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Overview Next section

30 June 2021

- Political analysis and outlook. Cyprus problem negotiations have re-entered a holding pattern but the opening of Varosha is set to begin and concerns are increasing in northern Cyprus about a slide towards annexation. Opposition parties have shunned participation in the Republic of Cyprus government, which may make reform legislation more difficult.

- Sectoral policies, reforms and energy. ExxonMobil is set to drill offshore in late 2021. The East Med pipeline remains an EU Project of Common Interest but Greek-Egyptian plans remain a rival. The Recovery and Resilience Plan involves ambitious justice reform. Covid-19 cases have started to trend upwards again.

- Fiscal performance and forecast. Government revenue recovered in April but expenditure growth remains high. Short-term debt has returned to pre-pandemic levels. The government and professionals seem unconcerned by the G7's proposed 15% corporate tax rate and are in any case planning tax reform. We have revised down our deficit forecast.

- Banking sector. BOC has issued debt securities to meet MREL capital requirements and we estimate that Hellenic Bank will need to issue at least €61m in debt for the same reason. BOC's Helix2 sale will bring its NPE ratio down to 16%. Mortgages have started to pick up. A rent-to-buy scheme is envisaged for the national asset management company (bad bank).

- Macroeconomic trends and forecast. We have examined the government's real GDP growth forecast of more than 4% for 2021. While the second quarter is likely to have been robust, we expect confidence to wane from the third quarter owing to Covid-19 uncertainties and inflation eating into real incomes. We now expect real GDP growth of 3% in 2021.

- Economy of northern Cyprus*. A new loan $500m agreement with Turkey has been approved. The authorities hope to raise tax from gambling but policymaking is likely to be hampered by coalition infighting, which may also complicate plans for Varosha. Banks in northern Cyprus remain highly liquid. Exports have continued to rise and imports to fall.

**Areas not under the effective control of the government of the Republic of Cyprus.*

Table 1

Sapienta Economics macroeconomic forecast

	2019	2020	*2021*	*2022*	*2023*
GDP at current prices (€ m)	22,287	20,841	*21,819*	*22,478*	*23,248*
GDP per capita (€)	25,270	23,397	*24,301*	*24,836*	*25,233*
GDP at constant 2005 prices (€ m)	21,632	20,528	*21,154*	*21,419*	*21,761*
Real GDP growth (%)	3.1	-5.1	*3.0*	*1.3*	*1.6*
Harmonized consumer price inflation (%)	0.5	-1.1	*1.6*	*1.7*	*1.8*
Unemployment rate (%)	7.1	7.6	*6.7*	*6.5*	*6.5*
Budget balance (ESA2010) (€ m)	326	-1,193	*-878*	*-800*	*-706*
% of GDP	1.5	-5.7	*-4.0*	*-3.6*	*-3.0*
Primary balance (ESA2010) (€ m)	1,142	-699	*-431*	*-375*	*-335*
% of GDP	5.1	-3.4	*-2.0*	*-1.7*	*-1.4*
Gross public debt (€ m)	20,958	24,823	*25,012*	*24,758*	*24,948*
% of GDP	94.0	119.1	*114.6*	*110.1*	*107.3*
Current-account balance (% of GDP)	-6.3	*-11.9*	*-10.5*	*-6.9*	*-6.1*

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

Political analysis and outlook Next section Previous section

Cyprus problem negotiations re-enter holding pattern—

Progress on resuming any kind of dialogue to solve the Cyprus problem has in practice slipped back into dormant mode despite a number of meetings on the subject. The UN senior official, Jane Holl Lute, visited Cyprus on 21-23 June, which Greek Cypriot media reported as bringing "nothing new". The UN Secretary-General, Antonio Guterres, met separately the Greek Cypriot leader and president of the Republic of Cyprus, Nicos Anastasiades, and the Turkish Cypriot leader and president of the unrecognized Turkish Republic of Northern Cyprus (TRNC), Ersin Tatar, in Brussels on 25 June. Mr Tatar went to Brussels to insist on a two-state solution. However, the European Commission president, Ursula Von der Leyen, said on 25 June that she had had a telephone conversation with Turkey's president, Recep Tayyip Erdoğan, in which she told him that "we will never ever accept as a European Union a two-state solution". Similarly, Mr Guterres is reported by the Greek Cypriots to have said that a two-state solution is a "non-starter". While Mr Anastasiades has suggested moving directly to fully fledged negotiations (probably to stave off developments on Varosha—see below), this is unlikely when the relevant parties are so far apart on the aim.

While there is clearly an international effort to keep the prospects of a united, federal Cyprus alive, including in the European Council conclusions on 24 June, the outcome of the recent meetings has nevertheless confirmed our expectations that there is unlikely to be another "informal" five-party meeting any time soon, and that fully fledged negotiations remain a distant prospect. The Cyprus problem negotiations have in practice re-entered the holding pattern in which they have been since July 2017.

This stagnation means that developments on the Cyprus problem will be increasingly driven by developments outside Cyprus, in particular Turkey's relations with the EU and the US. The NATO summit on 14 June seems to have heralded a de-escalation of tensions between Turkey on the one hand and the US, France and Greece on the other. However, the relationships between Turkey and others remain delicate, as witnessed by the rival NAVTEX notices to mariners sent by Greece on 21 June and Turkey on 22 June. The (Greek Cypriot) Republic of Cyprus is clearly concerned that decreased tensions between Turkey and the EU/US will see the international community turning a blind eye to drilling by Turkey in the Republic of Cyprus Exclusive Economic Zone (EEZ) or the development by Turkish companies of Varosha—the "ghost town" that had been fenced off and under the control of the Turkish military since 1974—in breach of UN Security Council resolutions dating back to 1984. This explains the inclusion of reference to Varosha in the latest European Council conclusions of 24 June and a more general reference to the need to sustain de-escalation in the Eastern Mediterranean.

—but the opening of Varosha is set to begin—

The European Council references ought to be enough to avoid major security upsets in the short term. However, stagnation on the Cyprus problem, combined with the abovementioned delicate relationships, raises the risk of more offshore drilling by Turkey in the Republic of Cyprus later this year, especially given ExxonMobil's plans to drill in the fourth quarter (see Sectoral policies, reforms and energy). Stagnation also makes it highly likely that additional parts of Varosha will be gradually opened under Turkish Cypriot control. Work is already under way to open the beach area which Mr Erdogan visited in November 2020. This is likely to be officially opened on 20 July, when Mr Erdogan will visit northern Cyprus to mark the anniversary of the invasion on 20 July 1974 that followed the coup on 15 July 1974. The UN Security Council Resolution 2561 of January

2021, which calls for the reversal of developments in Varosha, and the reference to Varosha in the European Council conclusions, mean that the whole area is unlikely to opened at once. Nevertheless, Mr Tatar stated his intention on 22 June to open the entire area under Turkish Cypriot control and Turkey's foreign minister, Mevlut Cavusoglu, will visit northern Cyprus on 1 July, apparently to discuss Varosha as well as the appointment of a new UN Special Representative of the Secretary-General (SRSG) to replace the outgoing SRSG, Elizabeth Spehar.

