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Sapienta Country Analysis

Cyprus

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Comprehensive monthly analysis of politics, economic policy and the economy

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- Political analysis and outlook Tensions over maritime activities continued to increase in June and remain at risk of escalating further, although recent moves by the US president, Donald Trump, among others, might have been enough to reduce the risk of a military conflict for the time being. Nevertheless, developments look more likely to lead to a permanent but ultimately unstable division of the island than to a united federal Cyprus.

- Structural reforms and natural gas A gas export deal for Aphrodite has been reached, while the estimated for $9.5bn in government revenue will depend on prices and volumes. The cabinet has approved extensions to existing exploration licences, in a possible sign of pressure from companies over Turkey's actions in the EEZ. LNG imports remain a long way off. A deputy ministry of innovation is planned, municipality reform is back on the table and the National Health System (GESY) has been launched.

- Fiscal performance and forecast EU grants helped produce large general government and primary budget surpluses in January-April and cashflow from the state asset management company should support revenue further. Legacy debt to the Central Bank has been paid off and we expect the debt/GDP ratio to drop back below 100% this year. The new Turkish Cypriot coalition's economic policy will focus on higher education and tourism.

- Banking sector The stock of loans has declined owing to both NPL deals and a fall in new mortgages despite lower interest rates. Japan Trust Bank's acquisition of a Cypriot company should be a boost for the financial services sector. The Council of Ministers has approved the ESTIA loan subsidy scheme. Turkish Cypriot banks boosted their profitability in 2018 as the Turkish lira declined.

- Macroeconomic trends and forecast First-quarter real GDP growth was revised down to 3.4%. Construction growth has come off its peak and retail sales appear to have been affected by the decline in tourism. Industrial production slowed from a high base. The current-account deficit remained large in 2018. In northern, Cyprus, spending from the south is the only bright spot for the Turkish Cypriot retail sector.

Table 1

Sapienta Economics macroeconomic forecast

	2018	*2019*	*2020*	*2021*	*2022*
GDP at current prices (€ m)	20,731	*21,639*	*22,620*	*23,561*	*24,513*
GDP per capita (€)	23,847	*24,767*	*25,685*	*26,541*	*27,395*
GDP at constant 2005 prices (€ m)	20,290	*20,976*	*21,548*	*22,047*	*22,488*
Real GDP growth (%)	3.9	*3.4*	*2.7*	*2.3*	*2.0*
Harmonized consumer price inflation (%)	0.8	*1.0*	*1.8*	*1.8*	*0.0*
Unemployment rate (%)	8.5	*8.0*	*7.9*	*7.8*	*7.5*
Budget balance (ESA2010) (€ m)	-990	*-240*	*668*	*646*	*582*
% of GDP	-4.8	*-1.1*	*3.0*	*2.7*	*2.4*
Primary balance (ESA2010) (€ m)	-475	*249*	*1118*	*1046*	*936*
% of GDP	-2.3	*1.1*	*4.9*	*4.4*	*3.8*
Gross public debt (€ m)	21,258	*21,420*	*21,039*	*20,808*	*19,912*
% of GDP	102.5	*99.0*	*93.0*	*88.3*	*81.2*
Current-account balance (% of GDP)	-7.0	*-6.0*	*-5.2*	*-5.3*	*-5.5*

Sources: Cystat, Ministry of Finance, Sapienta Economics estimates and forecasts in italics.

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Maritime tensions are likely to increase—

Tensions over maritime activities continued to increase in June and remain at risk of escalating further, although recent moves by the US president, Donald Trump, among others, might have been enough to reduce the risk of a military conflict for the time being. Nevertheless, developments look more likely to lead to a permanent but ultimately unstable division of the island than to a united federal Cyprus.

As noted in our May report, the Turkish drill ship, Fatih, arrived off the western coast of Cyprus on 4 May, in an area which the Republic of Cyprus has declared as its Exclusive Economic Zone (EEZ) and which Turkey claims lies within its continental shelf (see box). The European Council (heads of EU member-state governments) issued a strongly worded statement on 20 June, "condemning Turkey's continued illegal actions in the Eastern Mediterranean and the Aegean Sea" and asking the Commission and the European External Action Service (EEAS) "to submit options for appropriate measures without delay, including targeted measures." Turkey responded by rejecting the conclusions and saying that the EU was "positioning itself as a court". Turkey repeated a call made by Turkish Cypriots in 2011 for a joint committee of Greek Cypriots and Turkish Cypriots to discuss energy resources or revenues.

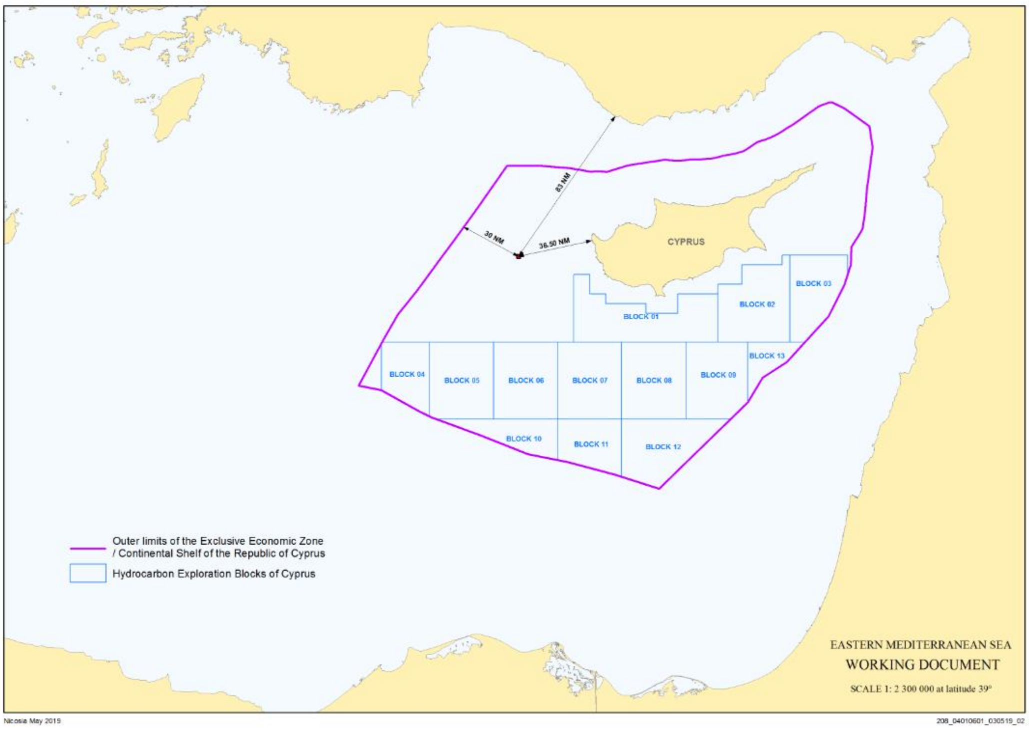
It is not clear what the measures will be or how fast they will be implemented, if at all. The final paragraph of the abovementioned response by Turkey contained hints that it could be less cooperative in stemming the flow of refugees from Syria to EU countries—something which is likely to make EU member states tread carefully. Nevertheless, the Council conclusions were a far stronger response than in the past, and seem to have been triggered by a number of issues. First, statements by Turkey's energy minister, Fatih Dönmez, on 18 June suggesting that drilling by Fatih had actually started. This followed news from an unnamed official of the Republic of Cyprus Ministry of Foreign Affairs on 13 June that arrest warrants had been issued for the crew of the Fatih drill ship. Second, the launch on 20 June (as the EU Council was under way) of the second drill ship, Yavuz. Yavuz is due to drill off the north-eastern coastal tip of Karpas, in areas licensed by the unrecognized Turkish Republic of Northern Cyprus (TRNC) to the Turkish Petroleum Corporation (TPAO). This would be inside the EEZ declared by the Republic of Cyprus but not inside blocks licensed by it (see Figure 1). Third, concerns by Greece that Turkey will attempt to drill close to Kastelorizo, a Greek island close to the Turkish coast over which Greece and Turkey disagree on maritime boundaries, and an increase of incursions by Turkish jets into the airspace of Greece. Fourth, the EU's desire to include in its conclusions the threat of more sanctions on Russia also seems to have strengthened the hand of Cyprus and Greece. Greece's prime minister, who faces elections in July, was also more vocal than usual about supporting Cyprus.

