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Sapienta Country Analysis

Cyprus

March 2020

Comprehensive monthly analysis of politics, economic policy and economics

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ISSN 2301-2439, Sapienta Country Analysis, Cyprus

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Overview

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31 March 2020

- Political analysis and outlook Both parts of the island have imposed a night-time curfew in response to the Covid-19 crisis. Test rates seem to be low compared with other countries. The crisis has deepened the division of the island, potentially irreversibly, as Greek Cypriots passed a critical psychological threshold with closing four crossing points. On the other hand, the "Taiwanization" of northern Cyprus now looks less likely.

- Structural reforms and natural gas The pandemic has naturally revealed strains in the universal public healthcare system, which is only half way through its rollout, with outpatient care technically due in June 2020, although this may be disrupted. The collapse of oil and gas prices has created uncertainty for the future of natural gas exports but might make plans to import natural gas more viable.

- Fiscal performance and forecast The government has the fiscal space for the €813m pledged to tackle the crisis but may yet issue new debt to cover the cost. The main risk is the high level of state guarantees, which under EU rules do not show up in public debt figures. We tentatively expect the debt/GDP ratio to rise to 108.8% in 2020, from 95.5% in 2019. The Turkish Cypriot administration has implemented income support but also cut public-sector salaries.

- Banking sector Parliament has authorized a nine-month suspension of loan payments. Bank of Cyprus and Hellenic Bank seem to be in a good position to absorb the hit, given the flexibility of the eurozone authorities and the banks' high capital ratios. State guarantees of €2bn are also expected to support new and restructured loans. The Turkish Cypriot central bank is also working with local banks on guarantees and other support.

- Macroeconomic trends and forecast We have produced three scenarios for real GDP growth in 2020-21, with a baseline decline of 6.2% this year. Sales of and pharmacy products and public spending should partly offset very declines in tourism, general retail and construction, as well as other sectors. In the longer term, the tourism market might have changed permanently, and has implications for infrastructure strategy. The Turkish Cypriot economy will be hit by declines in both the tourism and the important university sectors.

Table 1

Sapienta Economics macroeconomic forecast

	2018	2019	*2020*	*2021*	*2022*
GDP at current prices (€ m)	21,138	21,944	*20,477*	*21,852*	*22,623*
GDP per capita (€)	24,294	24,925	*23,075*	*24,428*	*25,089*
GDP at constant 2005 prices (€ m)	20,678	21,346	*20,031*	*21,313*	*21,633*
Real GDP growth (%)	4.1	3.2	*-6.2*	*6.4*	*1.5*
Harmonized consumer price inflation (%)	0.8	0.3	*-0.6*	*0.3*	*0.6*
Unemployment rate (%)	8.4	7.4	*12.1*	*10.8*	*9.0*
Budget balance (ESA2010) (€ m)	-926	603	*-1,013*	*-220*	*-47*
% of GDP	-4.4	2.7	*-4.9*	*-1.0*	*-0.2*
Primary balance (ESA2010) (€ m)	-416	1,142	*-573*	*204*	*343*
% of GDP	-2.0	5.2	*-2.8*	*0.9*	*1.5*
Gross public debt (€ m)	21,256	20,958	*22,286*	*22,939*	*22,565*
% of GDP	100.6	95.5	*108.8*	*105.0*	*99.7*
Current-account balance (% of GDP)	-4.4	*-6.5*	*-0.5*	*-4.8*	*-3.6*

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

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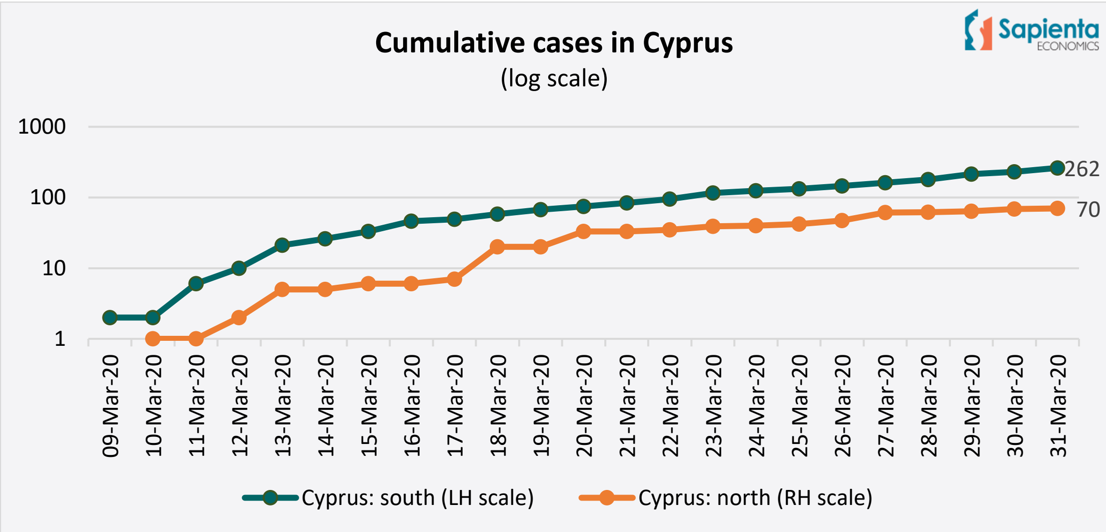
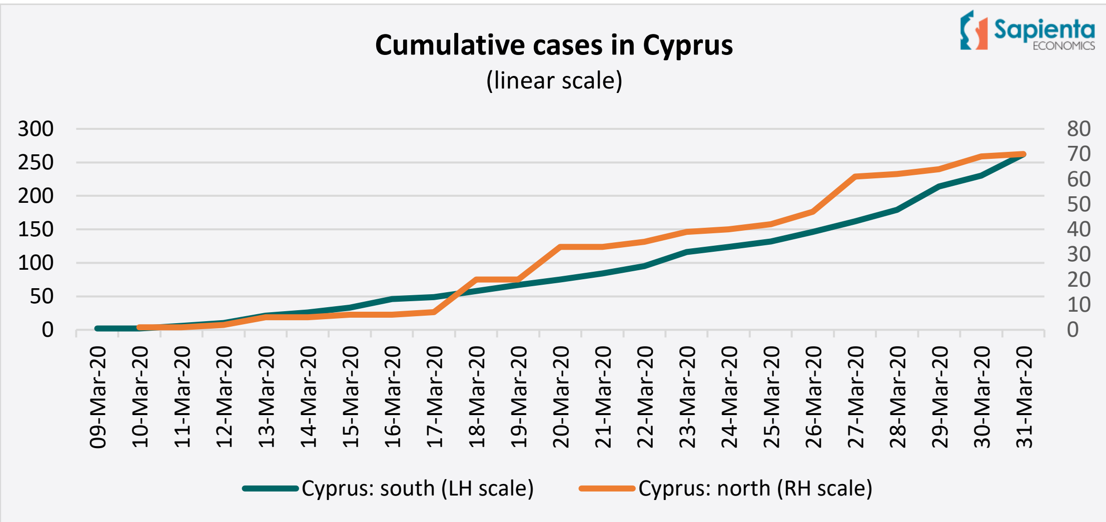
Both parts of the island impose a night-time curfew as virus cases rise rapidly—

The Covid-19 ("corona virus") pandemic has naturally dominated the political scene during March. The first diagnosis announced in the southern part of the island controlled by the (Greek Cypriot) Republic of Cyprus government was announced on 9 March, while the first case in the area *de facto* administered by the unrecognized Turkish Republic of Northern Cyprus (TRNC) was announced on 12 March. By 31 March, 262 cases and 8 deaths had been reported in the south and 70 cases and 1 death in the north. Based on the reported population of 880,400 in the south in 2019, this translates into a reported infection rate 297.6 per million by day 21 (31 March), compared with 140.4 in the UK and closer 193.6 in Italy 193.6 on day 21 according to Our World in Data website run by Oxford University. However, this database reports Cyprus' infection rate on day 21 at a rather lower 190.49 per million people, which suggests it is including the population of northern Cyprus but not the number of cases there. Because of its unrecognized status, data for northern Cyprus are not reported to the World Health Organization. Assuming a civilian population of 400,000 in the north, we estimate that the reported infection rate is 175 per million people. Analyzing the data on both linear and log scales, the pace of increase of reported cases seems to be a little faster in the south than in the north.