The plan appears to be to open Varosha in stages, starting with beaches, then religious sites that have always belonged to the Efkav (religious foundation dating from Ottoman times). Mr Tatar said on 10 June that the mosque of Bilal Agha Mezjit would be opened up once restoration had been completed. The opening of this mosque probably draws on the longstanding "convergence" (agreement in principle) that religious sites would be returned under a comprehensive settlement of the Cyprus problem. The next target is to encourage Greek Cypriot owners to surrender their properties for compensation via the Immovable Property Commission (IPC) that was established in northern Cyprus in December 2005 as a result of European Court of Human Rights (ECHR) rulings. Despite complaints about late payments and slow processes, the ECHR's Demopoulos decision of 2010, which found that the law establishing the IPC "provides an accessible and effective framework of redress", still holds.

To date, only 344 applications have been filed to the IPC among the approximately 6,000 title deeds owned by Greek Cypriots in Varosha (Mr Tatar has mentioned a figure of 3,000 owners), not least because the Republic of Cyprus government is actively discouraging applications. A prominent lawyer involved in Greek Cypriot property claims, Achilleas Demetriades, told Sapienta Economics that the Republic of Cyprus government is charging €3,000-€4,000 for each valuation of property in Varosha, is refusing to conduct a valuation for an area around the Tymvou/Ercan airport and is no longer supporting applications to the ECHR. While the Turkish Cypriot law establishing the IPC has yet to be amended to allow for rulings on applications in the Varosha area, and may be delayed by internal politics (see Economy of northern Cyprus) an amendment is in progress. One can therefore envisage a situation in which only a few Greek Cypriots come forward and the Turkish Cypriot authorities implement a *de facto* expropriation, perhaps starting with property over which the Efkav has made claims in the past. The final move would be to acquire the entire area.

—and concerns increase about a slide to annexation

The Greek Cypriots do not seem to have a strategy for preventing the opening of Varosha, beyond discouraging applications and hoping that their appeals to the international community will prevent the entire area being opened. The longer-term risk is that each unilateral move by Turkey and the Turkish Cypriots to open Varosha makes a solution of the Cyprus problem far more difficult. Given Turkey's close engagement with Varosha's development, it also increases concerns expressed by Turkish Cypriots about a slow *de facto* annexation of northern Cyprus through political, cultural and financial means followed by formal annexation in the longer term. Recent developments cited include accusations of unprecedented intervention in the presidential elections in October 2020, as detailed in a report published in June; accusations that the Turkish Cypriot authorities have granted 2,500 citizenships in six months; and the invitation to 3,750 schoolchildren to attend free Çanakkale National Struggle Camps and Joint Culture Camps in Turkey, which left-wing teachers' organizations among others have criticized for imposing "nationalism and militarism", "Islamic culture" and gender-based discrimination. The general feeling is that the Turkish Cypriots' agency in their own affairs is rapidly diminishing, raising fears that, at best, the unrecognized TRNC will become a part of Turkey in all but name, or, at worst, that these developments pave the way for a future referendum and annexation of northern Cyprus. This would create a new and potentially unstable land border between the EU and Turkey down the middle of Cyprus.

Table 2

Parliamentary election results, 2016 and 2021 % of vote unless otherwise indicated	**May-16** **% of vote**	**May-21** **% of vote**	**May-16** **Seats**	**May-21** **Seats**
DISY	30.69	27.77	18	17
AKEL	25.67	22.34	16	15
DIKO	14.49	11.29	9	9
ELAM	3.71	6.78	2	4
EDEK	6.18	6.72	3	4
DIPA (break-off from DIKO)	-	6.10	-	4
Greens	4.81	4.41	2	3
Active Citizens/Hunters' Movement	-	3.27	-	0
Generation Change (ex Independents)	-	2.82	-	0
Solidarity Movement	5.24	2.31	3	0
Famagusta for Cyprus	-	1.56	-	0
Awakening	-	1.35	-	0
Breath of the People	0.87	1.28	0	0
Animal Party	1.16	1.00	0	0
Citizen's Alliance (ran with EDEK in 2021)	6.01	-	3	-
Others	1.17	1.00	0	0
Total	**100.00**	**100.00**	**56**	**56**
Memorandum item				
Turnout (% of electorate)	67.37	65.72	-	-

Source: Ministry of Interior.

Note: Defections between 2016 and 2021 meant that by the time of the 2021 election DIKO had 8 seats, DIPA had 3, Solidarity had 2 and the Citizens' Alliance had 1.

Opposition parties shun participation in a government with a reputation problem—

The slow "train crash" that is coming on Varosha, the ongoing damage to the government from the passport programme, the unexpected appointment of a deputy from the ruling Democratic Rally (DISY), Annita Demetriou, as House President and political parties' considerations ahead of the presidential election in February 2023 explain the reluctance of any of the opposition parties to join the Council of Ministers (cabinet) after the parliamentary election on 30 May. The Republic of Cyprus president, Nicos Anastasiades, met all party leaders after the election and is reported to have offered participation in government to every party. He tried particularly hard to persuade Adamos Adamou, a respected politician from the "Left Forces" associated with the opposition Progressive Party of Working People (AKEL), to become health minister. However, all parties ultimately rejected the offer, leaving Mr Anastasiades to replace only the two ministers (health and justice) who had resigned of their own accord and to appoint a deputy minister (Anastasia Anthousi) for the new Deputy Ministry of Social Welfare. Stefi Drakou replaced Emily Yiolotis as Minister for Justice and Michalis Hadjipantelas replaced Costas Ioannou as Health Minister. Ms Yiolitis' resignation brought further embarrassment to the government when she wrote a letter to Mr Anastasiades government saying that it had "not made a good impression on society ... on issues of corruption and transparency". The full damning report on the passport scheme, which we discussed in our April issue, was published on 22 June.

Mr Anastasiades also reshuffled some communications positions, all of which are also closely associated with DISY. The shake-up of the presidential communications team came amid reports of conflicts between the various factions at the Presidential Palace. The most controversial appointment was the new government spokesperson, Marios Pelekanos, who is on the right of the party, has become known for supporting harsh measures against migrants and whose placement on the DISY ballot in the parliamentary elections in May was seen primarily as an attempt to curb the losses to the far-right National Popular Front (ELAM).

—and raises questions about reform legislation

The absence of other parties raises questions about whether the government will be able to pass the reforms necessary to attract the €1.2bn in Recovery and Resilience Funds (RFF), although with the Democratic Party (DIKO) retaining the powerful finance committee, there is still scope for cooperation. As usual there were intense negotiations for the distribution of committee chairmanships, with the thorniest subject being whether ELAM would receive one. Out of the 16 parliamentary committees, DISY and AKEL will chair five committees, DIKO will chair three, DIPA and the Greens will chair one each and ELAM will chair the newly created "ad hoc committee on demographics". This was upgraded from a subcommittee of the committee on labour issues as AKEL was adamant that ELAM should not get a parliamentary chair. AKEL will now abstain from participating in the ad hoc demographics committee. Nevertheless, the outcome of the elections and the committee distribution is that ELAM is now firmly established as a party political force.

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ExxonMobil is set to drill offshore again in the fourth quarter of 2021—

After a period of uncertainty about whether any companies would conduct the offshore drilling planned in the fourth quarter of 2021, the energy minister, Natasa Pilides, said on 29 June that ExxonMobil would drill Block 10 in November-December. According to a report by *Kathimerini*, drilling is expected to take place in Glaucus-1 and possibly elsewhere. Exxon estimated in February 2019 that Glaucus-1 had an "in-place natural gas resource" of 5 to 8 trillion cubic feet (tcf). Recoverable reserves at could ultimately be estimated at around the same size as those of Aphrodite in Block 12. Delek Drilling, one of the licensees in Aphrodite, cites Aphrodite resources at 129 billion cubic metres (bcm), which is 4.56 tcf. ENI and Chevron are also officially due to drill in the fourth quarter of 2021 according to schedules agreed with the government. However, there are as yet few signs that this drilling will take place.

