REPUBLIC OF CYPRUS
MINISTRY OF FINANCE
PUBLIC DEBT MANAGEMENT OFFICE

Newsletter no. 21/2018
July 2018

Macroeconomic Environment:

- The estimate for the Q1-2018 real growth rate is 4.0%, in seasonally adjusted terms, building on the previous quarters' growth momentum. Real GDP growth for 2017 in seasonally adjusted terms is estimated at 3.9%. The increased economic activity was broad based and is mainly attributed to sectors: hotels and restaurants, retail and wholesale trade, construction, manufacturing, professional, scientific and technical activities and administrative and support service activities.
- Developments are currently driven by increases in private consumption and net exports.
- Imports of goods increased by 16.7% in January-May 2018 compared to January-May 2017. The increase in imports is affected by developments in imports of transport equipment (aircrafts and vessels). Imports of goods, excluding imports of aircrafts and vessels, exhibit an increase of 12.5%.
- Exports of goods increased by 90.2% in January-May 2018 compared to January-May 2017 due to exports of transport equipment (aircrafts and vessels) occurred in 2018. Exports of goods, excluding exports of aircrafts and vessels, exhibit an increase of 26.7%.
- During the period January-June 2018 tourist arrivals increased at a rate of 12.4% compared to January-June 201. An increase of 15.6% was recorded in tourist arrivals from Greece, a 9.7% increase from the UK, a 9% increase from Germany, while a 4.7% decrease was recorded from Russia.
- The current account (CA) balance improved in 2018Q1, recording a deficit of €86.3 mn (-0.4% of GDP), compared with a deficit of €738.3 mn (-3.8% of GDP) in 2017Q1. This improvement was mainly due to the trade balance of goods, with exports of goods, mostly ships, recording very large increases compared with 2017Q1. The current account balance was, to a much lesser extent, positively affected by the improvement in services while both, primary and secondary income, recorded a deterioration. The CA balance for 2018Q1, adjusted to exclude imports/exports of Special Purpose Entities (SPEs) that primarily operate in the shipping industry (ship registration/deregistration) with a small footprint on the economy, records a deficit of -2.1% of GDP compared to a deficit of -2.4% of GDP the corresponding quarter of the year before.
- Inflation (HICP) in June 2018 increased by 1.7% compared to an increase of 1.0% in May 2018. For the period January-June 2018 the HICP remained stable compared to the corresponding period of the previous year. All subcategories of HICP presented a decrease except categories of housing, health, transport, education and restaurants and hotels.
- Labour Force Survey (LFS) unemployment, in monthly seasonally adjusted terms, decreased to 8.4% in May 2018 compared to 11.4% in May 2017. The most affected segment of the population is youth unemployment, although it has been on a downward trend since the 3rd quarter of 2013 falling to 22.4% in 2018Q1 from a peak of 40.4% in the 3rd quarter of 2013. Particularly challenging is also the relatively high long-term unemployment.
- Compensation per employee increased by 1.0% in 2018Q1 compared to 2017Q1.

Banking Sector:

The Government, as the major shareholder of the Cyprus Cooperative Bank (CCB), initiated the process of selling the whole or part of the assets and the liabilities of the CCB, and transaction was agreed with the Hellenic Bank.

In order to bolster up the balance sheet of the CCB and help rebuild confidence and credibility in CCB, the Government issued on 3rd April 2018, nine domestic bonds to the bank totalling €2,35 bln, through a private placement process. The proceeds of the bond issuance and additional funds, was deposited at State account held at CCB, for a total of €2,5 bln.

The Cyprus Government therefore developed a two-step liquidation plan for CCB:

(a) In a first step, CCB will be selling parts of its assets and liabilities to a third-party investor by way of an open, transparent, non-discriminatory and competitive tender process. Assets to be transferred will consist of the Government Bonds, performing loan exposures and other assets. Liabilities to be transferred will consist of non-government deposits of CCB. A Share Deal through an increase in capital was initially envisaged as an alternative but has since been disregarded.

(b) In a second step, the remaining assets of the Bank (NPEs and other non-core assets) as well as the Government Deposit and other liabilities (the Residual Entity) will be liquidated under the Cyprus national insolvency rules.

Binding offers were submitted on 14th May 2018 by two potential investors, with no positive price offered. One of the bidders left the process on 31st May 2018 as it could not meet the requirements and provisions of the transactions including the inability to find a credit institution through which the Fund could acquire the assets and liabilities of the CCB.

Final terms of the sale
The final offer of the successful bidder (Hellenic bank) was submitted on 14th June 2018. The perimeter of the transaction comprises a balance sheet of €10,3 billion, as follows:

- Deposits: €9,7 billion, excluding the government deposits of €3,54 billion (bond proceeds of €3,19 billion and cash placement of €351 million as explained below).
- Other liabilities: €66 million
- Loans totalling net book value of €4,593 billion of which NPEs with net book value of €420 million and market value €305 million.
- Cyprus Government bonds totalling €4,082 billion (including €3,19 bn new Gov bonds*)
- Cash €1,616 billion
- Other assets €25 million

The difference between Assets and Liabilities transferred, represent the Bidder estimates of fair value adjustment of €336 million and notional equity of €247 million against which a consideration of €74 million will be paid by the bidder.

