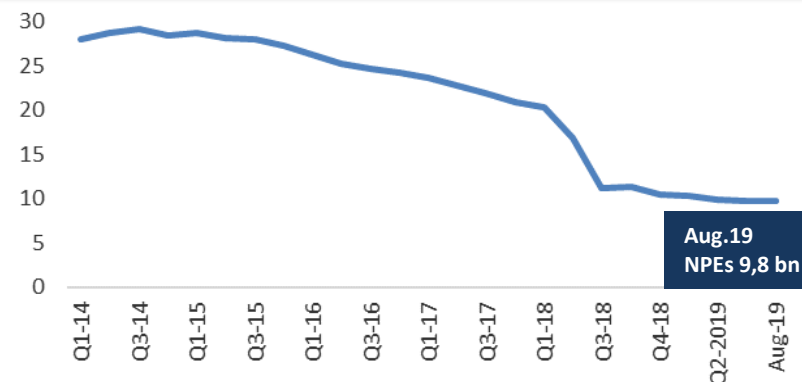
Data as at Q3-2019 for BoC, HB and EU average; 2018 for RCB



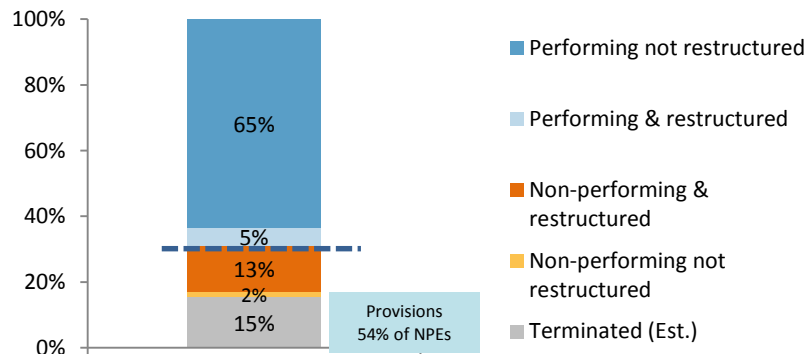
Sharp reduction in NPEs during 2018

- Reduction by 50% in NPES over 2018 due to sale by Bank of Cyprus (Project “Helix”) and the Cooperative Central Bank carve-out.
- Remaining reduction attributed to (i) cash repayments, (ii) successful restructurings reclassified as performing facilities, (iii) write-offs as well as (iv) settlement of debt through swaps of immovable property with the ultimate aim of property sale.