—which may prompt drilling by Turkey in the Republic of Cyprus EEZ

Block 10 does not lie in any of the Republic of Cyprus Exclusive Economic Zone (EEZ) that is claimed by Turkey as its continental shelf, nor in any of the blocks licensed by the unrecognized Turkish Republic of Northern Cyprus (TRNC) to the Turkish Petroleum Corporation (TPAO). Nevertheless, depending on political developments (see Political analysis and outlook), drilling by Exxon could trigger the resumption of unauthorized drilling by TPAO. Turkey's energy minister, Fatih Dönmez, said on 7 June that TPAO "will continue with plans to drill in both the Black Sea and the Mediterranean". Mr Donmez said that TPAO had drilled eight wells in the Eastern Mediterranean, which had so far have produced some "positive signs". (TPAO had been drilling in Blocks 6 and 7, which are officially licensed to ENI and Total.) Mr Donmez said that new drilling would have to wait until long-term maintenance work had been completed on TPAO's drill ship, Yavuz, which is currently in port at Silifke on Turkey's east Mediterranean coast. Earlier, there had been some hints that Turkey's president, Recep Tayyip Erdoğan, might announce gas finds in Block 6 or 7 when he visits northern Cyprus on 20 July.

Drilling in the Black Sea has proven more promising for TPAO than in the Republic of Cyprus EEZ. TPAO announced in June a further 135 bcm of gas reserves in the Black Sea from its Amasra-1 well, in addition to the 405 bcm announced in 2020, and according to media reports has shared its data with ExxonMobil and Chevron (both companies with licences in the Republic of Cyprus EEZ).

East Med pipeline remains a PCI but Greece-Egypt plans remain a rival—

Despite expectations, the East Med pipeline that would run from Israel via Cyprus to Greece, was kept as an EU Project of Common Interest in the fifth version of the list that was agreed on 11 June. The official reason was that Cyprus (and Malta, which also maintained a shorter gas pipeline) are isolated from the EU's gas infrastructure. However, geopolitical considerations, in particular, a desire to keep up pressure on Turkey, might also have played a part. The East Med pipeline remains commercially challenging and could well be taken over by plans between Greece and Egypt, which we have discussed in our previous reports, to pipe gas from western Egypt to Crete and then send it on from there to mainland Greece, either as liquefied natural gas (LNG) or other forms of what is being termed a "virtual pipeline". During a visit of the Greece's prime minister, Kyriakos Mitsotakis, to Egypt on 21 June, media reported that there were discussions about sending the gas from Egypt to Greece as compressed natural gas (CNG). This is a new technology that costs less to compress than LNG but the technology involved means that it is more costly to transport over anything but short distances. Ministers are also reported to have discussed an electricity interconnection between the two countries. It is not clear whether this relates to the EuroAfrica Interconnector or a rival plan.

—but with the EU joining the EMGF, more energy coordination can be expected

More generally, increased energy coordination in the Eastern Mediterranean can be expected as a result of the growing membership of the Eastern Mediterranean Gas Forum (EMGF), which comprises a mix of EU and non-EU Mediterranean countries. The EU officially applied to become an observer on 15 June and the US has been an observer since March 2021 (when France became a full member). The eight full members are now: Cyprus, Egypt, France, Greece, Jordan, Israel, Italy and the Palestinian Authority. Cyprus will take up the first official rotating presidency in 2022.

Recovery and Resilience Plan involves ambitious justice reform—

As we noted in our May issue, the Cyprus Recovery and Resilience Plan (RRP) was received by the European Commission on 17 May and the complete 1,008-page document was published shortly thereafter. The RRP is due for approval in July and implementing it is a pre-condition to receive some €1.2bn in EU funds under the Recovery and Resilience Facility (RRF). In our May issue we focused on energy reforms. In this issue, we focus on justice reform. The justice system in Cyprus is limited among others by the complex outdated procedural rules, absence of information and communication technology (ICT) tools, long delays in the delivery of justice and a serious backlog of cases.

A key aim of the reforms relating to justice is to bolster transparency, accountability and anti-corruption mechanisms on the basis that this will support sustainable growth and increase the resilience of the economy. There is also an aim to modernize and simplify rules and procedures, including via digitalization. The specific reforms related to an efficient justice system are incorporated in Component 3.4: "Modernising public and local authorities, making justice more efficient and fighting corruption". Within this component, the following two areas have been identified:

- Efficiency and Functionality of Justice (Subcomponent 3.4.3)
- Digital transformation of courts (Subcomponent 3.4.3)
- Fighting corruption (Subcomponent 3.4.4)

Investments include training judges, upgrading the infrastructure of courts and anti-bribery (ISO 37001) certification. The RRP outlines the following projects to enhance the efficiency and functionality of justice.

- **More judges**. The Supreme Court is in the process of recruiting additional judges and finding new court rooms to eliminate the backlog of cases.
- **New draft Rules of Civil Procedure**. New Rules of Procedure have been approved in principle by the Supreme Court and are undergoing a consultation process. The aim is for the new rules to be introduced and implemented uniformly by all judges, lawyers and court staff. The report says that new rules "will no doubt enhance considerably the efficient determination of cases and will be an obstacle to the creation of a new backlog of cases in the future".
- **Greater efficiency in the courts**. An "efficient Court Service" and "re-engineering" of Court Registries is promised. The RRP notes that much of the court registry system is still manual and there is "lack of active management of cases through the system". Digitization ("E-Justice"), including digital audio, and the new Rules of Procedure will play a key role in reforming all aspects of management, administration and support of the courts.
- **Greater specialization.** The aim of greater specialization is to enhance the quality and efficiency of justice.

While the Covid-19 pandemic had already necessitated some interim digital solutions, the plan to digitize the justice system is ambitious. The launch of the much-touted interim solution, the i-Justice, scheduled for April 2021, is already behind schedule owing to disagreements over who bears cost of digital platform maintenance and the 0.5% transaction costs for online financial transactions.

—and the new justice minister will need to bring in an array of stakeholders

Digitization and reform of the court system now rests on the shoulders of the newly appointed minister of justice and public order, Stefi Drakou. Ms Drakou is the former general manager of the Association of Insurance Companies and is considered to be methodical and well qualified. Her challenge will be to bring together all the stakeholders to agree on reforms that are not only controversial but also involve what is considered to be the most complex reform since the introduction of the GESY healthcare system. Three of Ms Drakou's predecessors failed to bring about substantive reforms. For example, a bill on justice reform tabled before the parliamentary election on 30 May was seen as premature and not holistic by members of the parliamentary Committee on Legal Affairs, who postponed its discussion to parliament's new session. The bill covers, *inter alia*, the separation of the Supreme Court, the establishment of a new second-tier Court of Appeal and other specialized courts, as well as the restructuring of the composition of the Judicial Council. Members of Parliament (MPs) who criticised the bill put forward by the government said that the lack of frequent coordination and deliberation between the parliament and the judges in the Supreme Court did not allow for a constructive exchange of views. The members of the Supreme Court themselves disagreed with some provisions of the bill and deemed them unconstitutional.