—test rates seem to be low—

The south is testing more people: 7,937 (0.8% of the population) as of 31 March, compared with 1,262 (0.3%) in the north, although both sides are on the low side compared with reports on the highest testers. Given differences in testing rates, drawing strong conclusions from reported cases should be treated with caution. What can be said with more certainty is that measures to restrict movement were generally taken earlier by the Turkish Cypriot authorities. In the north, a partial curfew was imposed on 22 March, and included an explicit ban on house visits, while 15 villages in the rural area of Karpass have since been entirely quarantined. The partial curfew in the south was imposed from 24 March but an explicit ban on house visits, which had been the source of many infections, was not imposed until 31 March. In a rare act of unity, which therefore might have been coincidental, both sides imposed a full night-time curfew from 9pm to 6am effective 31 March, meaning that only those who must work are allowed outdoors during these hours. In the south, the measures introduced from 31 March also limited the number of daily excursions outside to one, from no limits previously.

Table 2

Timeline of key public health measures

	Turkish Cypriot community (north)	Greek Cypriot community (south)
Entry ban (TC)/quarantine (GC) for arrivals from selected countries	29-Feb	09-Mar
First case reported	10-Mar	09-Mar
All schools closed	10-Mar	13-Mar
First crossing points closed	12-Mar	29-Feb
All crossing points effectively closed	14-Mar	n/a
Passenger flights stopped (except for a few repatriations)	21-Mar	21-Mar
Restricted movement (partial curfew)	22-Mar	24-Mar
Ban on house visits	22-Mar	31-Mar
Full quarantine for selected villages	27-Mar	n/a
Evening curfew	31-Mar	31-Mar

Sources: Media reports.

—but the public has been generally supportive of measures taken

While a decision not to let students back in the country unless they carried a certificate showing that they had had no virus was unpopular among parents, the public on both sides have been generally supportive of measures taken. According to an online opinion poll among Greek Cypriots published by *Politis* published on 29 March—before the night-time curfew came into force—only 6% of women and 9% of men disagreed with the measures that had come into force on 22 March, which involved sending an SMS text message to obtain permission to go outside for a limited range of activities. Permission was deemed necessary after reports that large family groups had been gathering, leading in one case to 15 new infections. Among Greek Cypriots, the public response on social media to the measures imposed from 31 March was generally more hostile, especially among dog-owners, although the rules were reportedly loosened slightly to allow dog-walking in the immediate vicinity of one's home. An online poll among Turkish Cypriots in *Havadis* published on 14 March found 86% support for a state of emergency suggested to the ruling coalition led by the National Unity Party (UBP) leader, Ersin Tatar, by the Turkish Cypriot leader and president of TRNC, Mustafa Akinci, although to date, no formal state of emergency has been declared on either side.

The virus crisis has deepened the division of the island, potentially irreversibly—

On the political side, one of the most lasting by-products of the virus crisis is likely to be the division of the island, which may now be irreversible. The decision by the president of the Republic of Cyprus and Greek Cypriot leader, Nicos Anastasiades, to close four crossing points across the UN-monitored buffer zone on 29 February, without it seems consulting Mr Akinci, the UN, or the EU (which is supposed to have a veto on changes to crossing-point procedures under the EU "Green Line" Regulation 866/2004), set the tone for the generally separate and divisive handling of the issue on both sides. On 12 March the Turkish Cypriot coalition closed an additional two crossing points without consulting even Mr Akinci, let alone others. On 14 March it effectively stopped all movement across the Green Line by barring the entry of non-residents and non-nationals (which for the Turkish Cypriot authorities includes Greek Cypriots), and requiring 14 days isolation for any Turkish Cypriot or resident coming to northern Cyprus from any point of entry (which essentially banned visit by Turkish Cypriots to the south, including some 1,500 registered as employees on the social insurance register). The only sign of cooperation on tackling the virus has come via the Bicommunal Technical Committee on Health, which is due to be involved in administering €5m in EU funds to support the Turkish Cypriot community's response to Covid-19.

—as a critical psychological threshold has been passed—

The first closure of the crossing points had already inflamed tensions, especially as there had been no Covid-19 cases (the first cases on both sides came from abroad) and the Republic of Cyprus government had imposed no restrictions at the two airports or taken any measures to stop mass carnival gatherings. Protests over the two weeks following the decision led to clashes between the Greek Cypriot police and protestors, and between Turkish Cypriot police and UN police. The closure of the crossing points by Greek Cypriots broke a taboo, as it was Turkey, backed by the late Turkish Cypriot leader, Rauf Denktash, that had kept the two communities physically apart between the invasion by Turkish forces in July 1974 and their surprise decision to open the first Ledra Palace crossing in April 2003. Since the Greek Cypriots had always insisted that the Green Line was not an external border, the decision to close four of them crossed a critical psychological barrier. Moreover, unconfirmed reports suggest that opinion polls found that the February closure was generally popular.

Reopening the crossing points is likely to be difficult. Before March 2020, there were nine open crossing points: Ledra Palace (pedestrians only apart from the diplomatic community), Agios Dhometios, Pergamos, Strovilia, Ledra Street (pedestrian only), Zodhia, Kato Pyrgos-Karavostasi, Lefka-Apliki Kato and Deryneia. Each of the crossing point openings after Ledra Palace was achieved only after painstaking negotiations facilitated by the UN, and the most recent opening in Deryneia near Famagusta had been unpopular with certain Greek Cypriot businesses. Greek Cypriot petrol station owners also did not like the surge in crossings at Ayios Dhometios to buy petrol after the depreciation of the Turkish lira. With the expected virus-induced recession, one can envisage only Ledra Palace being reopened in the short term, mainly because this is the primary crossing point for Turkish Cypriot school students who attend schools in the south, the diplomatic community, and because the area around Ledra Palace is home to a number of peacemaking activities centred around the Home for Cooperation, the Goethe Institut, and the Fulbright Centre.

—and the postponement of Turkish Cypriot elections puts back any return to the table—

Another reason why the virus crisis will cement division is that it has led to a decision to postpone the Turkish Cypriot presidential election from April to October 2020. The expectation was that negotiations to solve the longstanding Cyprus problem would resume in May. With both sides likely to be focused on the economic fall-out, a resumption any time this year seems unlikely. When the banking crisis hit the south in March 2013, it pushed the resumption of negotiations back by a year. However, by 2021, the Greek Cypriots will be focused on parliamentary elections due in May and by 2022 they will be focused on presidential elections due in 2023. By then, the Turkish Cypriot coalition is quite likely to have opened and started to develop the fenced-off district of Varosha, not least to bring investment into the economy. As argued in previous reports, we believe that the development of Varosha would critically impair efforts to unite the island.

—although "Taiwanization" of the north is also less likely now

One development that has probably become less likely because of the virus crisis, however, is any "Taiwanization", or *de facto* recognition of the TRNC. As we had argued in previous reports, a combination of factors outside Greek Cypriots' control—tensions between Greece and Turkey over natural resources and migration, between the EU and Turkey over migration, together with the natural gas ambitions of various players in the region—risked a "quick-fix" deal leading to the Taiwanization of the north, potentially even without the consent of Greek Cypriots. However, since the combination of the virus crisis and the oil-price war might have dealt a fatal blow to the island's natural gas prospects (see Structural reforms and natural gas), any incentives that might have existed to go down this route have probably faded.