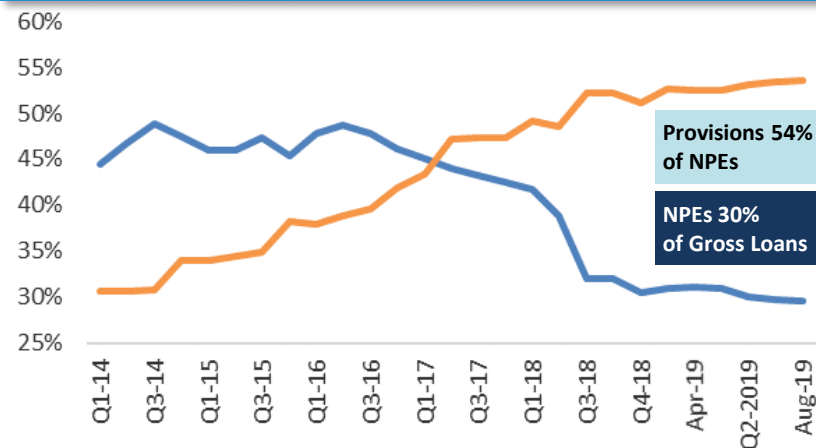
Non performing exposures, EUR bn



Gross loans breakdown, Aug. 2019



Non performing exposures and provisions



Source: Central Bank of Cyprus, Ministry of Finance



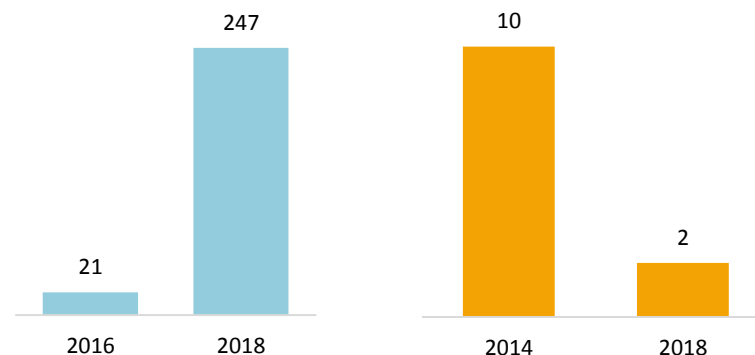
Non performing exposure management

- The banks' governance, and the regulatory and supervisory framework have been reformed to introduce incentives for borrowers and lenders:
 - Enhancement of banks' capacity: Centralized arrears management systems and dedicated recovery units have been implemented throughout the banking sector, whereas the largest banks have proceeded with outsourcing of NPE management;
 - Legislative measures: Legislation has been enhanced to facilitate a more streamlined and less time-consuming asset recovery process: property foreclosure, insolvency, sale of loans, swift transfer of property title deeds and loan securitisation.
- The impact of the ESTIA scheme, designed to address non-performing loans collateralised by primary residences, remains to be seen.
- Expected acceleration in 2020 – on the back of near portfolio sales.
- Another important aspect is progress with the state-owned asset management company (KEDIPEs), which needs effective management in order to recuperate the state aid provided.
- Property prices mark a first increase albeit from a low base.

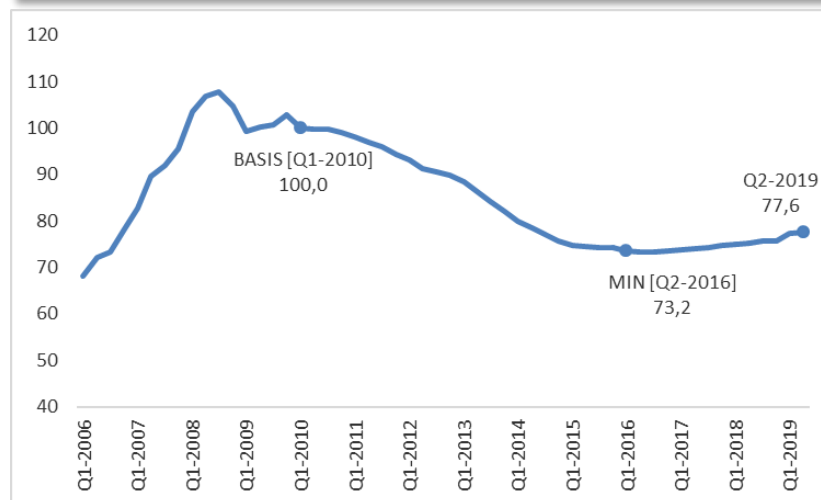
Source: IMF, Ministry of Finance, Central Bank of Cyprus

Auction sales, no. of properties

Years to foreclose (est.)