—and risks are heightened by the weaker leverage of diplomatic brokers

The situation initially seemed unlikely to calm down for a number of reasons. Turkey's president, Recep Tayyip Erdoğan, was probably already feeling vulnerable after his Justice and Development Party (AKP) lost the Istanbul election on 23 June. Then on 25 June the US Senate Foreign Relations Committee approved the "Menendez bill" that prevents the transfer of US-made F-35 aircraft to Turkey if it goes ahead with the purchase of S-400 missiles from Russia. The bill also alludes to sanctions on Turkey. It also lifts the 1987 US arms embargo on Cyprus (subject, it seems, to the government denying access to Russian vessels supporting Syria's president, Bashar Al Assad) and authorizes energy cooperation among Cyprus, Greece, Israel and the US. Any imposition of sanctions could prompt Turkey to look for a "soft target". Elections in Greece are historically accompanied by Turkey "testing" the new government with maritime or airspace incursions. While Mr Tsipras has made it clear that Greece has the military capacity to respond to Turkey, Cyprus does not have a navy, which makes it far more vulnerable. It also seemed that the risk of a military clash in the Aegean or Eastern Mediterranean was increased by the absence of diplomatic brokers. The US has been unable to play its historical role as the diplomat in the background, owing to tensions over the S-400 missiles from Russia. However, this seems to have changed, after a meeting between Mr Erdogan and Mr Trump, in which it appeared that Mr Trump had decided not to impose sanctions on Turkey for the S-400 purchase. Nevertheless, US-Turkey relations remain fragile. The UK's diplomatic role is also currently weak, as it is effectively without a government until a new prime minister is appointed in late July. The UN appears to have been sidelined in efforts to solve or simply "end" the Cyprus problem (see below) and the EU is seen by Turkey as having clearly picked sides. Indeed, references to foreign troops in the conclusions (paragraph 18) of the MED7 summit of southern EU countries on 14 June were a replica of Greek Cypriot positions on a settlement of the Cyprus problem.

In addition to more drilling around Cyprus and potentially increasing the flow of refugees and migrants to the EU, Turkey could take action against countries whose courts that act on the 25 arrest warrants. In June, a retired admiral proposed six measures if any Turkish national is arrested. They are: 1) expelling ambassadors; 2) closing the crossing points across the Green Line in Cyprus (which would take the situation back to before April 2003, when Greek Cypriots and Turkish Cypriots could only meet abroad or in the UN-monitored village of Pyla); 3) drilling inside blocks licensed by the Republic of Cyprus; 4) enhanced inspections of ships flying the Republic of Cyprus flag in the Turkish straits; 5) tightening restrictions on ships managed in, or flying the flag of, the Republic of Cyprus to exclude yachts and passenger ships; and 6) arresting Greek Cypriot fishermen who come close to the Karpas peninsula. It is not clear whether his proposals have been adopted by the Turkish government but they provide a taste of what might come.

Figure 1



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Private meetings and moves on Varosha may suggest a move to "normalize" the division—

Unless EU leaders privately asked Greek Cypriots to commit to a resumption of UN-facilitated negotiations in exchange for considering targeted sanctions against Turkey, the latest developments seem unlikely to lead to a settlement of the Cyprus problem under a united, power-sharing umbrella. Instead, there are signs of moves on both sides to "normalize" the current division. For example, on 14 June there was an exchange of prisoners who were wanted on suspicion of murder by authorities on the other side. While we understand that transfers have taken place before, this was the first time that it was done in such a public manner. Then on 18 June, the prime minister of the unrecognized Turkish Republic of Northern Cyprus (TRNC), Ersin Tatar, made a statement after a cabinet meeting that was taken to mean that the Turkish Cypriot administration had decided to open up the fenced-off district of Varosha to its former inhabitants. A later statement by the Turkish Cypriot foreign minister, Kudret Özersay, toned this down, saying that they had merely taken the decision to send in Turkish Cypriot experts to make an inventory of the area. Nevertheless, other remarks by Mr Tatar suggest that the plan is eventually to open the area under Turkish Cypriot administration.

Varosha, which is currently a Turkish military zone, is significant, as it was an area largely inhabited by Greek Cypriots who fled during the second advance of Turkish troops in August 1974. UN Security Council Resolution 550 of 1984 called on Turkey not to settle the area and asked for it to be handed over to UN administration—something that never took place. Various attempts over the years for a package deal, in which Varosha would be returned to its original inhabitants, the unrecognized airport of Ercan (Tymbou) and sea port of Famagusta in northern Cyprus would be opened to international traffic, and ships flying the Republic of Cyprus flag would be allowed to dock in Turkish ports, have failed. This kind of package deal is often proposed by those who support either a "step-by-step" settlement of the Cyprus problem, or by those who promote it as a final destination in the context of a two-state solution.

—and we now believe a two-state solution is more likely than a federal settlement—

Reasons to suspect it could be laying the ground for a two-state solution is that the prisoner exchange and statements about Varosha came after a private dinner between the president of the Republic of Cyprus and Greek Cypriot leader, Nicos Anastasiades, and Mr Ozersay, details of which emerged on 16 June. A meeting between a sitting president of the Republic of Cyprus and a member of the TRNC administration that only Turkey recognizes would have been anathema a few years ago, especially without the facilitation of the UN. While Mr Anastasiades insists that the dinner was merely a social one, Mr Ozersay reinforced suspicions that the prisoner swap was connected to it, by saying that such dialogues "are often more constructive". It also became clear that Mr Ozersay had not informed the president of the TRNC and Turkish Cypriot leader, Mustafa Akıncı, who is technically the only interlocutor on the Cyprus problem, both under the TRNC constitution and in the eyes of the UN and the rest of the international community, and the only prominent Turkish Cypriot politician who remains openly in favour of a federal settlement.

Further question-marks about the two men's underlying intentions come when rumours resurfaced that Mr Anastasiades had asked Turkey's foreign minister, Mevlüt Çavuşoğlu, to help him pursue a two-state solution immediately after the collapse of talks in Crans Montana in July 2017, and Mr Ozersay's frequent statements to indicate that he no longer believes in federal or power-sharing models. Although Mr Anastasiades is now calling for a return to the negotiating table if Turkish drill ships leave, this is more likely to be related to the forthcoming six-monthly decision by the UN Security Council on whether to renew the mandate of the UN Peacekeeping Force in Cyprus (UNFICYP) and a desire to be seen as willing to negotiate, after a long period in which his rhetoric had hardened. It seems unlikely that an undeclared dinner was preparing the ground for a federal settlement. Rather, we believe that the heightened tensions over natural gas, combined with private meetings away from UN auspices, make a formal partition of the island more likely now than any federal, power-sharing solution.

—although it is also likely that plans have not been thought through

If two states is the long-term aim for some key players, it is also possible that plans have not been thought through. Mr Tatar's stated preference is for "two states under an EU roof". However, even in the case of a velvet divorce, the TRNC is highly unlikely to gain international recognition, let alone EU membership. EU members are currently reluctant to grant even candidate status to any countries (most recently North Macedonia and Albania). Spain is also deeply resistant to giving seceding states an easy route into the EU. Following the events in Crimea, countries bordering Russia are also likely to be very wary of creating what might be seen as a precedent for invading a country and eventually recognizing the invaded part as a separate state. For similar reasons, membership of the European Economic Area (EEA), which also requires unanimity among members, is also unlikely. These obstacles do not mean that two states will not be pursued. Rather, it could mean that the political leadership might not be fully honest with the public about the true consequences. If there is a negotiated two-state solution but the TRNC gains neither full recognition nor EU membership status, it is likely to remain dependent on Turkey for budgetary support and investment. This raises the risk of the full eventual absorption of northern Cyprus into Turkey.

Differences over maritime delineation, updated June 2019

Turkey's activities in the exclusive economic zones (EEZ) relate to two separate issues: defending what it sees as its own continental shelf claims west of the island and defending the rights of Turkish Cypriots. As regards the continental shelf, when the EEZ agreement between the Republic of Cyprus (RoC) and Egypt was signed in 2003, Turkey lodged a complaint with the UN saying that delimitation west of longitude 32.16.18 also affects its "ab initio legal and sovereign rights". As regards the EEZ, the Turkish Cypriots have issued their own licences to the Turkish Petroleum Corporation (TPAO), covering perhaps 40% of the blocks licensed by the RoC, arguing that, since the Greek Cypriots are unilaterally exploiting a resource that belongs to both communities, they will do the same. Turkey's statements about the area it says is its own continental shelf (typically saying it "will use all means necessary") are more forthright than statements about the areas in which the Turkish Cypriots have issued licences (typically "defend their rights and interests"), and suggest that Turkey would use military force in those areas. Turkey's president, Recep Tayyip Erdoğan, hinted at military action in the Eastern Mediterranean and/or the Aegean on 9 May, when he told cadets to "give a response of steel to any threat to an inch of our borders but also beyond our borders".

The differences between over maritime delineation therefore relate both to the continental shelf and exclusive economic zones (EEZs). The legal framework involves the 1982 United Nations Convention on the Law of the Sea (UNCLOS) and what is known as customary international law. Cyprus and the European Union are signatories to UNCLOS, which formally defined EEZs. Turkey, Israel and Syria are not signatories, while Egypt signed UNCLOS in 1995 but has not ratified it. The US is also not a signatory. However, Israel (in delineating its EEZ), Turkey (in the Black Sea) and Egypt (in signing the EEZ with Cyprus in 2003) have made use of some UNCLOS provisions—in Turkey's case, using the UNCLOS provisions that it considers to be part of customary international law. When it comes to legal redress against Turkey's actions, the RoC has at least five challenges.