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The pandemic reveals strains in the public hospital system—

As elsewhere in the world, the pandemic has exposed weaknesses in the healthcare systems and hygiene protocols, particularly within the public hospital system. In the initial panic, Nicosia General Hospital was closed on 10 March in order to test 150 staff when it was discovered that a doctor had contracted the virus and had not gone on sick leave even when developing symptoms, although it ultimately transpired that he was not the source of any infections. On the same day, Limassol General Hospital closed outpatient treatment and cancelled surgeries for 48 hours while treating patients with Covid-19, while Paphos General Hospital was also closed for several days on 16 March for disinfection, with 10 health professionals from the hospital having been infected by a single patient. In the initial days, three private hospitals in Paphos were also placed in quarantine. Nicosia General Hospital is now operational and a slightly more settled system is in place, although it still involves moving patients around the country. Anyone with flu-type system goes first to special "flu clinics" to be tested and are then referred to Famagusta General Hospital in Paralimni if they are found positive. However, since Famagusta has no intensive care units (ICU), they are referred to Nicosia or Limassol, some 40-60 minutes away, if they need intensive care.

Inferring from television statements by the state health service organization (Okypy) on 31 March, the total number of ICU units in the south is around 74: 60 in Nicosia General Hospital, 10 in Makarios Hospital in Nicosia and 4 in Limassol. Nicosia Hospital plans to add 18 by 4 April and 22 by 10 April, while Limassol plans to add another 4. A separate hospital in northern Famagusta is also the referral centre for cases in northern Cyprus, which has 58 ventilators, of which 16 are set aside for Covid-19, are efforts under way to procure another 50.

—the government forces cooperation from the private sector—

The government forced cooperation from the private healthcare sector on 19 March, as the private sector was initially reluctant and unprepared to handle any cases. The Private Clinics Association (PASIN) eventually put itself at the state's disposal on 23 March and the private sector has also taken up the load of urgent operations scheduled in the state hospitals. After the health minister, Constantinos Ioannou, expressed disappointment at the level of support from the private sector, the Cyprus Medical Association (Cyma) put out a call on 19 March for offers of support. When it received only 128, the Ministry of Health issued a decree on the same day placing all registered doctors and nurses under the ministry's orders. The government then proceeded to set up five public health centres or flu clinics to test those with symptoms. This addressed complaints reported in the local media of patients whose general practitioners refused to see them. The government has also been condemned by the nurses' union for the lack of protective equipment and other medical supplies in state hospitals. While the government has tried to refute the criticism, it has accepted new supplies that will arrive from China in the first week of April.

—and pledges €100m for the sector

Attempting to respond to the pandemic crisis, the government has pledged to divert €100m for healthcare expenditures. The government referred to the need to employ more hospital workforce, acquire more medical supplies and to enhance the Cyprus Institute of Neurology and Genetics, the institute conducting Covid-19 tests. The Health Insurance Organization (HIO) announced that beneficiaries of the National Health System (GESY) whose residence or work permit has expired or will expire before September 30 will continue to receive services until that date. However, refugees and asylum-seekers, many of whom live in crowded conditions (and some in public parks), are more exposed. Patients are also not allowed to change their general practitioner for (GP) the time being. Previously, they were able to change a GP every three months.

The second phase of the National Health System rollout may be disrupted

The pandemic could disrupt the rollout of the second phase of GESY, which was due to introduce in-patient care on 1 June. In statements to Offsite news site on 29 March, the head of the Health Insurance Organization (HIO), Andreas Papaconstantinou, acknowledged the uncertainty. While saying that there was no change of plan, he said the situation would become clearer only in the coming weeks. One positive aspect of the Covid-19 is that it has emphasized the need for a public healthcare system and probably weakened those who sought to undermine it (or change the single insurer model). One consideration for the timing of the second phase is alterations to the GESY insurance contributions, which were due to start at the end of March. A law passed on 27 March suspends the rate-increase for a three-month period—from April to June for those who have already paid the higher rate in March, or from March to May for those who had not yet paid.

Table 3

Natonal Health System (GESY) insurance contributions
%

	1 Mar 2019 to '29 Feb 2020	1 Mar 2020 to 31 Mar 2020	1 Apr2020 to 30 Jun 2020	1 Jul 2020 onwards
Employer	1.85	2.90	1.85	2.90
Employee, pensioner, state official	1.70	2.65	1.70	2.65
Self-employed	2.55	4.00	2.55	4.00
State	1.55	4.70	1.65	4.70

Sources: media reports; PwC Tax Facts 2019; EY Tax Facts 2019.

Oil-price collapse creates uncertainty for natural gas plans—

The shock to oil and gas demand generated by the global Covid-19 pandemic, combined with the oil-price war that was already under way between large producers, has had a dramatic impact on the oil and gas sector, leading to a re-evaluation of capital expenditure all around the globe that is unlikely to leave the Eastern Mediterranean unaffected. After a series of delays, the Total and ENI consortium was due to start exploratory drilling using the Tungsten Explorer in Block 6 at the end of April. The Tungsten Explorer has been drilling in Lebanon's Block 4 since 27 February and according to a report by a Lebanese gas expert, Mona Sukkarieh, in the *Financial Mirror*, for now, its 55-day operation has so far not been affected. However, delays to the Cyprus drilling programme cannot be discounted, either owing to travel restrictions or to changes in capital expenditure plans. The same risks apply to drilling by the ExxonMobil - Qatar Petroleum consortium due in Block 10 in the second half of 2020. In a pessimistic outlook, hydrocarbons consultant, Charles Ellinas, presented the financial impact on all companies involved in the Eastern Mediterranean natural gas explorations, concluding that oil companies may not resume exploration activities that quickly.

—and Turkey's drilling offshore Cyprus is not left untouched

As of the end of March, the Turkish Petroleum Corporation (TPAO) continued its operations with the Yavuz drill ship, in violation of the Republic of Cyprus Exclusive Economic Zone (EEZ), although it is unclear how long this will last. When Turkey received its third drill ship, named Kanuni, on 15 March, the energy minister, Fatih Dönmez said that works on the drill ship would not begin until Covid-19 measures had ended. The rhetoric remains unchanged, however. The spokesperson of the Turkish Ministry of Foreign Affairs, Hami Aksoy, said on 26 March that "at the core of the Eastern Mediterranean issue lies the maximalist maritime jurisdiction area claims of the Greek/Greek Cypriot duo as well as the disregard of the Turkish Cypriots and their rights as the co-owners of the Island by both Greece and the EU". Separately, the Covid-19 crisis is already putting a stress on green investments and energy transition, as the oil-price decline makes oil and (already exploited) gas a cheap option.

The Natural Gas Infrastructure Company (ETYFA) is finally set up

While lower gas prices might put paid to natural gas exports, they might also make plans to import liquefied natural gas (LNG) more viable. After several delays and a series of obstacles, the participation of the Electricity Authority of Cyprus (EAC) in the shareholding of the Natural Gas Infrastructure Company (ETYFA) was finally signed at the offices of Natural Gas Public Company (DEFA) on 9 March. According to the terms of the agreement, EAC acquired a 30% stake in ETYFA, while DEFA holds the remaining 70%. The deal was sealed when the finance ministry accepted the offer by DEFA to waive any dividends until EAC recoups its investment, after threats of a strike by the EAC unions if this pre-condition was not accepted. The EAC will therefore first recoup its €45m-€50m contribution to ETYFA's capital before DEFA starts receiving its share of dividends. As noted in our February issue, the import of natural gas, which is due to feed private power plants, threatens EAC's historical dominance of the electricity power market. There is still uncertainty about construction of gas-import infrastructure, however. Delays to the establishment of ETYFA have put at risk the remainder of the funds needed for the construction of the infrastructure and the plan to import LNG by 2021. The government had envisaged obtaining €101m from the EU's Connecting Europe Facility, €45m-€50m from the EAC through ETYFA and €150m combined from the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). The establishment of ETYFA now allows DEFA to seek funds but the decision by the

EIB to end investment in fossil fuels at the end of 2021, together with the general shift away from fossil fuels, could prove to be yet another obstacle.

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Government pledges €813m worth of fiscal support for the virus crisis

Parliament passed on 27 March 10 bills to support businesses and the self-employed. The measures involve a supplementary budget of €369m (1.7% of 2019 GDP), while the total fiscal package is reported at €813m (3.8% of 2019 GDP), up from €700m initially planned. The measures in the €369m budget are as follows.