Additionally, the successful bidder assumes the employment of at most 1.200 CCB staff and the rental of 72 branches and 7 parking lots.

*The abovementioned government bonds include an additional domestic issue of €840 million, so that the total government bonds issued for the sale of CCB reaches €3,19 billion. The new bonds have been exchanged against the bonds issued in April, with new maturities falling between 2018-2022. The cash placements of €351 million were reached with an additional deposit of €180 million.

The residual entity
Against the State's deposit of €3,54 billion (€3.190 plus €351 million) with CCB, CCB pledged assets in return. The pledge covers CCB's NPEs as well as other non-core assets with a total nominal value of approximately €8,34 billion. The pledged assets are:

- All immovable property of the bank including branches valued at €625 million,
- Performing loans valued at €512 million including loans to local authorities amounting to €270 million,
- Non-performing loans valued at €6,97 billion at gross book value, and
- Other liquid assets and participation to other entities €230 million.

The above pledge was based on a bilateral agreement signed between the two parties. The state deposit as well as the above assets will remain in the residual entity. The Residual Entity's sole and single activity will be to manage the assets within in its perimeter, with the objective of divesting, liquidating or winding down the assets in an orderly manner but with a view to maximising the value to repay the State as much and as swiftly as possible.

The Government bonds with a total nominal value of €3,19 billion were issued as follows:

- Bond 1: nominal value EUR 500 million; interest rate 1,90%; maturity date 17 December 2018;

- Bond 2: nominal value EUR 750 million; interest rate 2,50%; maturity date 16 December 2019;
- Bond 3: nominal value EUR 750 million; interest rate 2,75%; maturity date 15 December 2020;
- Bond 4: nominal value EUR 580 million; interest rate 3,25%; maturity date 15 December 2021;
- Bond 5: nominal value EUR 610 million; interest rate 3,50%; maturity date 15 December 2022.

The terms of the acquisition include an Asset Protection Scheme created by the CCB, and guaranteed by the Republic of Cyprus. The Scheme will cover potential unexpected losses on certain assets only (PEs of €2,1 billion and NPEs of €0,5 billion). Prior to compensation, losses will be subject to control and validation. According to the valuation conducted by an independent third party, the losses are not expected to exceed a total of €155 million for a period of 12 years. The APS scheme entails a guarantee fee payable to the government set at €23 million and may reach €63 million over the life of the scheme. Any unexpected losses covered by the APS scheme will be met by the residual entity.

The transactions pertaining to the above process were determined and agreed with the supervisory entities such as the SSM/ECB, Central Bank of Cyprus and the DG Competition/European Commission. On 19th June 2018 the European Commission's DG Competition approved the state aid for financing the orderly market exit of Cyprus Cooperative Bank as compatible with EU state aid rules.

- The **capital position** has recently declined, following increased provisioning for non-performing exposures (NPEs), remaining at adequate level. CET1 capital ratio of the Cypriot banking sector was 14.1% at 31/03/2018 (14.9% at 31/12/2017).
- **Non-performing exposures** continued their downward trend in absolute terms dropping to €20.3 bn on 31/03/2018, down from €24.3 bn at 31/12/2016 and €27.3 bn at 31/12/2015).
- **Provisions** on non-performing exposures continued increasing as a share of the NPEs, reaching 49.1% on 31/3/2018 (up from 47.3% on 31/12/2017, 42.4% on 31/12/2016 and 38.3% on 31/12/2015).
- **Restructurings** were €11.5 bn on 31/03/2018 (€11.9 bn on 31/12/2017). 68% of undertaken fixed-term loan restructurings abide by the new repayment schedule agreed as part of restructuring.
- **Deposits** in the banking system have been on a rising trend since the second half of 2015 with deposits increasing from €46 bn in December 2015, to €50.9 bn in May 2018.
- Total **loans** continued their decreasing trend, being €48.8 bn in May 2018, down from €62.7 bn in December 2015, mainly due to write offs in the context of debt restructurings.
- Despite the overall decline of loans and strict criteria in supplying new credit, **new lending** (including loans transferred from other banks) are on an increasing trend. During 2017, new loans towards Non-Financial Corporations reached €2,141 mn, while those towards Households reached €1,087 mn. The respective figures for the first five months of 2018, were €774 mn and €515 mn.
- **Hellenic Bank** has executed a 10-year service level agreement with APS Cyprus, an independent company, for the management of the Bank's non-performing loan and real estate portfolio retaining ownership of the said portfolios. Furthermore, in January Hellenic Bank entered into an agreement to sell a non-performing loan portfolio of €145 million predominantly non-retail exposures to B2Kapital Cyprus Ltd, a wholly owned subsidiary of B2Holding ASA, a Norwegian corporation listed on the Oslo Stock Exchange.
- Eurostat's **house price index** for Cyprus increased to 74.6 on 31/12/2017 compared to 73.5 on 31/12/2016 (basis of 100: Q1-2010).