1. States that are not signatories to UNCLOS are not bound by its provisions, except where those provisions are customary international law. There are differing views among international lawyers about which of the EEZ provisions of UNCLOS should be considered as customary international

law. Turkey's persistent objections to the RoC's EEZ activities are intended to prevent the EEZ provisions as a package from being considered as customary international law.

2. When states deposit bilateral treaties or coordinates on maritime delimitation with the UN, their publication by the UN does not afford them any legal status beyond that which they already enjoy. The UN is simply the depository. The UN Secretariat does not take a position when states have differences on maritime delimitation, but rather encourages states to resolve their differences in accordance with international law. Paths to resolution include arbitration or judicial settlement. With respect to the Aegean, Turkey has always rejected the court route, although in a letter sent in May to the EU and permanent members of the UN Security Council about their responses to the drill ship off Cyprus, Turkey foreign minister, Mevlüt Çavuşoğlu, referred to the option of arbitration or international courts. There is a little-publicized potential opening for future negotiations, however, as the text of the Cyprus-Egypt EEZ agreement says that certain coordinates could be "reviewed and/or extended" in future.

3. If the continental shelf issue ever did go to court, both UNCLOS and customary international law are a little vague when it comes to how states with "opposite or adjacent coasts" should delimit either their continental shelf (Article 83(1)) or their EEZ (Article 74(1)). Both articles simply state that the delimitation "shall be effected by agreement on the basis of international law, as referred to in Article 38 of the Statute of the International Court of Justice, in order to achieve an equitable solution." The RoC uses the median line as a basis line, while Turkey argues that, because of its long coastline, it ought to be entitled under equitable principles to a larger area.

4. The area of a state's continental shelf or EEZ that lies beyond the internal waters and the territorial sea is not part of a state's sovereign *territory*, although states do enjoy sovereign *rights* in these areas. Drilling in the continental shelf or EEZ without the authorization of the coastal state would therefore be a violation of the *sovereign rights* of the state but might not be considered as a violation of *sovereignty* as such.

5. As noted above, Turkey is not a signatory to UNCLOS, therefore only the parts of UNCLOS that are customary international law are binding on it. As regards delimitation of both the continental shelf (Article 83(3)) and the EEZ (Article 74(3)), UNCLOS states, identically in both paragraphs, "[p]ending agreement as provided for in paragraph 1, the States concerned, in a spirit of understanding and cooperation, shall make every effort to enter into provisional arrangements of a practical nature and, during this transitional period, not to jeopardize or hamper the reaching of the final agreement. Such arrangements shall be without prejudice to the final delimitation". These articles imply that neither country should drill in the continental shelf area over which there is no agreement, and indeed no companies licensed by the RoC have ever drilled in this area. If Turkey does drill and if the issue ever goes to court, the question will be whether the provision of UNCLOS calling on states not to hamper a final agreement will be considered as part of customary international law, and therefore binding on Turkey.

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A deal has been reached with the Aphrodite consortium—

On 5 June the government announced that it had reached agreement with the partners in the Aphrodite reserve (Noble Energy, Delek Holdings and Royal Dutch Shell) over the terms of the Product Sharing Agreement (PSA) for the exploitation of the Aphrodite natural gas field in Block 12. Aphrodite was discovered in late 2011 and will be Cyprus' first natural gas deposit to be exploited. The energy minister, George Lakkotrypis, said that the government expected to finalize the development and production plan in July. The revised contract provides for strict deadlines. This includes a target of late 2024/early 2025 for natural gas to start flowing to the Idku liquefied natural gas (LNG) terminal in Egypt. If the consortium fails to deliver, then the government has the right to demand that the companies relinquish the gas reserve. The third confirmatory drilling (appraisal well) is due to take place in the second half of 2020.

—with disagreements about how much it is worth—

The deal involved raising the consortium's share in net revenues to 42.9% from what was reportedly 35.5% previously. According to media reports, the consortium had initially sought a 50% share. Mr Lakkotrypis said that deal was worth around $9.5bn over 18 years to the government, depending on the international price of oil. The $9.5bn estimate is based on reserves of 4.1 trillion cubic feet (tcf) and an average price of oil of $70 per barrel. (Many natural gas contracts are still linked to the price of oil, although this is gradually beginning to change.) The price of $70/barrel happens to be just above the average price of Brent crude in the 12 months between June 2018 and May 2019. According to media reports, the project would not be viable if the oil price fell below $60/barrel. There are a large number of variables which will affect the government's final take, including costs of well development, the pipeline to Idku, liquefaction, transport and so on. Two key variables are the gas sales price and the amount of recoverable reserves. The energy analyst, Charles Ellinas, has contested the government's $9.5bn estimate, largely because he disputes that 4.1 tcf is the recoverable amount.

Table 2

Results of Sapienta gas model		
Scenario 1: recoverable reserves of 4.1 tcf		
End-sales gas price at $/mmbtu (a)	$7	$6
Sales revenue ($ million)	$27,730	$23,769
Exploration, production, pipeline operational, liquefaction, transport, regasification costs	$10,536	$10,338
Net revenue from production and sales	$17,193	$13,430
Revenue to consortium (at 42.9%)	$7,376	$5,762
Revenue to government	**$9,817**	**$7,669**
per year for 18 years	$545	$426
Scenario 2: recoverable reserves of 3.1 tcf		
End-sales gas price at $/mmbtu (a)	$7	$6
Sales revenue ($ million)	$20,967	$17,971
Exploration, production, pipeline operational, liquefaction, transport, regasification, tariff costs	$10,198	$10,049
Net revenue from production and sales	$10,768	$7,923
Revenue to consortium (at 42.9%)	$4,620	$3,399
Revenue to government	**$6,149**	**$4,524**
per year for 18 years	$342	$251

(a) Average spot Dutch LNG price was $7.1 in June 2018-May 2019. Average oil price was $69.6/barrel in the same period.

Source: Sapienta gas model based on a range of industry sources for costs.

—as price and recoverable volumes will determine the final revenue

To test the various assumptions, we have re-run our gas revenue model (see Table 2). At the high end, we assume that the average gas price will be $7/mmbtu. This was the average LNG spot price for Dutch day-ahead contracts during the same period in which Brent crude oil averaged $70/barrel. It could therefore be close to the government's assumptions for the gas price. At the low end, we assume that $60/barrel (the minimum price for the consortium) is equivalent to $6/mmbtu.

Under a scenario of 4.1 tcf recoverable reserves, our model suggests that the government earns $9.8bn if prices are $7/mmbtu—a little higher than the government's estimates. It earns $7.7bn if prices are only $6/mmbtu (assumed to be equivalent to oil at $60/barrel). Under the second scenario, if there are only 3.1 tcf recoverable reserves, the government earns $6.1bn at $7/mmbtu and $4.5bn at $6/mmbtu. Even if the government only earns $4.5bn (€4bn), this would be around €220m per year and would help reduce the debt/GDP ratio. Under the National Investment Fund law (the law on the sovereign wealth fund), natural gas revenues must first be used to pay off public debt until the debt/GDP ratio reaches 60%.

Government approves changes to other existing exploration licences

Meanwhile, Chrysanthos Manoli of *Politis* reported on 20 June that the Council of Ministers has approved amendments to the law on natural gas licences that would allow them to be extended beyond their expiry date and without any limits on the number of years of renewal. The exploration licences for Blocks 2, 3, 9 (held by ENI and Kogas) and 11 (held jointly by Total and ENI), expire in January 2020 and under the current law, companies are obliged to relinquish licensed blocks to the government if they have not completed their drilling programmes by then. The aim is to present the bill to the parliament in the coming weeks. It is possible that the desire for amendments reflects a reluctance by companies to carry out exploratory activity when Turkey is objecting so forcefully to drilling (see Political analysis and outlook). If this is the case, then it means that efforts to exploit natural gas are more vulnerable than the government publicly admits. A second reason could be the award by the Greek government on 27 June of gas exploration licences for offshore Crete to Total, ExxonMobil and Hellenic Petroleum, and concerns that the focus of exploration will shift to Greece if the companies are not given incentives to stay. A third reason could be that it is part of the negotiating process over Block 7 and the government's related desire to see Total take stakes in all of the blocks currently held by solely ENI (Blocks 2, 3 and 9). One motive for bringing in Total is the belief that France would be more willing to defend French company interests than Italy. In February 2018 the Turkish navy prevented ENI from drilling in Block 3. However, Turkey did not prevent drilling a month earlier in Block 6 (held jointly by ENI-Total). As regards Block 7, Mr Lakkotrypis had announced at the end of May that the government was very close to an agreement with the Total-ENI consortium over this block but agreement has yet to be reached. This was at a time when the government needed a communications "win", following Fatih's arrival in the Eastern Mediterranean. It could therefore explain the hurry in which the minister announced an agreement that had not been finalized.

Cyprus' LNG import further delayed

DEFA has issued a request for expressions of interest for the supply of LNG to the planned floating LNG import terminal, while the submission date for the tender for the LNG import infrastructure has been extended once more to 12 July 2019. The persistent delays have made it highly unlikely that the new LNG import terminal will be completed by the targeted date of 30 November 2020, or that LNG can be supplied by the target date of 2021. They even raise questions why the government continues to pursue a project that has failed multiple times to secure suppliers and which will struggle to reduce the high cost of electricity for businesses. As regards timing, the government has indirectly admitted that it will indeed not meet the latest deadlines. *Politis* newspaper reported that in a supplementary budget that will include €26m for the completion of the import infrastructure, a note says that the infrastructure works will be completed in 2022. The total cost of the project is expected to be €253m, of which around €101m will be funded by the European Union.