Table 3

Cyprus Recovery and Resilience Facility estimated budget	€ m	% of total
1. Public health, civil protection & lessons from the pandemic	74.1	6.0
1.1. Resilient & effective health system, enhanced civil protection	74.1	6.0
2. Accelerated transition to a green economy	447.6	36.3
2.1. Climate neutrality, energy efficiency & renewable energy penetration	269.0	21.8
2.2. Sustainable transport	91.3	7.4
2.3. Smart & sustainable water management	87.3	7.1
3. Strengthening the resilience & competitiveness of the economy	449.3	36.4
3.1. New growth model & diversifying the economy	166.4	13.5
3.2. Enhanced research & innovation	64.0	5.2
3.3. Business support for competitiveness	78.4	6.4
3.4. Modernizing public & local authorities, making justice more efficient & fighting corruption	96.0	7.8
3.5. Safeguarding financial & fiscal stability	44.5	3.6
4. Towards a digital era	89.4	7.3
4.1. Upgrade infrastructure for connectivity	53.0	4.3
4.2. Promoting e-government	36.4	3.0
5. Labour, social protection, education & human capital	172.9	14.0
5.1. Educational system modernization, upskilling and retraining	94.0	7.6
5.2. Labour market, social protection, social welfare & inclusion	78.9	6.4
Total	**1,233.0**	**100.0**
Green transition (approximate)	501.0	41.0
Digital transition (approximate)	282.0	23.0

Source: Cyprus Recovery and Resilience Plan 2021-26.

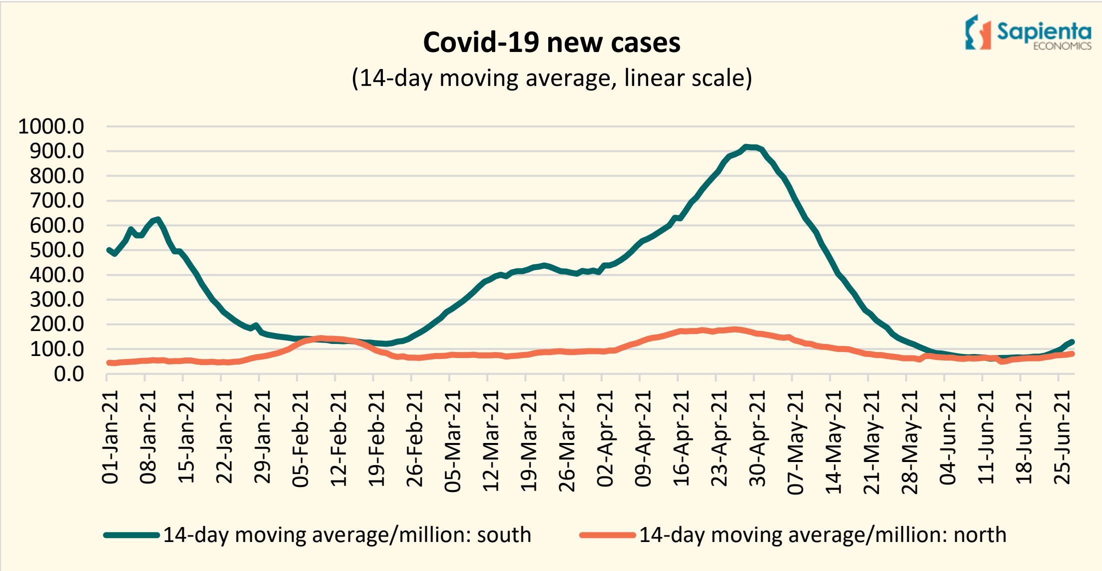
GESY healthcare system proves immensely popular two years after its introduction—

Two years after its launch on 1 June 2019, the Cyprus National General Health System (GESY) has proven to be highly popular, with 82% of beneficiaries saying the level of services is very satisfactory and 80% saying it has improved their quality of life according to a study conducted by IMR/University of Nicosia. GESY now has 892,000 beneficiaries, 4,000 health professionals of various specializations, 149 laboratories, eight accident and emergency (A&E) departments, 54 clinics and hospitals, and 554 pharmacies. These amount to more than 70% of doctors, 99% of pharmacies, 88% of available hospital beds and 100% of laboratories. The 892,000 cited for beneficiaries is a higher number than Cystat's most recent estimate for the total population of 888,000 in 2019. This suggests that the population census due in September will lead to an upward revision of population estimates.

—but keeping the system in budget balance will be a challenge

The budget of the Health Insurance Organization (HIO) that runs GESY was in surplus in 2020, with expenditure of €780m and revenue of €840m. However, in-patient care was only introduced in June 2020, not all healthcare professionals were included at the beginning of the year, and many surgical procedures were delayed as a result of the pandemic. In 2021, the HIO is budgeted in theory to be more or less balanced: expenditure is budgeted to rise by more than 60% to €1.276bn (€1.3bn) in 2021 while revenues are budgeted at €1.278bn. However, keeping the system in balance will be challenging. Anecdotal evidence suggests that the high demand for specialist services is leading to longer waiting times than under the previous system, when patients could also book directly with a specialist but would pay considerably higher fees for doing so. The full autonomy of hospitals has also been delayed by the pandemic.

While up-to-date statistics are not yet published, media reports suggest that the HIO finances were in cash deficit in the first three months of the year, with expenditures of €290m and revenue (for January-February social insurance receipts paid by the end of March) of €185m, although the same report notes that GESY began the year with a positive balance sheet of €350m. The deficit in the first quarter is partly because the increase in social insurance contributions earmarked for GESY were postponed for three months in 2020 but it is also related to lower employment and salaries levels, which could be a longer-term feature. To contain expenditure the HIO imposed a 10% cut on the income of personal doctors and a 6% cut on its payments for in-patient care in 2020. It is also trying to tackle reported abuse of the system with enhanced monitoring and stricter punishments.



Covid-19 cases start to trend up again

After a sharp drop in Covid-19 cases on both sides of the island in May, new cases started to rise again on both sides of the island. At the time of writing they had peaked at 226 new cases on 26 June in the southern part of the island and 50 on 24 June in the north. While these levels are much lower than the spikes reached in April, concerns about the infection rate of the "delta" variant among unvaccinated people led the Republic of Cyprus authorities in the southern part of the island to open up vaccines to 18-25 year-olds from 30 June. According to Our World in Data, 51% of the population in the south had received at least one dose as of 24 June, while available data suggest that 28.5% of the population in the north had received at least one dose by the same date. The drop in cases in May also supported the decision by the political leadership on both sides to reopen from 4 June all crossing points across the UN-monitored buffer zone. More than 33,000 crossings were made in the first four days.

With first-dose vaccinations in the south having reached the targeted 65% by the end of June, the Republic of Cyprus government is now focusing on trying to encourage younger people to take the vaccine, with suggestions that they might follow Greece's lead by offering incentives.

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Government revenue recovers in April—

After declining for six consecutive months, government revenue bounced back in April, rising year on year by 45.4% in April alone and by 5.8% in January-April (see Table 4). The biggest rise in value terms in the month of April came from social security contributions, which rose year on year by €83m. This may be related to increases in contributions for the GESY healthcare system, which came into force for some payers in March 2020 but were then delayed for other payers until July (see Table 5). A 0.3% increase in employment during the first quarter of 2021 (see Macroeconomic trends and forecast) might also have contributed to the increase. Revenue from value-added tax (VAT) was the second highest category showing an increase in the month of April, rising year on year by €60m, and probably reflects the easing of lockdown measures during that month, before more restrictive measures were imposed for two weeks on 26 April. The biggest rise in percentage terms in April came from the "defence contribution", a tax paid on interest income and dividends paid out of company profits, which rose by more than 100%. However, the increase in value terms was small, at just €7.9m.