Residential Property Price Index



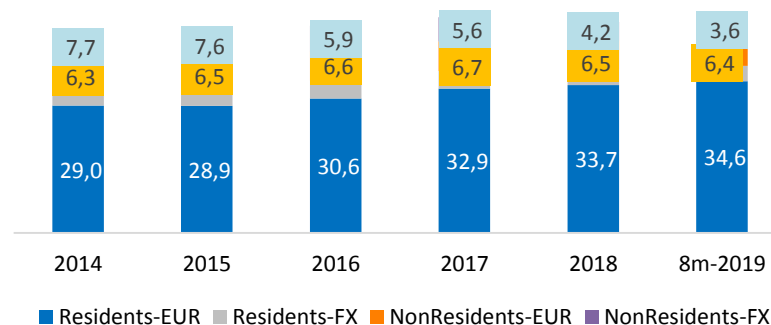


Comfortable liquidity position

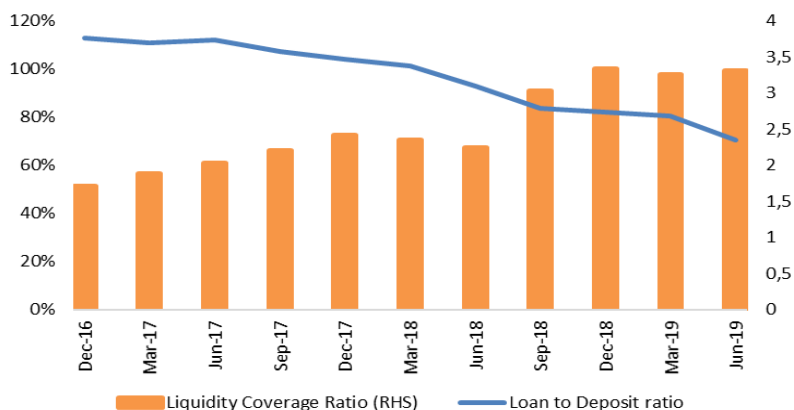
Low-cost deposit-funded banking sector

- Steady deposit increases in the domestic base reflecting the stronger domestic economy whilst reduction recorded in non-resident deposits due to proactive risk mitigating practices by banks.
- The Liquidity Coverage Ratio more than double the EU-average while the two largest banks report comfortable Net Stable Funding Ratios.

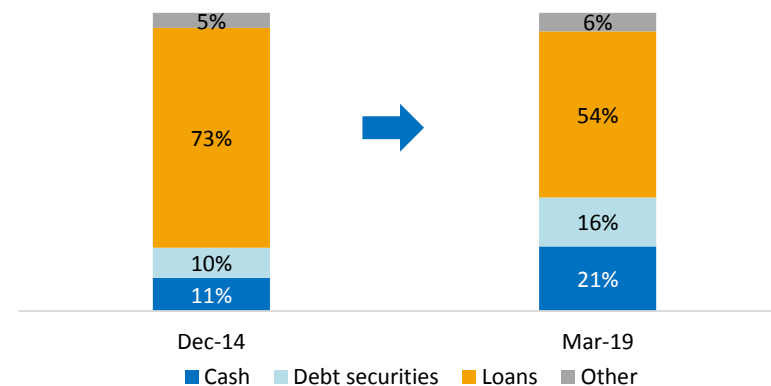
Evolution in deposits, EUR bn



Liquidity



Share of cash balance and liquid assets, % of assets



Source: Central Bank of Cyprus, EBA ; Note: LCR data not available in Jun-19



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MoF forecast (Budget)

	2016	2017 ^e	2018 ^e	2019 ^f	2020 ^f	2021 ^f	2022 ^f
Real GDP (%)	6.7*	4.4*	4.1*	3.2	2.9	2.7	2.7
Unemployment rate	12.9	11.1	8.4	7.0	6.0	5.5	5.0
HICP	-1.2	0.7	0.8	0.5	1.2	1.5	1.5

Sources of growth

- From the expenditure side: domestic demand, Pr. Consumption and GFCF
- From the production side: retail, tourism, shipping, other business services, construction, manufacturing, professional, scientific and technical activities, education, health



Main risks to the outlook

- Environment of **Low inflation** (–) impact on Growth
- The still **high level of private and public debt** -though both are on a declining path (render Cyprus economy vulnerable, including to potentially tightening financial conditions)
- **Banking sector** (sector consolidation, portfolio sales, **pressure on profitability** by low interest margins, excess liquidity and high operating cost, **adverse effects if the amendments to the foreclosure law are implemented**) +/-
- Adverse developments in the **external environment**
- **Confidence effects** +/-
- **Brexit** +/-
- Significant **investment opportunities** on the horizon



Policy challenges – Structural reforms

- NPLs
- Judicial reform
- Public Administration reforms – organizational streamlining
- Local Authorities reform
- Introduction of a National Health System



Main messages

- The **economic activity remains strong** -albeit at lower levels.
- **Labour market developments** continue to be **positive** amid healthy economic growth.
- Inflation positive, albeit **core inflation remains at very low levels**.
- Developments in **public finances** indicate that 2018 and 2019 fiscal targets were met with **comfortable margins**.
- **Competitiveness gains** led to **ameliorating external sector imbalances**
- however **challenges** looking forward, particularly in the financial sector
- **Deleveraging** helped by nominal GDP growth, new legal framework, recovery in the **housing market** could help reduce private debt
- **Structural reforms**, important for raising the growth potential of the economy...
- with prospects in **services** as well as in the **energy sector** our macroeconomic framework reflects growth of about 2½-3% in short to medium-term.