A deputy ministry for innovation is planned—

The president, Nicos Anastasiades, announced on 26 June that a bill to establish a Deputy Ministry for Digital Strategy, Research and Innovation will be put to the Council of Ministers shortly. This was somewhat of a surprise, since the next deputy ministry on the government's list had been a Deputy Ministry for Growth and Competitiveness. In an effort to get round constitutional barriers relating to the Cyprus problem and to reduce the workload of the large Ministries of Transport, Communications and Works, and Commerce, Energy, Industry and Tourism, the government established a Deputy Ministry of Shipping in March 2018 and a Deputy Ministry of Tourism in January 2019.

—while municipal reform is back on the table

After a long pause in attempts to reform the municipalities, deliberations between the interior minister, Constantinos Petrides, and representatives of the Union of Municipalities resumed on 21 June to discuss the additional responsibilities that the Union of Municipalities is seeking to acquire in the context of the reform that will reduce the number of municipalities while giving them more autonomy. Divisions among municipalities are also coming to the fore, with clashes between the mayor of Ayia Napa, Yiannis Karousos, and the Larnaca mayor and head of the Union of Municipalities, Andreas Vyras. Vested interests and the perceived significance of the reduction in the number of municipalities is clearly hindering the process. Many local government officials appear reluctant to let go of the privileges involved in political leadership at that level, and say that they are concerned that the clustering will diminish their value and autonomy. As things stand, it is very unlikely that the bill will be put to vote in the parliament before the summer break. In addition, if the rumours of an autumn cabinet reshuffle that would involve the transfer of Mr Petrides to another ministry are true, this could make it more difficult for the speedy consideration of the reform.

National Health System launches but specialists and hospitals remain an issue

The new universal, single-insurer National Health System (GESY) rolled out as planned with outpatient care on 1 June 2019, with more than 600,000 patients, or around 70% of the population, having joined by 13 June. A number of problems emerged with the registration of non-EU nationals, forcing the Council of Ministers (cabinet) to take temporary measures to provide cover for these people, and there were issues with software used by family doctors. While the launch was a success, GESY's viability is set to go through a major testing period in a setting in which many still hope that it will collapse. One issue is that the number of private specialists is still low. Maria Kithreotou, an official of the Health Insurance Organization (HIO), stated on 28 June that 700 specialists had joined GESY, but only 200 of those had come from the private sector. Rumours that there will be a switch to a multi-payer system (possibly spread by those who favour it), in addition to caution about the new system, appear to be some of the reasons for the low number of specialists from private practice for the time being.

The private hospitals' association (PASIN) is also still against GESY. The government has tried to lure private by announcing on 26 June a series of town planning incentives for the creation, expansion and upgrade of private hospitals. Since private hospitals account for half of all hospital beds, there will be a *de facto* multi-payer system on the ground if the government's attempt to convince hospitals fails.

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Revenue increase is strong despite weak growth in VAT receipts—

General government revenue rose year on year by 8.1% in the first four months of the year, despite value-added tax (VAT) receipts rising by only 1.2%. The overall increase in revenue supported an expansion of both the general government budget surplus, to €547m, from €427m in the same period of 2018, and the primary surplus (balance excluding interest payments), which rose to €641m, from €520m in January-April 2018.

Table 3

General government accounts (ESA2010)
€ million unless otherwise stated

	Jan-Dec 2018	Jan-Apr 2018	Jan-Apr 2019	% change year on year
Total revenue	**8,226**	**2,516**	**2,737**	**8.8**
VAT on products & services	2,089	683	691	1.2
Personal income tax: public sector	156	46	52	14.2
Personal income tax: private sector	291	95	102	7.3
Defence contribution (a)	305	146	170	16.3
Total corporate tax	803	89	121	35.2
Social security contributions	1,843	597	651	9.1
Property income	133	48	83	74.4
Revenue classified as "other"	1,029	276	340	23.5
Total expenditure	**9,215**	**2,089**	**2,190**	**4.8**
Compensation of employees	2,456	739	1,004	35.9
of which: public-sector pensions	543	167	173	3.5
Intermediate consumption	819	181	217	19.7
Social payments	2,709	819	831	1.4
Pensions	1,319	401	416	3.7
Unemployment	76	41	46	13.5
Other social transfers	1,315	378	369	-2.3
Interest	515	93	94	1.5
Gross fixed capital formation	1,095	70	43	-38.1
Expenditure classified as "other"	1,561	176	203	15.6
General government balance	**-990**	**427**	**547**	**28.2**
% of GDP	-4.8	-	-	-
Primary balance	**-475**	**520**	**641**	**23.4**
% of GDP	-2.3	-	-	-

(a) Mainly dividends and interest income.

Source: Cystat.

—while compensation of employees rose the most on the expenditure side

In absolute terms, the highest increases in receipts were for "revenue classified as other" (€65m), social security (€54m) and property income (€35m). The expansion of social security revenue is largely influenced by the increase from March 2019 of social insurance contribution rates. As for "revenue classified as other", in our April report we had assumed that it was coming from KEDIPES, the property arm of the SEPIDES asset management company that in September 2018 took over €8.3bn of assets transferred from the co-op, including €7bn in non-performing loans. However, the finance ministry has since informed us that "revenue classified as other" is primarily EU grants and dividends from state-owned enterprises. KEDIPES inflows and outflows are due to be recorded in the June accounts, as will revenue from the insurance contributions introduced in March for the new National Health System (GESY). On the expenditure side, the biggest increase in absolute terms was the rise in compensation of employees (€265m). This largely relates to the gradual removal of measures implemented in the 2012-13 crisis. "Expenditure classified as other", which reached €1.6bn in 2018 as a by-product of the co-op closure, rose in the first four months of 2019 by 15.6% or €27m, largely as a result of an increase in contributions to the EU.

State asset management company reports positive net cashflows

When the KEDIPES results appear in the general government accounts, they can be expected to boost the overall surplus. KEDIPES reported cash inflows of €79m of in the first quarter of 2019 and outflows of €38.6m, implying net positive cashflow of €40.4m. Since operations began in September 2018, inflows amounted to €180.3m and outflows to €128.6m, implying a net positive cashflow of €51.7m. Under the agreement with the EU authorities for the closure of the co-op, net cash surpluses must be used to repay state aid. Since operations began, income from loans (€102.6m) has been higher than income from property management and services (€77.6m).

Table 4

KEDIPES cash inflows
€ million

	Since 1 Sep 2018	**2018Q4(a)**	**2019Q1**
Loans and advances	102.6	*53.3*	49.3
Non-peforming loans	65.3	*28.1*	37.2
Performing loans	37.3	*25.2*	12.1
Property management and services	77.6	*47.9*	29.7
Property sales	62.3	*37.4*	24.9
Rental income	2.4	*1.3*	1.1
Services & other receipts	12.9	*9.2*	3.7
Total cash inflows	**180.3**	***101.3***	**79.0**

(a) Data inferred.
Source: KEDIPES; Sapienta Economics inferences in italics.

Table 5

Sapienta Economics budget and debt forecasts (ESA 2010)
€ m unless otherwise indicated

	2018	**2019**	**2020**	**2021**	**2022**	**2023**
General government revenue	8,226	*8,717*	*9,251*	*9,783*	*10,334*	*10,926*
% change	7.7	*6.0*	*6.1*	*5.8*	*5.6*	*5.7*
General government expenditure inc. one-offs (a)	9,215	*8,957*	*8,583*	*9,137*	*9,752*	*10,408*
% change	26.3	*-2.8*	*-4.2*	*6.5*	*6.7*	*6.7*
General government budget balance inc. one-offs	-990	*-240*	*668*	*646*	*582*	*518*
% of GDP	-4.8	*-1.1*	*3.0*	*2.7*	*2.4*	*2.0*
Primary balance inc. one-offs	-475	*249*	*1,118*	*1,046*	*936*	*817*
% of GDP	-2.3	*1.1*	*4.9*	*4.4*	*3.8*	*3.2*
One-off expenditure (a)	1,662	*915.0*	-	-	-	-
Gross government debt inc. one-offs	21,258	*21,420*	*21,039*	*20,808*	*19,912*	*18,994*
% of GDP	102.5	*99.0*	*93.0*	*88.3*	*81.2*	*74.4*
Memorandum item: balances excluding one-offs						
General government expenditure exc. one-offs	9,215	*8,957*	*8,583*	*9,137*	*9,752*	*10,408*
% change	3.6	*6.5*	*6.7*	*6.5*	*6.7*	*6.7*
General government balance exc. one-offs	672	*675*	*668*	*646*	*582*	*518*
% of GDP	3.2	*3.1*	*3.0*	*2.7*	*2.4*	*2.0*
Primary balance exc. one-offs	1,188	*1,164*	*1,118*	*1,046*	*936*	*817*
% of GDP	5.7	*5.4*	*4.9*	*4.4*	*3.8*	*3.2*

(a) €1.6bn fiscal impact of co-op deal (2018) & assumed pay reimbursements (2019).
Sources: Ministry of Finance; IMF; Sapienta Economics estimates and forecasts in italics.