Table 4

General government accounts € million unless otherwise stated; these figures no longer match ESA 2010				
	Jan-Dec 2020	**Jan-Apr 2020**	**Jan-Apr 2021**	**% change year on year**
Total revenue	**8,524**	**2,642**	**2,794**	**5.8**
Taxes on production & imports	2,872	953	1,050	10.1
VAT on products & services	1,782	619	676	9.2
Taxes on income & wealth	2,100	586	602	2.6
Personal income tax: public sector	197	57	63	9.6
Personal income tax: private sector	328	106	121	14.0
Defence contribution (a)	295	146	110	-24.3
Total corporate tax	911	131	138	4.9
Social security contributions	2,404	772	827	7.1
Property income	150	35	40	12.2
Revenue classified as "other"	998	295	276	-6.5
Total expenditure	**9,717**	**2,598**	**3,038**	**17.0**
Compensation of employees	2,891	862	911	5.7
of which: public-sector pensions	612	172	189	9.9
Intermediate consumption	908	237	232	-1.9
Social payments	3,552	996	1,112	11.7
Pensions	1,423	434	463	6.7
Unemployment	109	43	19	-55.3
Other social transfers	2,019	519	630	21.4
Interest	452	60	115	90.2
Gross fixed capital formation	615	137	95	-30.4
Expenditure classifed as "other"	721	230	232	1.0
General government balance	**-1,193**	**44**	**-244**	**-**
% of GDP	-5.7	0.2	-1.1	-
Primary balance	**-742**	**105**	**-130**	**-**
% of GDP	-3.6	0.5	-0.6	-

(a) Mainly dividends and interest income.

Source: Cystat.

Table 5

National Health System (GESY) insurance contributions
%

	1 Mar 2019 to '29 Feb 2020	1 Mar 2020 to 31 Mar 2020	1 Apr 2020 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.

—but expenditure continues to outpace revenue

Expenditure growth in the month of April, at 14.7%, was much lower than that of revenue. However, for the period January-April the pace of expenditure growth, at 17.0% year on year, was still higher than the abovementioned revenue growth of 5.8%. Most of the expenditure increase comes from pandemic-related spending. Social payments rose year on year by €116m in January-April and "other social transfers" by €111m. According to the labour minister, Zeta Emilianidou, 33.4% of workers have received support during the pandemic. She said that Cyprus ranks second in the EU for pandemic-related support to workers.

The tourist season looks set to be a challenging one (see Macroeconomic trends and forecast), therefore spending on various measures is likely to continue for some months. Indeed, the deputy tourism minister, Savvas Perdios, was reported on 23 June as saying that discussions were under way with the tourism sector about continued support. A second supplementary budget of €148.5m was put to parliament on 28 June, of which around 70% was focused on the pandemic, while the remainder was dedicated to expanding defence expenditure, probably as a result of Cyprus' growing partnerships with countries located or involved in the region. The supplementary budget in June followed another amounting to €250m in March.

Public finances could also be supported over the next few years by €968m in direct grants and €227m in low-cost loans from the EU's Recovery and Resilience Facility (RFF) (see Table 7), the plan for which awaits EU approval. For example, the labour minister, Zeta Emilianidou, said on 21 May that some €367m in support for labour reform will come from a combination of the RFF and the European Social Fund in 2021-27 combined. (We shall examine the planned labour reforms more fully in our July issue.) However, RFF disbursements will depend on implementing a range of structural reforms. The government also signed two loan agreements on 25 June for roadbuilding (€112m) and small and medium-sized enterprises (SMEs) with the European Investment Bank (EIB).

The €1.25bn Treasury bill issued in April 2021 is redeemed and not rolled over

One positive sign for government finances is that the government did not feel the need to roll over the large €1.25bn 52-week Treasury bill, which it issued at a yield of 0.5% in April 2020. In 2018-19 short-term public debt had been running at around €250m-€300m per year but rose to €1.5bn as a result of the abovementioned Treasury bill. Large short-term debt is generally an indicator of higher public debt risk. However, public finance statistics show that short-term public debt dropped to €275m at the end of April 2021 from €1.5bn in March 2021, implying that the 52-week Treasury bill was redeemed. No new large Treasury bills have been issued since, and issuance has returned to the regular 13-week Treasury bills of around €75m-€100m, which continue to enjoy negative yields (see Charts).

Foreign debt now accounts for around 80% of the total

The largest remaining debt payment due this year is Government Registered Development Stock (GRDS)—a domestic bond of €580m due on 15 December (see Table 6). This was part of the €3.19bn series of bonds issued in July 2018 (replacing the €2.35bn issued in April 2018). The bonds were issued ostensibly to support the Cyprus Cooperative Bank (co-op), although ultimately they boosted the assets of Hellenic Bank, which absorbed the "good" part of the co-op in September 2018. After the €580m is paid this year, only another €610m remains, due in December 2022. The government has not issued any GRDS since 2018, as they tend to attract a higher coupon (interest rate) than international bonds known as European Medium Terms Notes (EMTNs), which now account for around 80% of debt stock (excluding internal debt to the social security fund).

Table 6

Debt redemptions due as of end-March 2021
€ million

	2021 Year	2022 Year	2023 Year	2024 Year	2025 Year	2026 Year
European Medium Term Notes (EMTN)	0	1,000	1,000	1,850	1,000	1,000
Gov't Registered Development Stock (GRDS)	648	663	225	300	92	0
Retail bonds	101	171	70	114	80	0
EIB/CEDB/SURE	91	94	95	95	245	340
Total redemptions exc Treasury bills	**749**	**1,834**	**1,309**	**2,264**	**1,696**	**2,048**
Treasury bills	1,350	*100*	*100*	*100*	*100*	*100*
Total redemptions inc Treasury bills	**2,099**	***1,934***	***1,409***	***2,364***	***1,796***	***2,148***

Sources: Public Debt Management Office; IMF; Sapienta Economics estimates in italics.

Table 7

Cyprus' planned post-pandemic recovery spending

	Grant or loan?	Amount in € m	Disbursement period
Recovery & Resilience Facility (RFF) grants	Grant	968	2021-23
Recovery & Resilience Facility (RFF) loans (requested)	Loan	227	2021-26
Subtotal RFF	-	*1,195*	2021-27
Multiannual Financial Framework (the EU regular budget)	Grant	1,800	2021-27
Private & public-private partnerships		1,400	n/a
Total	-	**4,395**	2021-27
Memorandum item			
Support to mitigate Unemployment Risks in an Emergency (SURE) - all received	Loan	604	2020-21

Sources: European Commission; government statements.