- €100m for the healthcare sector, including employment of additional healthcare staff as required.
- €182m for partly covering salaries between 16 March and 12 April as long as companies do not lay off staff. The scheme will pay up to 60% of insurable salaries for four weeks to employees of companies that have been forced fully or partly to suspend operations. The measure covers up to 90% of employees of affected companies. The same fund will also go towards companies that can demonstrate that they have suffered a 25% reduction in turnover. In this category small and medium-sized enterprises will receive benefits for up to 75% of staff, while enterprises with more than 50 employees will receive benefits for up to 60% of staff. The scheme is expected to cover around 220,000 employees, which is some 60% of all private-sector employment.
- €20m to cover the incomes of the self-employed whose work is suspended from 16 March to 12 April. The self-employed (probably mainly in the construction sector) will be eligible for 60% of their incomes up to a maximum of €1,000. Around 40,000 people are estimated to be affected.
- €20m for up to four weeks' special parental leave and a partial subsidy of public- and private-sector workers with gross salaries up to €2,500 who have no choice but to stay home to take care of children.
- €15m to pay sickness benefits to 20,000 high-risk groups at €800 per month.
- €15m for grants of €750 per student abroad for accommodation, to encourage them to stay abroad. According to the most recent statistics, 22,197 Cypriots were studying abroad in the academic year 2016/17, of which 12,259 were in Greece and 9,241 were in the UK.
- €6m for the repatriation of Cypriots abroad.
- €11m in support for tourism promotion in the summer and winter months.

Other measures passed on 27 March were are as follows.

- A three-month postponement until the end of May of the planned increase in contributions to the National Health System (GESY) due from 31 March (see Structural reforms and natural gas). More generally, there has been no suspension of social insurance payments. Inferring from social security contributions, we estimate that the postponement of the GESY contribution increase will have cost around €71m in deferred payments.
- Parliament authorized the government to issue a decree postponing until 10 November 2020 value-added tax (VAT) and certain other taxes due for the tax periods ending February, March and April 2020. We understand that the postponement in VAT payments applies only to companies whose operations have been fully or partly suspended. The measure is estimated to liberate €240m into the economy.

- The government was also authorized to extend repayment periods for those paying late social insurance payments by instalments.
- Evictions of tenants are suspended until 31 May.
- Board meetings of companies may now take place online.
- On 23 March payment of the annual company registration fee of €350 was also postponed until the end of December. With 224,230 registered companies as of February 2020, this implies deferred revenue for the government of €79m.

An earlier proposal to cut the standard rate of value-added tax (VAT) from 19% to 17% and the lower rate from 9% to 7%, at a cost of €70m, was abandoned after complaints that it would simply add to technology costs at a time when revenues had collapsed and there would therefore be little VAT collected.

Other initiatives to support private sector and households include a 10% cut in tariffs by the state-owned Electricity Authority of Cyprus (EAC), although its costs are likely to have dropped considerably more than that given the collapse in the oil price. The state-owned telecoms provider, Cyta, has increased broadband speeds free of charge. JCC Payments Systems and RCB Bank have increased the contactless limit for plastic card use to €50 from €20 previously, and suspended rentals for point of sale (POS) terminals. Tonnage tax in the shipping sector has been postponed from 31 March to 31 May.

Table 4

Fiscal measures taken in March 2020 € million unless otherwise stated	
Healthcare spending	100
Employee wage support	182
Self-employed income support	20
Special parental leave	20
Special sickness benefit	15
Student accommodation	15
Tourism promotion	11
Repatriation of citizens	6
Total supplementary budget approved on 27 March	**369**
% of GDP in 2019	1.7
VAT postponement for affected companies	240
Healthcare (GESY) contributions three-month postponement (estimate)	*71*
Company registrar fee postponement to end-December (estimate)	*79*
Other measures not specified (estimate)	*55*
Total fiscal support announced	**813**
% of GDP in 2019	3.7

Sources: Media reports and official statements; Sapienta Economics estimates in italics.

The government can afford the fiscal support for now—

The government can afford €813m in support for the time being. It reported a primary surplus of €257m in January and, as of December 2019, held €1bn in cash with the Central Bank of Cyprus. The Central Bank figures have not been updated but we calculate that it must now have €2.3bn including the primary surplus, having issued two bonds amounting to €1.75bn in January and paid €714m for the early repayment of the IMF loan in February. Taking out €1.3bn due in debt payments later this year, that leaves the government with €1bn. The Supreme Court case that was due to rule in March on the cuts in public-sector pay has now been postponed, which also gives the government some breathing space. The government will be reluctant to use all of its cash reserves, however, as in recent years it has tended to keep aside 12 months of debt payments and it has

€987m falling due in 2021. This probably explains why the finance minister, Constantinos Petrides, said on 31 March that the government would need to borrow to cover the fiscal measures.

Table 5

General government accounts (ESA2010)
€ million unless otherwise stated

	Jan-Dec 2019	Jan 2019	Jan 2020	% change year on year
Total revenue	**9,258**	**810**	**862**	**6.4**
VAT on products & services	2,122	183	181	-1.4
Personal income tax: public sector	180	13	15	11.4
Personal income tax: private sector	310	30	30	1.0
Defence contribution (a)	307	88	90	2.3
Total corporate tax	894	78	81	3.8
Social security contributions	2,348	183	246	34.5
Property income	176	2	2	-5.3
Revenue classified as "other"	1,313	68	66	-2.6
Total expenditure	**8,655**	**552**	**624**	**13.1**
Compensation of employees	2,734	194	208	7.6
of which: public-sector pensions	573	41	43	4.9
Intermediate consumption	1,146	35	79	126.5
Social payments	2,872	204	222	8.7
Pensions	1,371	102	107	5.1
Unemployment	83	8	8	-7.4
Other social transfers	1,418	94	107	14.1
Interest	539	22	20	-11.7
Gross fixed capital formation	370	5	9	75.5
Expenditure classifed as "other"	924	90	85	-5.8
General government balance	**603**	**258**	**238**	**-8.0**
% of GDP	2.7	-	-	-
Primary balance	**1,142**	**280**	**257**	**-8.3**
% of GDP	5.2	-	-	-

(a) Mainly dividends and interest income.

Source: Cystat.

—but may yet issue debt to cover the fiscal cost—

Mr Petrides also hinted that it might be difficult to access international debt markets, given the likely high demand from other countries. Indeed, the yield on Cyprus sovereign 10-year bonds has been volatile. It shot up from 0.436% on 24 February to 2.014% on 18 March, fell back to 0.946% on 27 March but rose again to 1.132% on 31 March. Actual interest paid on any new debt could be even higher. For example, the yield on the 10-year bond issued on 14 January was 0.734%, whereas the market yield for all outstanding 10-year bonds on the same day was 0.555%. At the eurozone level, there are also difficulties in finding consensus for any swift, jointly issued eurozone "corona bonds". For these reasons, the government might take advantage of very high liquidity in the local banks, as well as action by the ECB (see Banking sector), to issue domestic debt, even though this could also be expensive. The last time the government issued domestic debt was in July 2018, not least because it could borrow more cheaply on the international market. We assume that any debt issued, whether local or international, will be at a shorter maturity than 10 years, given market conditions.

—as state guarantees of 29% of GDP pose a risk

Another reason for not using up the cash balance is the major uncertainty for public finances posed by the potential cost of state guarantees. Parliament is expected to approve state loan guarantees amounting to €2bn on 2 April (see Banking sector). Under the EU's ESA accounting system, government guarantees are not recorded as government debt but as off-balance sheet contingent liabilities. They would be recorded as government expenditure, however, if those guarantees are called on and the government pays the debt. The state has already has already issued some €4.3bn (19.5% of GDP) in guarantees: €2.0bn, which is recorded by the Public Debt Management Office (PDMO), and another €2.3bn issued to Hellenic Bank as part of its acquisition of the "good" part of the Cyprus Cooperative Bank, which is not recorded. PDMO simply states that its figures exclude the Hellenic Bank guarantees. It is not clear why the bank guarantees are not recorded, since they are most at risk of being called on. For example, in its accounts for the third quarter of 2019, Hellenic Bank reported that it had made a €65.8m claim for losses under the (state-guaranteed) Asset Protection Scheme. Hellenic also paid a guarantee fee of €15m, therefore the net cost to the state would have been €50.8m. One can expect that these calls will continue as a by-product of the virus crisis.