Legacy debt to the Central Bank of Cyprus has been paid off

The fiscal accounts for April show that the government paid off the remainder of its legacy debt to the Central Bank of Cyprus in November 2018. This was debt acquired before Cyprus joined the EU, after which central bank borrowing was no longer permitted. After a period of gradual cuts, debt to the central bank had reached €1.1bn in October 2017 but dropped to €510.9m after a large repayment in November 2017. The amount continued to fall gradually until the remaining €483.4m was paid off in November 2018. As we noted in our May report, movements in cash balances with the central bank suggest that the government has also paid off the €1.57bn that remained of the €2.5bn Russian bilateral loan. However, at present this is not showing in the fiscal accounts. Given the strong fiscal performance in the first four months of the year, we still expect public debt to fall back below 100% of GDP in 2019, assuming that there are not external shocks (see Macroeconomic trends and forecast).

New Turkish Cypriot coalition seeks to transfer budgetary control—

Changes to fiscal policy formation may be under way in northern Cyprus after the formation on 22 May of the new Turkish Cypriot coalition between the National Unity Party (UBP) and the People's Party (HP). The new prime minister of the unrecognized Turkish Republic of Northern Cyprus (TRNC), Ersin Tatar, who is an accountant by training, is seeking to transfer control over the budget from the finance ministry to the prime minister's office. Opposition parties have said that it would turn the finance ministry functions into a simply rubber-stamping exercise and that is unconstitutional. Mr Tatar has already moved the EU relations office to the prime ministry. Both the finance ministry and prime minister positions are held by Mr Tatar's UBP, therefore it is not clear why the attempt has been made. Kudret Özersay, the leader of HP, is both the foreign minister and deputy prime minister, therefore the move could be a way of giving more say over finances to HP. The move could also be related to the idea mooted by UBP to turn northern Cyprus into a presidential system, like that of Turkey and the Republic of Cyprus. This is partly to do with differences between the coalition and the president and Turkish Cypriot leader, Mustafa Akinci, over approaches to the Cyprus problem, where the current constitution grants the role of the Cyprus problem exclusively to the TRNC president.

—Turkish funds may still be some months away

One of the first tasks of the new coalition is to agree the 2019-21 economic protocol with the government of Turkey, which was not signed under the previous administration. The protocol involves funds from Turkey in the form of direct grants (mainly for infrastructure) and loans (direct budget support). As noted in our May issue, apart from a couple of grants and credits from Turkey to pay for contractors in 2018, funding from Turkey had dried up under the previous administration, leaving the coalition to implement *ad hoc* measures such as taking dividends in advance from the Turkish Cypriot central bank as well as payments from the operator of Ercan/Tymbou airport. While the new administration has better relations with Turkey than the one led by the Republican Turkish Party (CTP), Turkey's internal distractions, including changes brought about by the new presidential system, mean that it may yet take a few months before the protocol is finalized. This raises the risk of a budget crisis later in the year.

Another reason for a likely delay is differences between the Turkish Cypriot administration and Turkey over who funds the planned electricity cable. We understand that Turkey wants to fund half of it but the administration is arguing that it needs to be fully funded by Turkey. The cable is due to have a capacity of 800 megawatts (mw), and will probably run 90 km from Akkuyu in southern Turkey (where the Russian-built nuclear power plant is due to start operations in 2023) to the Tecnecik power plant in Kyrenia. Peak demand in northern Cyprus is only 339 mw, and the interconnection between the north and south has now been declared permanent, therefore the new capacity could support the electricity system in the south. In April this year, the Electricity Authority of Cyprus (EAC) in the southern part of the island took 100 mw of electricity from KIB-TEK, the primary supplier in the north, after a blackout at the main power station of Vasilikos.

Economic policy includes focus on higher education and tourism

In his speech to the Turkish Cypriot parliament shortly after assuming his position, Mr Tatar outlined the key policy areas for the new administration. Economic policy measures included a feasibility study for the electricity cable; creating an Under-Secretariat for Higher Education; upgrading the marina in Famagusta; transforming the unused military airport at Geçitkale for civilian use; tackling money-laundering; and addressing human rights abuses in casinos. The latter two are probably under pressure from the US. Higher education is a priority because it now generates more foreign exchange than tourism, earning $999.9m in 2016 compared with $739.4m for tourism according to the most recent statistics. In the academic year 2016/17 there were 95,531 students, of which 55.8% were from Turkey, 28.8% were from other countries and 15.3% were locals. By comparison, in the south there were 45,263 students in the same academic year, of which 49.7% were students from abroad.

Table 6

Turkish Cypriot central budget outturns
₺ '000

	2017 Year	2018 Year	% change	2018 Jan-Apr	2019 Jan-Apr	% change
Total revenue, of which:	5,102	5,502	7.8	1,012	1,417	40.0
Taxes	3,076	3,799	23.5	733	898	22.5
Grants from Turkey (a)	706	447	-36.7	0	0	0.0
Credit from Turkey (b)	225	41	-81.8	0	0	0.0
Total expenditure, of which:	4,995	5,452	9.1	941	1,437	52.6
Personnel expenses	1,571	1,873	19.2	373	501	34.3
Pensions	653	777	19.0	168	229	36.3
Balance inferred	**107**	**50**	-	**71**	**-20**	-

(a) Grants for infrastructure, defence and the real sector.
(b) Budget support.
Source: KKTC Maliye Bakanlığı.

Banking sector Next section Previous section

Loan-stock drops on the back of both NPL deals but also falling mortgages—

The total stock of loans in the banking system continued to decline in the first quarter, dropping year on year by €10.4bn (21.3%) to €38.3bn. Much of this decline relates to the €7bn of loans that were transferred the state-run SEPIDES asset management company in September 2018. Another €2.7bn relates to the BOC "Helix" loan-sale deal. The decline from these deals was partly offset by new lending. New loans are likely to have been in the corporate sector, as data on mortgages show a decline. After a fall of 15.5% for the whole of 2018, the value of new mortgages declined by another 6.5% year on year in the first quarter of 2019. The absolute number of new mortgages dropped at a slower pace—by 3.5% in 2018 and by 6.5% in the first quarter of 2019. This suggests that there is now a shift to either smaller/cheaper housing units or to lower loan-to-value ratios.

Table 7

Change in total loan stock
% change over same period of previous year; end-period

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Non-financial corporations	-13.4	-10.1	-13.3	-12.4	-3.9
Households	-8.2	-8.6	-31.6	-31.3	-28.9
Consumer credit	-10.1	-9.2	-26.8	-27.3	-22.6
Housing loans	-5.7	-5.9	-22.5	-22.2	-20.7
Other household lending	-12.2	-13.1	-50.3	-49.8	-47.1
Total non-government resident loans	-11.6	-14.1	-24.3	-22.9	-20.5
Total loans inc others	**-11.5**	**-14.0**	**-24.6**	**-23.7**	**-21.3**
Total loans inc others (€ million)	48,667	46,706	39,650	39,202	38,284
Memorandum items (quarterly averages)					
New mortgages (% change in value)	-23.5	5.6	-8.6	-32.8	-6.5
New mortgages (€ million)	689	886	886	669	644

Sources: Central Bank of Cyprus; Department of Lands and Surveys.

—and despite lower interest rates

The apparent weakness in housing loans comes despite a decline in borrowing costs. Interest rates on new housing loans dropped to 2.2% on average in the first quarter of 2019, from 2.6% in the same period of 2018. These rates are still higher than the eurozone average, where the equivalent rate was 1.6% in January.

Table 8

Bank lending rates
%, new business unless otherwise indicated

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Households, floating rate & up to 1 year fixed					
Consumer credit	4.1	4.0	3.7	3.3	3.2
Housing loans	2.6	2.4	2.4	2.2	2.2
Other	3.2	3.2	3.3	2.8	2.4
Non-financial corporations					
Overdrafts	4.3	4.2	4.1	4.0	3.8
Over €1m, floating rate & up to 1 year fix	3.3	3.2	3.3	3.3	3.1
Under €1m, floating rate & up to 1 year fix	3.7	3.6	3.5	3.5	3.4

Source: Central Bank of Cyprus.

Central Bank is due to restructure decision-making

The government has drafted a bill to restructure the decision-making processes at the Central Bank of Cyprus. The main aim is to shift the concentration of power from the governor to the board of directors. The new decision-making body will comprise a governor, deputy governor and two executive directors. At present there is no deputy governor position because, under the Republic of Cyprus constitution, this is supposed to be held by a Turkish Cypriot. The new law will therefore involve changes to the constitution. According to media reports, the European Central Bank has welcomed a change in the procedures for dismissing board members and bolstering their independence. Calls for a change in decision-making structures have been made since at least the financial crisis of 2013. The previous three governors (Anastasios Orphanides, Panicos

Demetriades and Chrystalla Georghadji) clashed with both the board and the Republic of Cyprus president, therefore the new rules should reduce the risk conflicts based on personality differences.