Government and professionals seem unconcerned by push for 15% corporate tax—

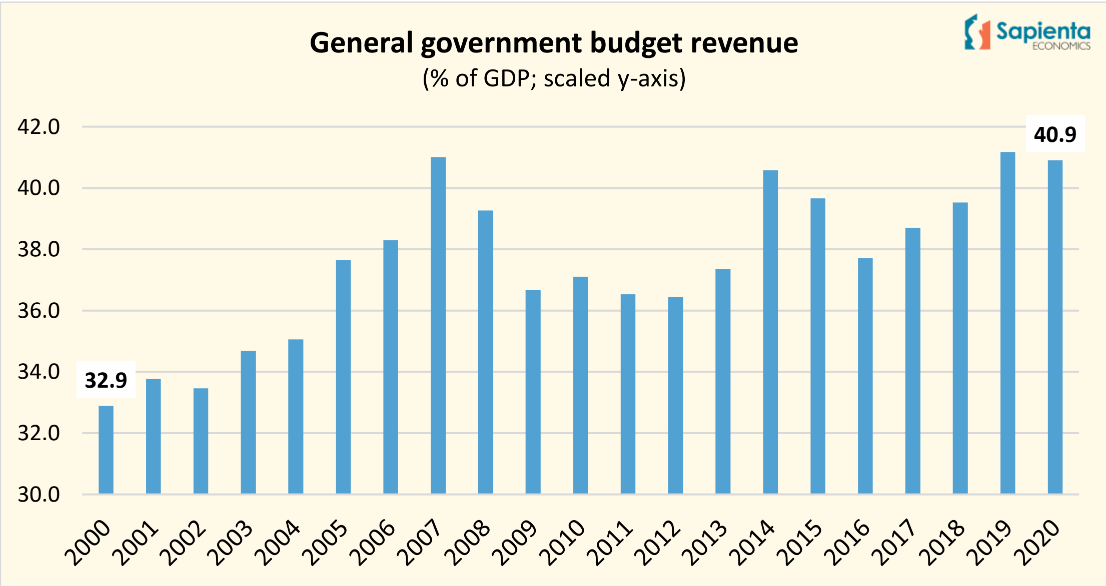
The government and professional services sector have made little fuss about the decision at the summer of G7 leaders on 7 June to seek a global minimum corporate tax rate of 15%, compared with the rate in Cyprus of 12.5%. The permanent secretary of the finance ministry, George Panteli, said that "at first glance" it did not appear to affect "businesses active in the Cypriot economy" and other professionals have not showed signs of serious worry. While the global shipping sector has expressed concerns that it will also affect shipping, which is taxed on the basis of tonnage, rather than revenue, Mr Panteli's reference to "active" may mean that he did not include special purpose entities (SPEs). SPEs have no involvement in the local economy but can have a very large impact on investment and balance-of-payments statistics. However, in the absence of disaggregated tax statistics, it is difficult to tell how important SPEs are to corporate tax revenue.

Nor is there much apparent concern about the EU's proposed directive on public country-by-country reporting (CBCR), which requires companies operating with consolidated revenue of more than €750m and which operate in more than one EU member state to disclose publicly how much tax they pay in the 27 EU member states as well as in another 19 other "non-co-operative jurisdictions". International lobbyists have said that the requirement not to report disaggregated income in every country of operation, including some which are used heavily by large corporations, is inadequate and open to abuse.

—but tax reform is on the table

Where the global trend towards greater tax transparency and the EU push for green transition do seem to be having an impact is on a desire for a wholescale tax reform. The last significant changes to the tax system came in 2002 but new proposals are expected to be presented by the beginning of 2022. In advance of Cyprus' EU membership in 2004 the "offshore" status of non-resident companies was abolished and the corporate tax rate was harmonized at 10%. In 2012-13, under pressure ahead of the bailout programme of international lenders, several increases in tax rates were introduced. The corporate tax rate was raised from 10% to 12.5%; value-added tax (VAT) was increased in two stages from 17% to 19%; the top income-tax bracket was increased from 30% to 35%; the "defence dividend" tax on interest income was increased in two stages from 10% to 30%; the defence tax on dividends was increased from 15% to 20%; and an annual company registration fee of €350 was introduced. This has led to an overall increase in the tax-take as a percentage of GDP.

Various suggestions for tax reform involve abolishing the annual registration fee, returning the tax on interest income to 15% and potentially raising the tax-free threshold on personal income tax from €19,000 (largely to offset increases in social insurance contributions that have been introduced in the past few years and which are levied on the first euro). In the context of the RFF, the government has also pledged to introduce "revenue-neutral" green taxes.



We have revised down our deficit forecast

We have revised our forecast for the budget deficit in 2021. While expenditure is likely to remain high, the very high revenue bounce-back in the month of April suggests that the deficit will be lower for the full year than we had forecast in our May issue. We have therefore revised down our forecast for the general government deficit to €878m from €1.2bn in our May forecast. Largely thanks to the repayment of the abovementioned Treasury bill, gross public debt should decline as a percentage of GDP from the peak of 119% recorded in 2020 and trend towards 110% of GDP by the end of the forecast period.

Table 8

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

	2018	2019	2020	2021	2022	2023
General government revenue	8,471	9,176	8,524	*9,611*	*9,942*	*10,330*
% change	8.8	8.3	-7.1	*12.8*	*3.4*	*3.9*
General government expenditure inc. one-offs (a)	9,227	8,850	9,717	*10,490*	*10,742*	*11,036*
% change	24.8	-4.1	9.8	*8.0*	*2.4*	*2.7*
General government budget balance inc. one-offs	-756	326	-1,193	*-878*	*-800*	*-706*
% of GDP	-3.5	1.5	-5.7	*-4.0*	*-3.6*	*-3.0*
Primary balance inc. one-offs	-249	1,142	-699	*-431*	*-375*	*-335*
% of GDP	-1.2	5.1	-3.4	*-2.0*	*-1.7*	*-1.4*
One-off expenditure (a)	1,564	0.0	0.0	*0.0*	*0.0*	*0.0*
Gross government debt inc. one-offs	21,256	20,958	24,823	*25,012*	*24,758*	*24,948*
% of GDP	99.2	94.0	119.1	*114.6*	*110.1*	*107.3*

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

Banking sector Next section Previous section

Bank of Cyprus increases total capital with securities issuance—

Bank of Cyprus (BOC) issued €300m of debt on 16 June at a rate of 2.50% and with a reasonably strong amount of interest from investors. The debt was in the form of senior preferred notes, which enjoy a lower interest rate because they are less at risk than "junior" creditors or shareholders of being bailed in (having their securities converted into shares) if the bank becomes insolvent. The bank said that debt is expected to be counted as the minimum requirement for own funds and eligible liabilities (MREL) and should raise its MREL ratio to 18.37%. This follows €300m of Tier 2 capital at 6.625% that was issued in April. The MREL ratio is already above BOC's January 2022 target of 14.94% and must reach 23.32% by the end of 2025. These various layers of non-equity capital have been introduced at EU level since the eurozone banking crisis in order to reduce the risk of taxpayer-funded bailouts and to protect both insured (under €100,000) and uninsured depositors. Depositors who hold more than €100,000 rank higher than holders of senior debt (that is, are less likely to be bailed in). In the Cyprus banking crisis of 2013, BOC had next to no debt and was obliged to turn a portion of deposits above €100,000 into (near-worthless) shares. Separately, CarVal Investors, an alternative investment fund, raised its stake in BOC to 6% on 15 June. It has been the third-largest shareholder in BOC since April.

—and completes the Helix2 sale to cut its NPE ratio to 16%

BOC also announced on 28 June the completion of Helix 2 sale, which affects €1.34bn of gross loans, of which €1.1bn are non-performing. The loans, collateralized with property, were sold to an affiliate of the US-based firm, Pimco, for €560m, which is payable over 3.5 years. This essentially means that they were sold at a discount of around 58%, or even less if one takes into account the period of payment. The deal reduces the ratio of non-performing exposures (NPEs) to total loans to 16%, from 25.2% previously (see Table 10). Moves at EU level to increase the liquidity of the market for non-performing loans (NPLs) took a step forward on 28 June, when the European Council and European Parliament reached a provisional agreement to harmonize rules for those buying and servicing NPLs. The move is designed to support a secondary market for NPLs.