Table 6

Cyprus government guarantees € million	
Loans	1,816
of which NPLs	112
Other (mainly EFSF)	159
Total reported end-2018 excluding	**1,976**
Hellenic Bank guarantees for co-op acquisition)	2,300
Total de facto guarantees	**4,276**
% of GDP in 2019	19.5
Proposed new bank guarantees (Covid19)	2,000
Total de facto guarantees if bill is passed	**6,276**
% of GDP in 2019	28.6

Source: Cyprus Treasury, Hellenic Bank.

Our fiscal forecast is highly tentative

Given all of the uncertainties, our fiscal forecast this month is highly tentative. Even in more normal times, government revenue and expenditure in Cyprus does not lend itself easily to modelling, as policy interventions, such as changes in tax rates over the years, as well as the huge cuts to regular public expenditure implemented during 2012-15, create significant distortions. We assume that the suspension of various revenues will amount to €500m (compared with around €440m currently expected) and that it will not be recouped this year. How this is treated in the EU's ESA accounts is open to question but we are assuming that the loss to revenues is fully reflected. We also assume that additional expenditure will be twice as much as the €369m currently budgeted, and that the government will only be able to offset this partly with cuts in discretionary spending. Together with our (also tentative) baseline scenario for a real GDP contraction of 6.2%, this yields a general government budget deficit of 4.9% of GDP and a primary budget deficit of 2.8% of GDP. If the government also issues another €500m in debt this year, this would push the debt/GDP ratio to around 109% of GDP in 2020, falling to 105% in 2021, assuming that the tourism lockdown does not drag on until the autumn.

Table 7

Sapienta Economics budget and debt forecasts (ESA 2010) € m unless otherwise indicated						
	2018	**2019**	**2020**	**2021**	**2022**	**2023**
General government revenue	8,287	9,258	*8,140*	*8,599*	*8,876*	*9,262*
General government expenditure inc. one-offs (a)	9,213	8,655	*8,615*	*8,719*	*8,923*	*9,265*
General government budget balance inc. one-offs	-926	603	*-1,013*	*-220*	*-47*	*-3*
% of GDP	-4.4	2.7	*-4.9*	*-1.0*	*-0.2*	*0.0*
Primary balance inc. one-offs	-416	1,142	*-573*	*204*	*343*	*335*
% of GDP	-2.0	5.2	*-2.8*	*0.9*	*1.5*	*1.4*
One-off expenditure (a)	1,564	0.0	*538.0*	*100.0*	*0.0*	*0.0*
Gross government debt inc. one-offs	21,256	20,958	*22,286*	*22,939*	*22,565*	*22,262*
% of GDP	100.6	95.5	*108.8*	*105.0*	*99.7*	*94.8*
Memorandum item: balances excluding one-offs						
General government expenditure exc. one-offs	7,649	8,655	*8,077*	*8,619*	*8,923*	*9,265*
General government balance exc. one-offs	638	603	*-475*	*-120*	*-47*	*-3*
% of GDP	3.0	2.7	*-2.3*	*-0.5*	*-0.2*	*0.0*
Primary balance exc. one-offs	1,149	1,142	*-35*	*304*	*343*	*335*
% of GDP	5.4	5.2	*-0.2*	*1.4*	*1.5*	*1.4*

(a) €1.6bn fiscal impact of co-op deal (2018) & assumed Covid19 expenditure (2020-21).

Sources: Ministry of Finance; IMF; Sapienta Economics estimates and forecasts in italics.

Turkish Cypriot administration implements income support but cuts public salaries

Given its unrecognized status, the Turkish Cypriot administration is unable to borrow on international markets to tackle the Covid-19 crisis. Moreover, the only funds it has been received from Turkey in the past few years have been for defence purposes, as successive coalitions on both sides of the political spectrum have not managed to sign the three-year protocol (financial support agreement) with Turkey. Even with the crisis, there is little hope that there will be any support from Turkey beyond some medical supplies. Separately, the European Commission has pledged €5m in support for medical supplies and equipment.

While the budget (excluding social insurance) ran a surplus in the first quarter of 2020, it was small, at ₺235m (€33m), or around 1% of GDP, which is not enough for the scale of the problem. On 25 March the ruling coalition therefore implemented a mix of support for incomes and expenditure cuts. As regards support for incomes, the main measures were as follows.

- ₺750m (€104 million), or around 3.4% of GDP to provide ₺1,500 (€208) of social insurance payments in April and May for businesses whose activities have been suspended and who do not lay off staff. Given that the minimum wage is ₺3,800 (€528) per month, the measure has been criticised for not giving enough income support. Moreover, it only applies to Turkish Cypriots and Turkish citizens. It therefore excludes 16,000 insured full-time employees in the private sector, as well as an estimated 4,000 part-time workers.
- A three-month suspension of employee and employer social insurance payments and provident fund (pension) payments (March to May), with a 10% discount offered to those who pay on time.

- Suspension of interest and penalties until 30-31 March (depending on the obligation) for social insurance contributions, provident fund premiums and tax payments that have already fallen due in February and March.
- Three-month suspension of rents for businesses forced to close.
- Interest-rate subsidies for businesses to maintain employment.

In order to be able to afford these measures, the coalition cut spending in other areas as follows.

- 25% cut in public-sector salaries above ₺5,000 (€690), with some exceptions for "essential services", and a ₺8,500 cap on all public-sector salaries. This was naturally unpopular. Turkish Cypriots say that, even before the most recent cuts, public-sector salaries have now fallen below those in Turkey, although we have been unable to confirm this.
- Abolition of inflation-adjustment (the cost of living allowance) between March and June.
- 25% cut (theoretically reimbursable) in budget contributions to public bodies, local governments and political parties.
- An increase in the withholding tax on interest income to 15%.
- Tighter eligibility in social payments to those on pensions that exceed the minimum wage.

With pressure increasing to rise the income support and broaden its scope, but revenues likely to collapse, the coalition will probably try to borrow from the liquid local banks or potentially the Turkish Cypriot central bank (KMB). Banks may be reluctant to lend directly to the administration, given that it does not have the best payment record. Instead, banks are working with the KMB on guarantees and other loan-support schemes (see Banking sector).

Table 8

Turkish Cypriot central budget outturns
₺ million

	2018 Year	2019 Year	% change	2019 Jan-Mar	2020 Jan-Mar	% change
Total revenue, of which:	5,506	7,403	34.5	995	1,321	32.8
Taxes	3,799	4,969	30.8	590	822	39.3
Excise duties on fuel	647	787	21.6	106	104	-1.7
Grants from Turkey (a)	447	579	29.5	0	54	-
of which: defence (Turkish Cypriot military)	170	512	200.3	0	54	-
Credit from Turkey (b)	41	0	-100.0	0	0	0.0
Total expenditure, of which:	5,452	7,688	41.0	902	1,086	20.4
Personnel expenses	1,873	2,480	32.4	327	367	12.1
Transfers to households	1,273	1,723	35.4	223	241	8.3
Pensions	777	1,032	32.9	152	172	12.8
Defence (Turkish Cypriot military)	170	512	200.3	49	62	26.3
Balance inferred	***53***	***-286***	*-634.6*	***93***	***235***	*152.0*
Memorandum item						
Consumer price inflation rate (%)	-	-	19.5	-	-	13.4

(a) Grants for infrastructure, defence and the real sector.
(b) Budget support.

Source: KKTC Maliye Bakanlığı; Sapienta inferences in italics.