Major Japanese acquisition should be a boost for the financial services sector

Japan's Trust Bank (Mitsubishi UFJ Trust and Banking Corporation), a subsidiary of Mitsubishi UFJ Financial Group (MUFG), announced on 9 June that it would be acquiring Point 9, a Cypriot-owned and operated financial services provider that serves international banks, asset managers and hedge funds in middle and back office functions such as post-trade execution, processing and reporting. MUFG is a very large bank, with assets of ¥311 trillion (€2.5 trillion) in the fiscal year ending March 2019. We understand that the new acquisition will help to speed up functions for a large bank that has generally grown by acquisition. According to media reports, Trust Bank was initially reluctant to house operations in Cyprus, given the country's historical reputation for money-laundering. However, it was eventually persuaded to do so. The move is therefore a vote of confidence in Cyprus generally and is expected to lead to other larger operators basing themselves in Cyprus. This, in turn will put pressure on the Cyprus Securities and Exchange Commission (CySEC) to expand resources and capacity. Anecdotally, there are complaints that CySEC is primarily geared up for small, privately owned funds focused on real estate, rather than larger more sophisticated investors.

Hellenic Bank reports another profit in the first quarter

Hellenic Bank reported another post-tax profit, of €14.8m, in the first quarter, following a net profit of 24.1m in the fourth quarter of 2018. We shall examine the results in more detail in our July issue.

ESTIA loan-subsidy scheme is approved

The government loan-subsidy scheme known as ESTIA received the approval of the Council of Ministers (cabinet) on 26 June. Customers will begin applying in September and the scheme should start operating by the end of the year. Eligibility for the scheme is very generous as regards assets (see box), which creates a risk of moral hazard—sending the message that the government will always bail out bad debtors. The government counters that the scheme only covers some 13,000 accounts and was a necessary element in stabilizing the banking sector.

The ESTIA government subsidy scheme, updated June 2019

Passed in July 2018, the ESTIA scheme is due to be launched in the second quarter of 2019. It will subsidize, and in some cases partly write off, the NPLs of individuals or companies whose loans are collateralized with primary residences. The scheme applies to loans in arrears for more than 90 days as of 30 September 2017. It was initially expected to cover around €3.4bn in NPLs and 13,070 accounts. BOC estimates that it has €870m of eligible loans, Hellenic Bank estimates €240m, while the former co-op was estimated to have had €1.3bn, much of which will now be transferred to the state asset management company, KEDIPES. Other banks account for the remainder.

To take part in the ESTIA scheme, banks must offer the scheme to all eligible customers.

The scheme incorporates contributions from both the banks (which we estimate at €895m) and the state (estimated by the government at €840m over 25 years). The government believes that the banks will be able to recover 70% of their loans through this scheme.

Under the scheme, where the value of the collateral is lower than the value of the loan, the banks will first cut the value of the loan to the value of the collateral and then extend maturities where appropriate. The government will pay one-third of the instalments due on the restructured loan (including accumulated arrears and penalties) via the Cyprus Land Development Corporation.

Borrowers will pay the remainder, estimated at 50% of the original value, over a period of up to 25 years. They will also pay reduced interest (the Euribor rate plus 2.5% up to a maximum of 3.5%). Since banks have already provisioned around 50% of their NPEs, a contribution of around 26% should not have a significant impact on capital ratios. Borrowers who fall back into arrears will no longer be eligible for the government subsidy.

Eligibility for the scheme is based on a combination of controversially generous income and asset criteria, which were altered in early November. Previously the scheme applied to households with gross income of €50,000. This has now been changed to: €20,000 for single persons; €35,000 for households with no dependants; €45,000 for households with one dependant; €50,000 for households with two dependants; €55,000 for households with three dependants; and €60,000 for households with four dependants.

The collateralized primary residence must still be worth less than €350,000 but the net value of all other assets has been reduced. Previously it was no more than 125% of the value of the primary residence. Now it must be no more than 80% of the value of the primary residence, with a cap of €250,000.

Borrowers must also contribute either 20% of the remainder of their assets, or deposits over €10,000 not already used as collateral (whichever is higher) to the NPL before restructuring takes place.

Turkish Cypriot banks increase profitability in 2018

Annual data for four of the five largest banks in northern Cyprus showed that profitability increased in 2018, no doubt thanks to increasing net interest margins as the Turkish lira declined (see Table 9). The return on assets (ROA) for CreditWest, the second largest bank with ₺3.2bn (€779m) in assets, rose to 1.94% in 2018 according to our calculations, compared with 1.64% in 2017. The ROA of Iktisat bank, with ₺2.1bn (€516m) in assets, rose to 1.99% from 1.46% in 2017. The ROA of the Vakiflar (Evfkav foundation) bank rose less sharply, to 0.18% in 2018 from 0.17% in 2017, while the ROA of the small and generally risk-averse Turk Bank rose to 0.75% in 2018 from 0.38% in 2017. By comparison, in 2018 the ROA for Hellenic Bank was 2.0% in 2018, while that of Bank of Cyprus was negative, at -0.48%. The largest bank, the Koop Merkez Bankası (the co-op), has not yet reported.

All four banks that reported results cut their already comparatively low non-performing loan ratios, despite an increase in absolute NPLs levels for all but Turk Bank. We understand that NPLs are reported on a standard 90 days past due (90+ DPD) basis and that the banks do not record unpaid instalments as revenue, therefore, with the exception of the Koop, the figures ought to be a fairly accurate representation of the true picture. The Koop has legacy NPLs from publicly owned institutions, which it does not report in its NPL figures.

The banks continued to hold more foreign-exchange deposits than they had issued in foreign-exchange loans. Turkish Cypriots suffered a severe banking crisis in 2001, which tends to encourage them to save in foreign currencies whenever they can afford to do so. However, the ratio of forex deposits to loans declined from a very high base, presumably as customers drew on foreign-exchange deposits to maintain consumption as the inflation rate soared. The impact of inflation is exacerbated by the fact that many items are priced in foreign currency. For example, rents and property sales are priced in sterling, while many big-ticket items are priced in euro.

Table 9

Top 5 Turkish Cypriot bank highlights, end-2018

TL million unless otherwise stated

	Turk Bankasi	Vakif-lar	Iktisat Bankasi	Credit-west	Koop Merkez (a)	Total top five
Total assets	1,310	1,334	2,124	3,209	5,411	13,388
of which gross loans	224	663	1,201	2,004	3,357	7,449
of which in TL	104	333	350	548	2,577	3,912
of which in FX	120	330	851	1,456	780	3,537
Total liabilities	742	968	2,214	3,303	5,411	12,636
of which customer deposits	1,034	1,152	1,873	2,766	4,862	11,686
of which deposits in TL	278	556	687	933	2,780	5,234
of which deposits in FX	756	595	1,186	1,833	2,081	6,452
FX deposits minus FX loans	636	266	335	377	1,301	2,915
Gross NPLs	5	100	86	99	92	382
NPL ratio (%)	0.0%	4.4%	4.1%	0.8%	1.3%	5.1%
Cumulative provisions	-5	-71	-37	-84	-53	-244
Coverage ratio ex Turk Bankasi (%)	100.0%	70.8%	42.6%	84.7%	56.9%	63.8%
Risk weighted assets	350	720	1,207	1,629	1,263	5,169
Estimated common equity tier 1 (CET1) (b)	*1*	*85*	*139*	*173*	*318*	*716*
Estimated CET1 ratio (%)	*26.1%*	*11.8%*	*11.5%*	*10.6%*	*25.2%*	*13.8%*
Return on assets	*0.75%*	*0.18%*	*1.99%*	*1.91%*	*0.30%*	*0.99%*

Note: these five banks accounted for 69% of assets in 2017.

(a) Koop is 2017 results. Koop NPLs exclude unserviced loans to public institutions.

(b) Paid-in capital, statutory & voluntary reserves & retained earnings.

Source: www.kktcmerkezbankasi.org; Sapienta estimates in italics.

Table 10

Key indicators of the Turkish Cypriot banking system

₺ million unless otherwise stated

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Gross loans	15,306	16,196	17,330	19,752	18,906
In Turkish lira	8,569	8,700	8,933	8,869	9,406
In foreign exchange	6,738	7,495	8,397	10,884	9,500
Deposits	21,098	22,353	24,131	28,163	26,442
In Turkish lira	9,582	9,733	9,843	10,183	10,605
In foreign exchange	11,516	12,620	14,288	17,980	15,837
NPLs (90+ days past due)	875	926	947	983	1,045
NPLs in € million equivalent	€192	€189	€177	€141	€172
NPL ratio (%)	5.7	5.7	5.5	5.0	5.5
Coverage ratio (%)	60.1	56.8	57.0	60.6	68.3
Memorandum item					
TRY per EUR (end-period)	4.5464	4.8976	5.3385	6.9650	6.0588

Note: does not include arrears of public organizations.

Source: KKTC Merkez Bankası.