We estimate that Hellenic Bank will need to issue at least €61m in securities this year

Hellenic Bank is also likely to issue securities this year in order to meet MREL requirements. In its financial statement issued on 8 June, it noted that its required MREL ratio for January 2022 was 16.57% of risk-weighted assets. It had calculated in December 2020 that its MREL ratio was 19.1%. However, this ratio included around 3.625% in capital (estimated for January 2022) that it turns out will not be eligible for MREL. This implies that Hellenic will need to raise at least 1.1% of risk-weighted assets. Based on its risk-weighted assets in March 2021, this implies it will need to issue at least €61m. The bank did not provide any details about its plans but said that it was "evaluating options" for meeting MREL requirements. At present, Hellenic Bank has no Tier 2 capital, therefore, it might issue either Tier 2 capital or, like BOC, senior preferred notes.

Hellenic Bank reported a profit of €12.9m in the first quarter, despite a sharp increase in salary costs related to retrospective salary payments and a drop in net interest income. The main reason for the profit was lower provisions for bad loans, after a non-contractual loan write-off amounting to €0.6bn in 2020. Like BOC, around 5% of Hellenic's moratorium loans have fallen into arrears since the main moratorium expired at the end of December 2020.

Table 9

Hellenic Bank Group financial statement highlights
€ million unless otherwise stated

	30-Mar-21 3 mths	31-Mar-20 3 mths	31-Dec-20 12 mths	31-Dec-19 12 mths
Profit/loss before impairment of loans and advances	22.9	29.6	125.7	131.6
New provisions on financial instruments	7.4	29.1	55.0	23.2
Post-tax profit/loss for the period	12.9	-2.2	50.5	108.4
Net interest income	65.3	69.1	285.5	301.3
Common Equity Tier 1 capital	1,120	999	1,112	1,007
Risk weighted assets	5,541	5,199	5,556	5,039
Common Equity Tier 1 capital ratio transitional basis (%)	20.2	19.2	20.0	20.0
Customer deposits	14,284	14,136	14,180	14,602
Gross loans	6,797	7,256	6,802	7,244
NPEs: EBA definition (a)	1,521	2,293	1,503	2,276
NPE ratio: EBA definition (a) (%)	22.4	31.6	22.1	31.4
Accumulated provisions	724	1,324	705	1,265
Coverage ratio (provisions as % of NPEs under EBA definition)	47.6	57.7	46.9	55.6
Net interest margin (%)	1.72	1.80	1.88	1.92

(a) Includes, inter alia, loans restructured and less than 90 days past due.

Sources: Hellenic Bank financial statements and investor presentations; Sapienta calculations in italics.

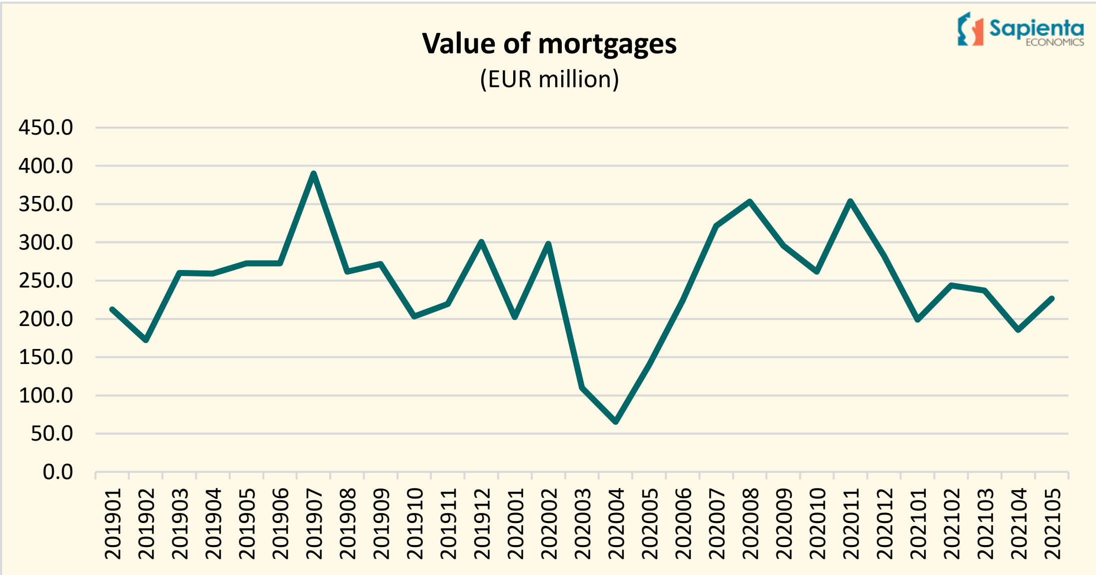
Mortgages start to pick up

Hellenic did not fare as well as BOC in the first quarter as regards new lending. New loans dropped compared with the previous quarter by 50.5%, which the bank attributed to the pandemic. BOC, meanwhile, saw new loans rise over the previous quarter by 30.2% to €487m, with just under half of that going to corporate loans. However, as noted in our May issue, demand for housing loans is picking up. Data from the Department of Lands and Surveys (land registry) point to a rise in the value of mortgages approved, although in January-May 2021 they were 7.2% below their value in the same pre-pandemic period of 2019.

Table 10

Bank of Cyprus and Hellenic Bank result highlights Year-to-date	BOC 31-Mar-21	HB 31-Mar-21
Net profit/loss (€ m)	-172	50
Customer deposits (€ m)	16,533	14,180
Gross loans (€ m)	12,261	6,802
% of total banking loans	38.6	21.4
Year-on-year change in net interest income (%)	-4.0	-6.1
NPEs EBA definition (€ m)	3,086	1,503
NPE ratio EBA definition (%)	25.2	22.1
Provisions/gross loans EBA definition (coverage ratio) (%)	61.6	46.9
Common equity Tier 1 (CET1) ratio (%)	14.8	20.0
Net interest margin (%)	1.8	1.9

Sources: Financial statements, investor presentations and key performance indicators.



Rent to buy scheme envisaged for the "bad bank"

The authorities continue to move ahead with plans to turn the state asset management company, KEDIPES, into a formal national asset management company ("bad bank"). According to media reports the plans are currently with the European Commission Directorate-General for Competition and include a "rent to buy" scheme for NPLs of low-income groups that are particularly difficult to manage. Ownership of residential properties up to a value of €350,000 would transfer to the national asset management company at a rate of 60% of market value, while borrowers in residential accommodation would have the right to rent the property during their lifetime at a rate of 2%-3% of market value. They would have the right repurchase within five years if they are under 65, while the national asset management company would have the right to sell to individuals after five years. First-degree relatives would also have first refusal on repurchases. According to the IMF's latest Staff Report issued on 16 June, some 45% of NPLs are more than five years old.

While NPEs (NPLs measured on a stricter basis) have dropped dramatically in recent years, from a peak of 51.7% (€16.5bn) in November 2014 to 18% (€5.2bn) according to the latest statistics from the Central Bank of Cyprus, tackling bad loans has been hampered at almost every stage by opposition members of parliament (MPs). At their first session after the parliamentary election on 30 May, opposition MPs push for another extension of the suspension of foreclosures beyond the deadline of end-July.