<u>Fiscal Developments, 2017 and January-June 2018:</u>

- General government **budget balance** was in surplus in 2017 of the order of €344 mn (1.8% of GDP), compared to a surplus of €59 mn (0.3% of GDP) the year before. General government **primary balance** was in surplus in 2017 of the order of €844 mn (4.4% of GDP), compared to a surplus of €545 mn (3% of GDP) the year before. The above **overperformance** reflects the improving economic environment and labour market conditions.

- General government **budget balance** was in surplus during the first semester of 2018 of the order of €327 mn (1.7% of GDP), compared to a surplus of €64,5 mn (0,4% of GDP) during the same period of the year before. General government **primary balance** was in surplus during the first semester of 2018 of the order of €529 mn (2.6% of GDP), compared to a surplus of €288 mn (1.5% of GDP) the year before.

- **Total revenue** increased in absolute terms to €3,663 mn during the period under review from €3,349 mn in the year before, exhibiting a positive rate of growth of 9.4%.
  - revenue from taxes on production and imports reached €1,567 million compared to €1,391 million the year before, exhibiting a positive rate of growth of 12.6% attributed mainly to an increase in VAT receipts by 22.3%.
  - revenue from taxes on income and wealth increased by 9.3% from €662 million during January-June 2017 to €724 million during the period under review, reflecting the increase both in the employment levels and in salaries.
  - social contributions recorded a positive rate of growth of 8.8%, reaching €893 million during the first semester of 2018 compared to €821 million the year before, reflecting improving conditions in the labour market.
  - other current recourses reached €420 million, compared to €449 million, exhibiting a negative rate of growth of 6.5%, mainly due to the lower CBC dividend received during the period under review compared the year before, by about €35.7 mn.

- **Total expenditure** exhibited a positive rate of growth of 1.6% during the first semester of 2018 reaching €3,336 million from €3,285 million during the same period of the year before.
  - compensation of employees recorded a positive rate of growth of about 2.5%, reaching €1,106 million compared to €1,078 million the year before, partly attributed to an increase in gratuity payments during the first two months of 2018.
  - intermediate consumption recorded an increase of 2.3% during January-June 2018 compared to the same period of the year before, reaching €305 million from €298 million.
  - social transfers recorded an increase of 2.7%, reaching €1,313 million during the period under review compared to €1,279 million during the same period of the year before.
  - subsidies exhibited a positive rate of growth of 8.6% during the period under review (€20) compared to the same period of the year before (€19 million).
  - gross fixed capital formation exhibited a positive rate or growth of 1.1%, from €136 million during the first semester of 2017 to €138 million during the year under review.

<u>Public debt and financing:</u>

- The General Government **Debt** reached €20.8 bn in June 2018, recording an increase over the end 2017 debt stock of €18.7 bn due to the bond issuances as part of the Cyprus Cooperative Bank – Hellenic Bank transaction. The debt-to-GDP ratio increased from 97.5% in 2017 to 108.5% at the end of June 2018

- Available **cash** covers the financing needs up to H1-2019.

- The Cyprus Government international bonds have seen their yields decline from their peak in the end of May 2018 dropping by around 64 to 98 bps for the most liquid bonds (2022s, 2023s, 2024s, 2025s). This was due to the reduction in uncertainty in the banking sector.

- The yield at the monthly 13-week **Treasury Bill** auctions continue to be negative. The latest auction on the 30th of July recorded a yield of -0.22% and a bid-to-cover ratio of 1.7.

- On 25th May DBRS upgraded Cyprus by one notch to BB maintaining the positive outlook and on 27th July Moody's upgraded Cyprus by one notch to Ba2 assigning a stable outlook. The next rating review is scheduled for 14th September 2018 (Standard & Poor's: BB+, Positive).

Contacts:

Public Debt Management Office, Ministry of Finance, Nicosia 1439, Cyprus
pdm@mof.gov.cy ; www.mof.gov.cy/pdmo ; Tel: +357 22 601182 ; Fax: +357 22 602749

New publications:

Quarterly Debt Bulletin Q4-2017
http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/All/F0C650FEBD5E4C11C225788D00208D2A?OpenDocument

Macroeconomic Monitor July 2018
http://mof.gov.cy/assets/modules/wnp/articles/201801/386/docs/macro_monitor_july_2018.pdf

Stability Programme 2018-2021
http://mof.gov.cy/assets/modules/wnp/articles/201805/402/docs/stability_programme_2018_2021_final.pdf

Fiscal accounts Jan-Mar 2018:
http://www.cystat.gov.cy/mof/cystat/statistics.nsf/All/76C02C9288761B9CC22582D700306A7E?OpenDocument&sub=2&sel=1&e=&print