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Parliament authorizes a nine-month suspension of loan-payments—

Parliament voted on 29 March to suspend instalments of capital and interest on loans for a period of nine months until the end of 2020, while postponing until 2 April a vote on €2bn worth of state guarantees (see below). The measure applies to individuals, businesses and the self-employed and only those loans that were not in arrears as of 31 December 2019. This means that it will also include restructured loans that are still classified as non-performing exposures (NPEs) but which are no longer in arrears. Loans that are eligible for suspension will not be counted as being in arrears, and will therefore not add to banks' reported NPE levels during this period. The accrued interest and capital will be payable at the end of the loan term, rather than immediately after the nine-month period is over, or may be restructured. Accrued interest on the deferred loans will be low. The Central Bank Governor, Constantinos Herodotou, tweeted that, for a €100,000 loan at 3% interest, the additional cost will be less than €55. This implies that accrued interest will amount to just 0.1% of the original loan. The suspension is on an "opt-in" basis, meaning that it is available only to those who apply for it.

Table 9

Potentially eligible loans under the payment suspension scheme
€ million

	EUR m
Gross loans in the banking system	33,206
Performing loans	23,700
% of total	*71.4*
Non-performing exposures (NPEs)	9,505
of which: performing restructured loans	1,525
Total potentially eligible loans	***25,226***
% of total	*76.0*
Eligible loans according to the finance minister	16,000
% of total	*48.2*
Memorandum items	
Gross interest income in January-September 2019	1,159
Deferred gross interest income if eligible loans are €25 billion	*881*
Deferred gross interest income if eligible loans are €16 billion	*559*

Source: Central Bank of Cyprus; Sapienta Economics calculations in italics.

—which involves deferring an estimated up to €880m in cash revenues—

The finance minister, Constantinos Petrides, said on 31 March that the measures would affect €16bn of loans. This may be an underestimate. Inferring from Central Bank data on performing and restructured loans, we estimate that the potentially eligible loans amount to €25bn. In January-September 2019 (the latest data available), gross interest income for the entire banking system amounted to €1.2bn, while non-interest income before operating expenses amounted to €333m. Gross interest income therefore accounts for some 77% of bank revenues. On the other hand, it appears from a Central Bank statement that the loan-suspension might only apply to those who can demonstrate a large loss in turnover. We calculate that the banking system could defer €559m in gross interest income (cash basis) if eligible loans amount to €16bn, or €881m if they instead amount to €25bn (see Table 8). Since the suspended loans will not be counted as NPEs, banks are hoping that they will be able to record the deferred interest income in their accounts within the same accounting year. If, at the other extreme, if they have to take the full hit this year, it would involve a very large reduction in bank revenues and therefore bank profits, which in turn would reduce bank capital. Gross interest income for Bank of Cyprus (BOC) was €310m in January-September 2019, while Hellenic Bank's was €283m.

—but BOC and Hellenic seem to be in a good position to absorb losses—

If banks do take the loss this year, they are in a stronger position than before the banking crisis of 2013. Indeed, there are several factors that should prevent an all-out crisis, at least in the short term. First, unlike in 2013, the Cypriot banking system is highly liquid, with deposits of €48.4bn (most of which are domestic) and gross loans of €33.6bn as of January 2020 (see Table 10). Excess liquidity in the system is therefore some €14.8bn, or 66% of GDP. Bank of Cyprus (BOC) had excess liquidity of €3.4bn in September 2019 (latest figures), while Hellenic Bank had €7.4bn. This means that the banking sector can withstand significant deposit outflows should those occur. The high cost of ample liquidity should also fall, now that the European Central Bank (ECB) is offering €3 trillion to banks at negative interest rates, meaning that they will earn interest on what they take.

Table 10

Total capital and Pillar 2 guidance

	BOC	HB	RCB (a)
Total capital (€ million)	2,506	1,122	459
Total capital ratio (%)	18.2	21.53	23.7
Pillar 2 Guidance levels (€ million, estimate)	*413*	*167*	*68*
Pillar 2 Guidance (%)	3.0	3.2	3.5
Risk weighted assets (€ million)	13,758	5,212	1,935
Gross interest income Jan-Sep 2019 (a)	310	283	n/a

(a) Jan-Dec 2018 except for Pillar 2 guidance. Gross interest income in this period was €307m .

Second, on 12 March the European Banking Authority (EBA) loosened rules on capital and liquidity requirements. Banks will be permitted to operate temporarily below their Pillar 2 Guidance (P2G)—meaning below the additional capital required by eurozone authorities. The EBA said that this would release €90bn of capital for eurozone banks. The EBA added that the immediate implementation of the rules of the Capital Requirements Directive V (CRD V) on the composition of Pillar 2 Requirements (P2R) would release another €30bn. Stress tests due this year have also been suspended.

The new Pillar 2 rules will help the three banks under the Single Supervisory Mechanism (SSM): BOC, Hellenic Bank and RCB Bank. Inferring from financial statements, we estimate that the Pillar 2 Guidance amounts to around €647m for the three banks, of which €413m is BOC (with guidance of 3.0%), €167m is Hellenic Bank (3.2%) and €68m is RCB Bank (3.5%). Moreover, the application of CRD V rules on Pillar 2 seem to have more than doubled the amount of capital that can be released. On 16 March, the Central Bank of Cyprus authorized the release of €1.3bn in capital for "systemic Cypriot banks". On 18 March it said that another €100m could be released for other banks. The three main banks are already running capital ratios well in excess of their targets (see Charts).

—and the ECB emergency programme will also be broadly supportive for Cyprus

At the EU level, the European Central Bank (ECB) announced on 18 March the launch of the €750m Pandemic Emergency Purchase Programme (PEPP), aiming at pumping liquidity into the non-financial sector. A key element of PEPP is that it expands the range of debt instruments that the ECB and national central banks can buy. Thus, the ECB will now buy non-financial commercial paper (unsecured short-term corporate debt) "of sufficient credit quality". Additional Credit Claims related to the financing of the corporate sector are also eligible. Another key element is that purchases under the programme will have the same status as the private sector, meaning that if the debt is not repaid, the ECB or central banks do not have a higher claim than other lenders. Another key element is that the ECB has removed its 33% limit on buying eligible debt from a single country. Greece is also eligible for PEPP purchases. This might not help Cypriot non-financial corporations directly, as we understand that they do not issue commercial paper. But it helps the liquidity of the eurozone financial system more generally by encouraging the buying and selling of such securities.

Table 11

Bank loans and deposits
€ million; end-period

	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4
Deposits					
Total deposits	47,864	47,490	48,360	48,869	48,735
Resident	37,599	37,393	38,515	38,625	39,251
Euro area non-resident	3,258	3,157	3,116	3,023	2,854
Other non-resident	7,006	6,940	6,728	7,220	6,630
Loans					
Total loans to non-financial institutions	39,202	38,283	34,116	34,313	33,663
Resident	30,877	30,948	27,047	27,044	26,669
Euro area non-resident	2,497	1,483	1,362	1,393	1,447
Other non-resident	5,828	5,852	5,707	5,876	5,547
Funding gap (-)/Liquidity surplus (+)					
Deposits minus loans	8,662	9,208	14,243	14,556	15,072
Loan/deposit ratio (%)	81.9	80.6	70.5	70.2	69.1

Source: Central Bank of Cyprus, Monetary and Financial Statistics.

State guarantees of €2bn are also expected for new and restructured loans

Another measure to support the banking system will be considered by parliament again on 2 April. Although it was postponed from 29 March, we understand that it is expected to go through. The key elements are as follows.

- €1.75bn for new, low-interest loans to small businesses and the self-employed, as long as the companies retain employees until at least 31 December 2020.
- €250 million to part-subsidize interest rates paid by individuals, the self-employed and larger businesses until 31 December 2020, as long as the companies retain employees.

The Central Bank has already loosened requirements on new loans and the biggest demand for these loans is expected to come from the tourism sector and potentially the construction sector. The accounting treatment for guarantees means that this will not be added to general government debt but nevertheless will constitute a large contingent liability (see Fiscal performance and forecast).