Macroeconomic trends and forecast Next section Previous section

Slight downward revision to real GDP growth in the first quarter

The full national accounts revised down the estimate for real GDP growth in the first quarter of 2019. Real GDP is now reported to have expanded by a seasonally adjusted 3.4% year on year, compared with 3.5% in the flash estimate published in May. Compared with the previous quarter, real GDP growth in the first quarter was estimated at 0.7%, compared with 0.9% in the flash estimate. The main reason for the slowdown is on the export side: exports of goods and services fell in real terms by 9.1% in the first quarter, which meant that the net contribution of the foreign balance to growth was negative, at -8.5%. This will partly be related to tourism: tourism arrivals fell year on year by 3.2% in the first quarter and revenue declined in the same period by 6.2%, to €188.6m. As explained in our April report, this was partly for seasonal reasons relating to the timing of religious holidays, but also because of the closure of some airlines. However, exports of goods also declined sharply in nominal euro terms by 27.2% year on year to €930.5m in the first quarter. A breakdown of foreign-trade figures shows that this was largely as a result of a fall of mineral manufacturers, after a large rise in 2018 (see below). Household consumption, which includes food, energy use, and restaurants and hotels and accounts for more than 60% of GDP, held up in the first quarter, rising by a still buoyant 3.7% year on year. The government has also accelerated consumption compared with the early part of 2018.

Table 11

Real GDP growth by expenditure, seasonally adjusted
% change over the same period of the previous year

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Household consumption	3.5	4.4	3.4	3.7	3.7
Non-profit institutions serving households	2.1	3.3	4.1	4.3	4.3
General government consumption	-0.7	0.4	4.3	13.7	9.6
Gross fixed capital formation, of which:	-53.2	26.5	39.4	-13.3	66.2
Dwellings	20.6	13.7	16.7	16.1	15.9
Other buildings and structures	16.4	24.1	26.1	26.9	7.3
Transport equipment	(a)	278.9	(a)	-31.1	(a)
Inventories (contribution to growth)	1.5	1.5	4.0	-1.2	1.9
Exports of goods & services	23.6	-1.2	-7.5	-0.2	-9.1
Imports of goods & services	4.7	5.9	5.8	-6.8	3.0
Foreign balance (contribution to growth)	**11.2**	**-4.6**	**-8.6**	**5.0**	**-8.5**
GDP	**4.0**	**3.9**	**3.8**	**3.8**	**3.4**
% change over previous quarter	1.1	0.8	0.9	0.9	0.7

(a) The current or year-earlier period includes a negative number (disinvestment) therefore percentage changes would be meaningless.

Source: Cystat.

Construction comes off its peak

On the sectoral side, the sharpest slowdown came from the construction sector, albeit from a high base. Gross value-added in construction rose by 13.7% year on year in the first quarter of 2019, compared with 25.1% in the final quarter of 2018 (see Table 12). This likely to be related to the beginnings of a slowdown in real estate sales at the high end of the market. As noted in our April report, real estate sales declined in Limassol by 0.1% year on year in the first quarter. Growth in the very large sector that encompasses both retail trade and tourism also slowed, as one would expect with the abovementioned decline in tourism arrivals, and the deceleration in retail sales growth (see below). Financial and insurance activities remained in negative territory, as banks continue to focus more on reducing the number of non-performing loans rather than on growing their assets.

Table 12

Real GDP growth by sector, seasonally adjusted
% change over the same period of the previous year

	% of total (a)	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Agriculture, hunting, forestry & fishing	1.6	-0.4	0.8	2.0	2.1	2.0
Industry excl. construction	6.4	3.1	6.6	3.5	4.1	4.7
of which: manufacturing	4.5	6.9	6.3	4.4	4.8	4.1
Construction	6.0	22.0	22.3	29.1	25.1	13.7
W/sale & retail trade, hotels & rest's, transport & communications	21.5	6.5	4.4	5.3	3.2	1.6
Information & communication	4.7	2.7	1.1	2.0	4.7	13.9
Financial & insurance activities	6.6	-4.3	-4.7	-8.9	-4.1	-4.2
Real estate inc. imputed rent	9.6	0.7	0.7	0.7	0.7	0.7
Professional, scientific, technical & support services	9.0	6.9	6.7	6.2	6.1	6.1
Public services inc. defence, educ'n, health & social	18.9	2.2	2.9	2.7	2.5	2.4
Other services	3.9	6.4	7.2	7.5	7.6	8.3
Gross value added	**88.1**	**4.0**	**3.9**	**3.8**	**3.8**	**3.4**
Taxes on products net of subsidies	11.9	4.0	3.9	3.8	3.7	3.3
GDP	**100.0**	**4.0**	**3.9**	**3.8**	**3.8**	**3.4**
% change, quarter on quarter	-	1.1	0.8	0.9	0.9	0.7

(a) In 2018 at current prices.

Source: Cystat.

Both food and non-food retail sales growth decelerates

Retail sales growth rose by just 1.9% in the first quarter of 2018, from 3.4% in the fourth quarter of 2018, with the pace of growth slackening for both food and non-food sales. Some of this weaker growth will have been linked to the decline in tourism in the same period. Signs that demand from locals is being maintained (in line with the household consumption figures above) come from sales of discretionary items, as sales of computer equipment and electrical goods and furniture remained fairly strong in the first quarter, growing by 7.1% and 5.9% respectively.

Table 13

Retail trade volume
% change over same period of previous year

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Food, drink & tobacco	10.7	6.4	1.9	2.3	0.6
In non-specialized stores	10.4	6.1	3.0	3.6	1.6
In specialized stores	12.9	7.7	-4.4	-5.4	-5.3
Non-food products (except auto fuel)	13.8	7.0	6.3	6.0	3.1
Textiles, clothing & footwear	11.6	2.0	0.5	0.4	-2.8
Electrical goods & furniture	18.6	11.4	12.7	8.7	7.1
Computer equipment, books & other	12.4	7.0	6.3	10.3	5.9
Other trade in non-specialized stores	13.6	1.5	-1.4	-3.1	-5.4
Auto fuel in specialized stores	-3.2	-0.2	-2.7	-2.7	2.8
Total retail trade volumes	**10.0**	**5.9**	**3.3**	**3.4**	**1.9**
Retail trade values	6.8	6.3	4.9	4.0	2.6

Source: Cystat.

Industrial production growth slows from a high base

Industrial production growth slowed to 4% in the first quarter of 2019, from 7.2% in the fourth quarter of the year. One of the reasons was the rather higher base in the same period of the previous year for pharmaceuticals, which are typically the largest manufacturing export (depending on the size of the more volatile mineral manufactures exports). It is not clear whether the sharper slowdown in food, beverages and tobacco production is related to the loss of a trademark case for halloumi (by far the largest manufactured food product) in December. Trade data suggest that this is not the case, as exports of halloumi rose in nominal euro terms by 22.3% year on year in the first quarter. This suggests that there was at least a market in the first quarter for halloumi that had already been produced. More foreign trade statistics will need to be released before making any firm conclusions on the production figures.

Table 14

Industrial production
% change over same period of previous year; 2015=100 index

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Mining & quarrying	**-1.0**	**9.2**	**36.9**	**3.9**	**-0.8**
Manufacturing	**10.0**	**12.1**	**7.7**	**8.5**	**3.0**
Food, beverages & tobacco	6.6	5.7	4.0	5.5	0.8
Textiles, clothing & leather	4.6	16.1	13.5	6.2	3.3
Wood products excl. furniture	14.8	18.7	15.0	29.3	2.9
Paper products	-3.7	-3.9	-2.4	-2.6	-2.6
Pharmaceuticals, chemicals & refined petroleum products	20.4	16.8	8.6	4.1	1.6
Rubber & plastics	10.8	8.1	0.8	-2.7	-4.5
Non-metallic minerals	5.1	24.1	11.8	8.1	9.2
Metals	10.0	18.1	14.8	13.0	1.8
Electronic, electrical & optical	85.8	51.9	47.2	85.3	0.3
Machinery, equipment & transport	11.1	4.7	2.4	0.7	6.7
Furniture & other manufacturing	5.3	6.5	2.7	4.0	9.6
Electricity supply	**-6.3**	**8.9**	**-0.7**	**3.0**	**9.4**
Water supply & materials recovery	**1.2**	**3.7**	**0.1**	**3.4**	**-3.8**
Total industrial production	**5.7**	**11.1**	**5.5**	**7.2**	**4.0**

Source: Cystat.

We continue to expect real GDP growth of 3.4% in 2019

We continue to expect real GDP growth to slow to 3.4% in 2019, from 3.9% in 2018 (see Table 15). The latest quarterly data suggest that growth could be even a little lower, but given that historical quarterly growth rates are often revised upwards, we have erred on the more upbeat side. Private consumption (household consumption plus the much smaller non-profits serving households) held up well in the first quarter, therefore we are only forecasting a slight slowdown in 2019. Government consumption, meanwhile, seems likely to be stronger this year than last. Forecasts for fixed investment and exports/imports are difficult given the larges swings that can occur as a result of transactions by shipping companies. We assume that, overall, fixed investment will remain fairly high and concentrated in the shipping sector, but will slow as construction investment starts to weaken. Similarly, our forecast for exports of goods and services is more a reflection of our expectations for the domestic economy than the shipping sector. The primary risk to this forecast is a no-deal Brexit, which remains high. Although there are now contingency plans to allow for basic air connectivity between the UK and EU countries in the event of a no-deal Brexit, one can expect a sharp depreciation of sterling, which would hit Cyprus' largest tourist market. The forecast also assumes that there is no onland military flare-up with Turkey over natural gas.