The longer-term impact will probably be negative for NPLs

Other measures include the suspension for three months of foreclosures, announced by both the State Asset Management Company (KEPIDES) and the Commercial Bankers' Association, and a three-month extension for applications to the ESTIA scheme. This is the scheme in which the state will subsidize up to one-third of the interest payments of eligible loans but which has had a very small take-up to date because of the large amount of documentation required. While all of these measures will be important for containing the crisis, we believe that they will ultimately make it more difficult for banks to reduce their outstanding stock of non-performing loans (NPLs). The years since the 2013 crisis have involved a long bank struggle to instil a cultural mindset among both politicians and the general public that loans should be repaid, which had only just started to take root. This culture may now go into reverse. The virus crisis has already delayed BOC's expected sale of NPEs. The bank announced on 16 March that it expected to record additional provisions of around €75m in the Group's financial results for the fourth quarter of 2019.

Table 12

Non-performing exposures (NPEs) in the banking system

	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3
Levels (€ million)					
Total NPEs, of which:	11,182	10,386	10,276	9,830	9,624
Non-financial corporations	5,511	4,890	4,794	4,503	4,345
Construction	1,488	1,305	1,292	1,166	1,129
Wholesale & retail trade	1,579	1,413	1,405	1,347	1,324
Households	5,321	5,166	5,157	5,013	4,912
Ratios (%)					
Total NPEs, of which:	32.0	30.5	30.9	30.0	29.0
Non-financial corporations	36.8	33.7	32.1	30.2	28.8
Construction	48.7	48.6	49.6	47.6	47.0
Wholesale & retail trade	45.7	42.7	40.2	39.4	38.4
Households	38.0	37.6	37.8	37.0	36.5
Memorandum items					
Total loans (€ million)	34,908	34,085	33,296	32,779	33,201
NPLs (>90 DPD)	8,343	7,744	8,058	7,883	4,191

Source: Central Bank of Cyprus.

Turkish Cypriot banks step in with low-interest loans and guarantees

In northern Cyprus, the Turkish Cypriot banking system is in a fairly strong position to deal with the Covid-19 crisis and indeed may be the only real lifeline for the Turkish Cypriot economy, since the authorities cannot borrow internationally, financial assistance from Turkey seems unlikely and the currency of use is the Turkish lira, therefore there is no local lender of last resort. Total deposits in the banking system amounted to ₺32.8bn (€4.9bn) at the end of 2019, while total loans were ₺22.6bn (€3.4bn) (see Table 13). The banking system therefore has some ₺10.3bn (€1.5bn) in liquidity, which is around 47% of GDP (estimated by the authorities at ₺21.8bn in 2019).

On 31 March the Turkish Cypriot bankers' association and the Turkish Cypriot central bank (KMB) agreed on the creation of two funds to support two schemes amounting to ₺1 billion (€139 million).

- **The Interest Rate Differential Fund.** This involves a lower-than-usual interest rate on Turkish lira loans of 12% (which is below the inflation rate of 13.8% in February). Of the 12% interest rate, 3% will be financed by the Interest Rate Differential Fund, which is financed by the KMB's deposit insurance fund. The remaining 9% will be paid by the borrower. Interest payments have a six-month grace period and loans are payable within a year.
- **Credit Guarantee Fund.** This fund, administered by the Turkish Cypriot central bank, provides a 50% guarantee on loans to small and medium-size enterprises (SMEs). One of

the key fears among SMEs is that any cheques that they have collected during March will bounce and since business loans account for 65% of the total this has been a key concern. The Credit Guarantee Fund is meant to help prevent that.

Unusually for a crisis period, the KMB has raised the liquidity reserve requirement (the ratio Turkish lira deposits required to be banked overnight with the central bank) four times in three months: from 7% to 7.25% on 31 December, to 7.5% on 31 January, to 7.75% on 29 February and to 8% on 31 March. At the same time, it has lowered the interest rate it pays on these reserves. Normally a central bank would lower the reserve requirement during a crisis in order to encourage banks to lend to businesses. (For example, the US Federal Reserve has reduce its requirement to zero.) The unusual move may therefore reflect an expectation that the administration may end up borrowing directly from the central bank (something which is not permitted in the eurozone). The KMB is also auctioning foreign-currency Treasury bills, with a plan to auction \$5m, €30m and £40m on 6 April, presumably to help finance the interest-rate fund. T-bill auctions are not unprecedented but they do not take place very frequently. Other measures that have been taken include a cut in interest rates on overdue credit cards.

Other banks have also offered new credit facilities. Halkbank is offering five-year loans of up to ₺225,000 (around €31,000) to shop-owners and retailers at an interest rate of 4.5% (compared with a normal rate of double digits). The Turkish Cypriot Development Bank is offering 36-month loans of ₺50m (around €7m) with a six-month grace period.

Table 13

Key indicators of the Turkish Cypriot banking system
₺ million unless otherwise stated

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Gross loans	18,906	19,824	20,347	20,200	22,573
In Turkish lira	9,406	9,610	9,807	9,962	10,934
In foreign exchange	9,499	10,214	10,542	10,238	11,640
Deposits	26,442	28,449	29,572	30,225	32,837
In Turkish lira	10,605	10,729	11,338	12,171	13,014
In foreign exchange	15,837	17,721	18,234	18,054	19,823
NPLs (90+ days past due) (a)	1,045	1,085	1,103	1,104	1,266
NPLs in € million equivalent (a)	€172	€171	€168	€180	€189
NPL ratio (%) (a)	5.5	5.5	5.4	5.5	5.6
Coverage ratio (%)	68.3	67.4	66.5	67.0	60.6
Memorandum item					
TRY per EUR (end-period)	6.0588	6.3446	6.5655	6.1491	6.6843

(a) Does not include arrears of public organizations.
Source: KKTC Merkez Bankası.

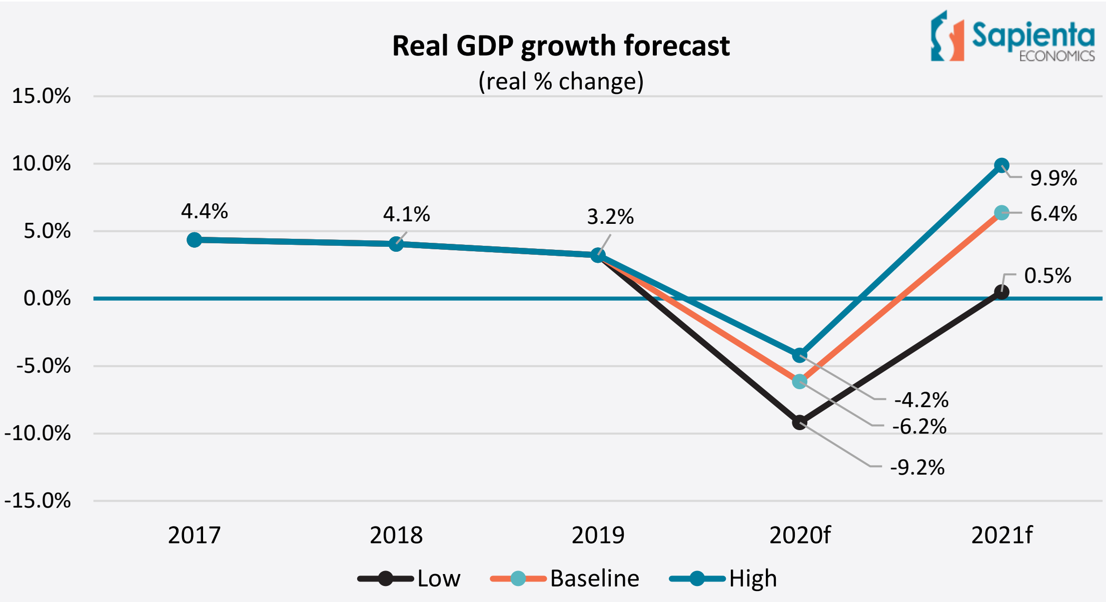
Macroeconomic trends and forecast Next section Previous section

We have produced three scenarios for real GDP in 2020-21—

With the Covid-19 situation changing rapidly, we have produced three tentative scenarios for GDP performance in 2020-21. The three scenarios are as follows.