Table 15

Sapienta real GDP growth forecast % change over same period of previous year					
	2017	**2018**	***2019***	***2020***	***2021***
Private consumption	4.1	3.7	*3.5*	*3.1*	*3.2*
Government consumption	3.1	4.4	*4.9*	*3.4*	*1.7*
Gross fixed capital formation	29.0	-7.1	*15.2*	*13.6*	*9.4*
Final consumption	**8.2**	**1.6**	***5.9***	***5.3***	***4.3***
Exports of goods + services	6.0	3.3	*1.0*	*3.4*	*3.3*
Imports of goods + services	12.2	2.0	*4.0*	*4.1*	*4.4*
Net exports of goods + services (contribution to growth)	**-3.9**	**0.7**	***-2.1***	***-0.7***	***-0.9***
Gross domestic product	**4.5**	**3.9**	***3.4***	***2.7***	***2.3***
Average quarter-on-quarter growth rate, seasonally adjusted	0.9	0.9	*0.8*	*0.6*	*0.6*

Source: Cystat; Sapienta estimates and forecasts in italics.

The current-account deficit narrows but remains large at 7% of GDP—

The current-account deficit narrowed to €1.5bn (7% of GDP) in 2018, from €1.6bn (8.4% of GDP) in 2017, thanks largely to a surge in exports. Data on domestic exports (which are measured on a different basis) show an increase of 27.3% in 2018 to €1.6bn, largely because of exports of mineral products related to the VTTV oil terminal in Vasilikos. The remaining exports will have come from re-exports—that is, goods that do not enter Cyprus. Another factor keeping the current-account deficit high is a declining trend in exports of financial services since 2014, probably as a result of both stricter rules against money-laundering as well as pressure from the US to shed certain Russian clients. A current-account deficit of such magnitude points to competitiveness problems. This is exacerbated by Cyprus' reliance on fossil fuels for well over 90% of electricity production, as well as the absence of a reliable public transport system, both of which make the value of imports vulnerable to swings in international oil prices.

Table 16

Current account (balance of payments) € m			
	Jan-Dec 2017	**Jan-Dec 2018**	**% change**
Exports of goods fob	2,616	3,495	33.6
Imports of goods fob	7,372	7,870	6.8
Trade balance (fob-fob)	**-4,756**	**-4,374**	**-8.0**
Exports of services	10,111	9,961	-1.5
Transport	2,727	2,783	2.1
Travel	2,769	2,838	2.5
Financial services	2,259	2,115	-6.4
Telecoms, computer & information services	1,899	1,800	-5.2
Other business services	157	174	10.4
Imports of services	6,045	6,039	-0.1
Services balance	**4,066**	**3,922**	**-3.6**
Primary income balance inc. investment	-534	-587	9.9
Secondary income balance inc. remittances	-419	-422	0.7
Current-account balance	**-1,643**	**-1,461**	**-11.1**
% of GDP	-8.4	-7.0	-
Capital account balance	103	148	43.4

Source: Central Bank of Cyprus.

—and is not offset by the financial account

The current-account deficit was not offset by the financial account, leading to a decline in official reserves of €50m. The balance of payments now include activities by special purpose entities connected with the shipping sector, which can lead to large swings, amounting to several billion euros, of assets and liabilities. These kinds of large moves would be a greater problem if Cyprus had its own currency. The very large transactions may also explain the fairly sizeable "errors and omissions".

Table 17

Financial account (balance of payments)
€ m

	Jan-Dec 2017	Jan-Dec 2018	% change year on year
Direct investment assets (-ve figure is divestment abroad)	5,243	-4,924	-
Direct investment liabilities (-ve figure is divestment from Cyprus)	9,782	-246	-
Equity investment	4,557	1,532	-66.4
Other equity investment inc real estate	643	522	-18.9
Net direct investment	**-4,540**	**-4,678**	**3.0**
Portfolio investment assets (-ve figure is divestment abroad)	3,726	3,421	-8.2
Portfolio investment liabilities (-ve figure is divestment from Cyprus)	3,695	899	-75.7
of which equity	-462	1,773	-
Net portfolio investment	**31**	**2,521**	**8,088.5**
Derivatives	197	24	-
Other investment assets (-ve figure is divestment abroad)	1,136	-2,174	-
Other investment liabilities (-ve figure is divestment from Cyprus)	-2,084	-3,388	62.6
Net other investment	**3,219**	**1,214**	**-62.3**
Movement of reserves (- indicates increase)	-6	50	-
Financial account inc. reserves	**-1,098**	**-869**	**-20.9**
Net errors & omissions	441	444	0.7

Source: Central Bank of Cyprus.

Spending from the south the only bright spot in the Turkish Cypriot economy

The average inflation rate in northern Cyprus to date continues to hover at round 30% (see Table 18), compared with under 20% in Turkey, thanks to the weak Turkish lira. Northern Cyprus typically has higher inflation than Turkey because of its high import dependence, small market size and general lack of competition. With tourism also suffering both because of cheaper competition from Turkey and because Turks are less willing to travel, spending by Greek Cypriots north of the Green Line is the only bright spot in the Turkish Cypriot economy at present. Plastic card spending with cards issued in the south rose year on year by 72.8% to €7.8 million in January-May, while spending with cards issued in the north fell by 22% in the same period to €6.5 million. Greek Cypriot spending started to surpass Turkish Cypriot spending in August 2018 (the month of the sharp depreciation) and has continued to surpass it ever since. JCC no longer publishes the breakdown of expenditure by category, citing confidentiality reasons, but anecdotally, the main purchases in the north are for motor fuel and medicines. However, at €15 million in 2018, plastic card spending by Greek Cypriots represents only a fraction of the retail sector, which we estimate at €650m in gross terms.

Table 18

Northern Cyprus: selected short-term statistics % change over the previous period indicated in the column heads				
	Latest month	**Period measured**	**% change latest month**	**YTD % change**
Consumer price inflation	May	y/y	26.7	29.2
Tourism arrivals	May	y/y	-10.1	-9.2
Plastic card spending south of the Green Line	May	y/y	-19.0	-22.0
Plastic card spending north of the Green Line	May	y/y	77.9	72.8
Imports of goods (expressed in US dollars)	Dec	y/y	-23.0	2.1
Of which from Turkey	Dec	y/y	-29.4	2.4
Exports of goods (expressed in US dollars)	Dec	y/y	-46.8	-4.5
Of which to Turkey	Dec	y/y	-62.6	-18.3

Sources: SPÖ; Turizm Planlama Dairesi; JCC Payments Systems; Ticaret Dairesi.

Table 19

Northern Cyprus: key macroeconomic indicators					
	2013	**2014**	**2015**	**2016**	**2017**
GDP (₺ billion)	7,607	8,859	10,222	11,601	14,545
GDP (€ billion, converted at annual average exchange rate)	3,003	3,048	3,379	3,470	3,530
Population ('000)	301,988	313,626	326,158	335,455	n/a
GDP per capita (€)	9,943	9,718	10,359	10,344	n/a
Real GDP growth (%)	1.1	4.8	4.0	3.6	5.4
Consumer price inflation (%)	10.2	6.5	7.8	10.2	14.7
Unemployment rate (%)	8.4	8.3	7.4	6.4	5.6
Fiscal balance (% of GDP)	-7.2	-4.0	-3.2	-1.1	-0.3
Public debt (€ million, converted from $ and ₺)	4,292	4,348	5,060	5,129	4,893
of which debt to Turkey	2,610	2,730	3,362	3,424	3,409
Public debt (% of GDP) (a)	143.0	142.7	149.8	147.8	138.6
of which debt to Turkey (% of GDP)	86.8	89.6	98.9	98.8	96.6
Number of tourists ('000)	1,233	1,366	1,483	1,577	1,734
Exports of goods ($ million)	121	134	118	106	108
Imports of goods ($ million)	1,699	1,784	1,501	1,557	1,667
Memorandum items					
United Cyprus debt (% of GDP)	*87.7*	*108.3*	*112.7*	*114.3*	*113.2*
United Cyprus debt if debt to Turkey written off (% of GDP)	*76.6*	*96.0*	*99.4*	*98.3*	*97.3*
Turkish lira per euro (ECB)	2.5335	2.9065	3.0255	3.3433	4.1206
Turkish lira per US dollar (US Forex and ECB-derived)	1.9038	2.1885	2.7119	3.0249	3.6475

(a) Based on figures published by the government of Turkey.

Sources: Devlet Planlamar Örgütü (SPO); Maliye Bakanligi; Turkiye Cumhuriyeti Lefkosa Buyukelciligi.

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