- In our low scenario, real GDP declines by 9.2% in 2020 and rises by 0.5% in 2021, producing an average real GDP *decline* of 4.3% in 2020-21.

- In our baseline scenario, real GDP declines by 6.2% in 2020 and rises by 6.4% in 2021, producing an average *growth* rate of 0.2% in 2020-21.
- In our best-case scenario, real GDP declines by 4.2% in 2020 and rises by 9.9% in 2021, producing an average *growth* rate of 2.8% in 2020-21.



—we assume zero tourism arrivals in April for all three scenarios—

The key assumptions for the three scenarios relate to tourism (6.1% of GDP), retail and wholesale trade (9.5% of GDP), healthcare (5.3% of GDP) and spending by the public sector (7.1% of GDP)—see Charts. In all three scenarios, we assume no tourism arrivals at all in April. In the worst-case scenario, we assume that there are no tourism arrivals at all in April-June and that they reach only 60% of their 2018-19 levels by December. Our baseline scenario assumes that there is a trickle (5% of 2018-19 levels) in May, probably focused on those who can demonstrate that they are virus-free. By the end of the year, tourism arrivals are 70% of 2018-19 levels. In our best-case scenario, tourism arrivals start in May at 10% of 2018-19 levels and reach 80% of 2018-19 levels by December.

In all three scenarios, we assume that tourism arrivals still will not have reached their levels of 2018-19 in 2021. The crisis is likely to eliminate a number of airlines, thus reducing the availability of flights, and will therefore limit price competition even when fuel prices are low. This trend in airline availability could be exacerbated globally if there is also a reduction in academic travel, which will further dampen demand. We also assume that proof of virus-free status will be a permanent feature for airline travel, which will raise the costs of flights.

—while food, pharmacies and the public sector will partly offset declines elsewhere

For both communications, health and public sector, we expect a rapid expansion in gross value-added as various services are ramped up to deal with the crisis. Since the public sector is large, this will offset to some extent the decline in tourism. Our expectations for wholesale and retail trade are based on subsectors pulling in different directions. We expect wholesale and retail sales of food to increase by around 6%, as they did in the 2013 banking crisis. Indeed, various anecdotal reports suggest that food sales have been strong. We also expect sales of medicines and pharmacy products to rise even more quickly, by 20%. In the other subsectors that comprise the wholesale, retail and auto repairs sector, we assume a similar pace of decline to the banking crisis in 2013.

Together, food and pharmacies account for about 36% of the total, therefore even strong growth rates in these two subsectors are not enough to offset a decline in other subsectors. In our baseline forecast, therefore, wholesale and retail trade declines by 7.4% in 2020. One major technical assumption is that gross value-added at constant prices falls at the same pace as the volume of retail sales. This may not be the case and is something that we shall revisit more closely in future forecasts. For transport, while we expect airlines (which account for only 1% of transport value-added) to decline sharply, whereas we expect shipping to grow, as container ships take advantage of low oil prices by stocking up on crude. While developers have lobbied to speed up the authorization of pending applications for the controversial Citizenship by Investment (passport) scheme, we believe that the sector, which was already overheating in Limassol, is unlikely to avoid a recession in 2020-21.

Table 14

Real GDP by main sector (baseline forecast)
rela % change

	2018	2019	2020	2021
Construction	24.7%	13.4%	*-19.5%*	*-13.4%*
Wholesale & retail trade & auto repairs	4.5%	3.5%	*-7.4%*	*8.6%*
Transportation & storage	4.5%	2.2%	*3.5%*	*4.6%*
Accommodation & food services	5.7%	2.0%	*-69.1%*	*159.1%*
Information & communication	2.7%	9.8%	*12.4%*	*5.0%*
Public administration & defence; compulsory social security	1.6%	1.5%	*10.0%*	*8.0%*
Healthcare	4.1%	4.1%	*20.0%*	*15.0%*
All other sectors	1.8%	1.3%	*-5.4%*	*0.5%*
GDP	**4.1%**	**3.2%**	***-6.2%***	***6.4%***

Sources: Cystat; Sapienta Economics baseline scenario in italics.

The tourism market might have changed permanently

If the expected reduction in airline routes and higher costs become a permanent feature of global air travel, then this has major repercussions for Cyprus. Over the past decade the government has sought to attract higher-spending tourists by encouraging the construction of marinas, higher-star hotels and other property. However, the process is not yet complete. While package travel has fallen from a peak of more than 75% in 2001, it still accounted for 58.8% of visits in 2017 according to the latest available statistics. Moreover, higher-spending tourists are also more demanding in other ways. In a world in which air travel is already becoming unfashionable among the younger generation, Cyprus has little to offer increasingly green-conscious tourists, as it still plans to produce electricity from fossil fuels for many years to come, has next to no electric cars and a substandard public transport system. The world after Covd-19 might therefore also require a whole rethink of tourism and infrastructure strategy.

Higher education and tourism are hit in northern Cyprus

With similar lockdown measures in place in northern Cyprus, the Turkish Cypriot economy is also expected to record a major hit to tourism. The higher education sector, which these days earns as much foreign-exchange revenue as tourism, attracted more than 108,204 students in the academic year 2018/19, of which 54,966 were from Turkey and 35,480 were from other countries. According to Mete Hatay, a senior researcher at PRIO who specializes, inter alia, in northern Cyprus demographics, around 65,000 people left through sea and airports since 10 March, Like the southern part of the island, the Turkish Cypriot tourism sector is also vulnerable to markets that have responded more slowly to the crisis, with some 77% of arrivals coming from Turkey. Although arrivals counted as tourists could also include students and workers, it underlines the scale of the problem if Turkey remains out of bounds for several months.

Table 15

Northern Cyprus tourism arrivals
'000

	Jan-Dec 2018	Jan-Dec 2019	% change year on year
Arrivals of Turkish nationals	1,359	1,358	-0.1
Other arrivals	400	392	-2.2
Total arrivals	**1,760**	**1,750**	**-0.5**

Source: Turizm Planlama Dairesi.

Table 16

Northern Cyprus: key macroeconomic indicators

	2014	2015	2016	2017	2018
GDP (₺ billion)	8,859	10,222	11,601	14,545	18,324
GDP (€ billion, converted at annual average exchange rate)	3,048	3,379	3,470	3,530	3,210
Population ('000, year-end)	320,884	331,432	339,487	351,965	372,486
GDP per capita (€)	9,498	10,194	10,222	10,029	8,619
Real GDP growth (%)	4.8	3.9	3.6	5.4	1.3
Consumer price inflation (%)	6.5	7.8	10.2	14.7	23.1
Unemployment rate (%)	8.3	7.4	6.4	5.8	6.8
Fiscal balance (% of GDP) (a)	-4.0	-3.2	-1.1	-0.3	n/a
Public debt (€ million, converted from $ and ₺) (a)	4,348	5,060	5,129	4,893	n/a
of which debt to Turkey (a)	2,730	3,362	3,424	3,409	n/a
Public debt (% of GDP) (a)	142.7	149.8	147.8	138.6	n/a
of which debt to Turkey (% of GDP) (a)	89.6	98.9	98.8	96.6	n/a
Number of tourists ('000)	1,366	1,483	1,577	1,734	1,760
Exports of goods ($ million)	134	118	106	106	111
Imports of goods ($ million)	1,784	1,501	1,557	1,778	2,081
Memorandum items					
United Cyprus debt (% of GDP)	*108.3*	*112.7*	*114.3*	*113.2*	-
United Cyprus debt if debt to Turkey written off (% of GDP)	*96.0*	*99.4*	*98.3*	*97.3*	-
Turkish lira per euro (ECB)	2.9065	3.0255	3.3433	4.1206	5.7077
Turkish lira per US dollar (US Forex and ECB-derived)	2.1885	2.7119	3.0249	3.6475	4.8329

(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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