Macroeconomic trends and forecast Next section Previous section

Government expects fairly high real GDP growth of "more than 4%" in 2021—

The finance minister, Constantinos Petrides, said on 28 June that the government expected real GDP growth of more than 4% of GDP in 2021. This is lower than the 4.5%-5% forecast that he had cited in May, which in turn was similar to forecasts he made in January. Mr Petrides noted that forecasts are subject to a high degree of uncertainty and that the European Commission was forecasting 3.2%. Given that the government's forecast is considerably higher than our own forecast in May of 2.6%, we examine below the evidence for and against a higher growth rate in order to revisit our forecast. In brief, the evidence is mixed.

Table 11

Real GDP growth by expenditure, seasonally adjusted

% change over the same period of the previous year

	2020 Q1	**2020 Q2**	**2020 Q3**	**2020 Q4**	**2021 Q1**
Household consumption	1.4	-13.7	-1.2	-1.6	7.0
Non-profit institutions serving households	-0.2	-19.5	-2.4	-8.2	-6.2
General government consumption	15.8	16.7	9.2	11.4	12.4
Gross fixed capital formation, of which:	28.5	-44.8	-6.1	23.6	7.2
Dwellings	-6.0	-21.1	-1.0	-3.7	2.5
Other buildings and structures	-0.7	-28.3	-2.4	-3.3	3.7
Transport equipment	(a)	(a)	-22.3	670.7	21.3
Inventories (contribution to growth) (b)	*-1.7*	*2.7*	*7.3*	*-2.6*	*-11.3*
Exports of goods & services	0.7	-16.8	-27.9	-5.8	-1.8
Exports of goods	-17.5	29.2	-12.0	-9.9	-16.2
Exports of services	6.1	-25.6	-31.5	-4.8	1.6
Imports of goods & services	8.0	-17.0	-11.6	3.9	-2.4
Imports of goods	5.1	-24.6	-12.0	6.8	-8.2
Imports of services	10.9	-10.2	-11.3	1.3	3.0
Foreign balance (contribution to growth) (b)	*-5.4*	*0.6*	*-11.5*	*-7.0*	*0.6*
GDP	**1.1**	**-12.5**	**-4.6**	**-4.4**	**-1.6**
% change over previous quarter	-0.8	-13.0	9.5	1.1	2.0

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

Source: Cystat.

—which is probably related to strong household consumption in the first quarter

We assume that the government's high forecast is based on the strong rebound of household consumption in the first quarter of 2021, which rose in real terms by 7% over the same period of the previous year and by 9.8% compared with the previous quarter (see Table 11). Household consumption accounts for around two-thirds of GDP, therefore growth in this category has a strong impact on the overall GDP growth rate. Although the first lockdown in 2020 did not come into effect until the last 10 days of March, a leap in private consumption in the first quarter of 2021 is likely to reflect pent-up demand after successive lockdowns since then, as well as the fact that the financial impact of the pandemic has fallen disproportionately on a minority of the population. A survey by Bank of Cyprus found that 52% of households had either experienced no negative or even a positive financial impact from the pandemic (given there were fewer opportunities to spend), another 25% had been affected "slightly", while 23% had experienced a significant impact. An indication that many households saved during the pandemic is that household deposits were €674m higher at the end of March 2021 than at the end of March 2020.

Household spending in the first quarter partly went on retail sales. Although retail sales volumes rose year on year by only 0.5% in the first quarter, there was a surge in March, when sales of non-food products leapt by 46.7% year on year. Spending on cars also expanded strongly in March, with new registrations rising year on year by 45.6%, although for the quarter as a whole, registrations were down by 2.8%. Thanks to government subsidies for first-time buyers and lighter Covid-19 restrictions, there was also a strong increase in property sales in April-May.

Table 12

Retail trade volume
% change over same period of previous year

	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
Food, drink & tobacco	15.0	2.9	0.6	6.3	1.9
In non-specialized stores	16.0	2.8	0.4	6.5	0.5
In specialized stores	7.9	3.6	2.5	5.2	11.8
Non-food products (except auto fuel)	-1.8	-23.0	-6.0	-4.0	0.9
Textiles, clothing & footwear	-10.3	-41.4	-11.1	-19.2	-16.3
Electrical goods & furniture	-1.5	-5.0	10.4	4.7	11.6
Computer equipment, books & other	-1.1	-33.4	-16.3	-1.9	4.9
Other trade in non-specialized stores	1.7	-22.7	-6.9	-9.1	-7.5
Auto fuel in specialized stores	-7.6	-27.6	1.9	-5.6	-7.4
Total retail trade volumes	**5.6**	**-10.9**	**-2.1**	**0.5**	**0.5**
Retail trade values	5.5	-13.3	-3.8	-1.0	-2.0

Source: Cystat.

Indicators do suggest that second-quarter growth will be fairly strong—

There are no new statistics on retail trade to indicate whether the surge in March lasted. One indication that it might not have is that motor vehicle registrations more than doubled in April but then declined by 7.8% in May. This will have been partly related to the two-week lockdown from 26 April. On the other hand, consumer confidence has been rising. The Economic Sentiment Indicator produced by the University of Cyprus Economics Research Centre (CyREC) showed a significant increase in sentiment in June. The Cyprus Composite Leading Economic Index (CCLEI) produced by CyREC and Hellenic Bank showed a 9.9% year-on-year leap in May.

The CCLEI is normally a fairly good indicator of growth in the current quarter, therefore one can assume that the year-on-year real GDP growth in the second quarter will be strong, especially as the baseline in the second quarter of 2020 was when real GDP contracted by 12.5%. However, for the annual growth rate to reach more than 4% in 2021, we estimate that it would need to post a year-on-year real GDP growth rate of around 13% or more in the second quarter. Given that CCLEI's index shows a year-on-year increase of 4.2% in April and 9.9% in May, this currently seems unlikely, even with the sharp increase of confidence in June.

—but there is more uncertainty about the third quarter—

What is more difficult to tell is whether the increase in positive sentiment will last into the third quarter, as this period is likely to be affected by new uncertainties relating to the delta Covid-19 variant. The date of publication of Economic Sentiment Indicator (24 June) suggests that the survey was conducted before it became clear that the UK, which is the source of one-third of all tourists, would not be putting Cyprus on the "green" list for tourism. Flights from Russia, which accounts for just under 20% of tourists, started from 28 June but Israel, which is the third largest market, put Cyprus on the "red" list on 27 June. Hoteliers have suggested that they expect only a slight improvement in tourism arrivals compared with 2020—a year in which arrivals fell by 84.1%. In 2020 the absence of spending by tourists from abroad was partly offset by locals who holidayed at home. However, with much of Greece open for travel, anecdotal evidence suggests that local residents will be heading for Greece for their holidays. The third quarter therefore looks likely to show a much slower year-on-year growth rate than the second.

—and higher prices will eat further into real incomes—

Another consideration is that, after a long period of low or negative inflation rates, prices in Cyprus have started to rise as a result of higher global commodity prices. The EU-harmonized consumer price inflation rate reached 1.5% in May owing to a 10.5% increase in transport prices. As Cyprus relies heavily on imported diesel and heavy fuel oil for electricity, prices in the category that includes electricity also rose by 5%. The rise in raw materials prices is also affecting the cost of housebuilding. Construction materials prices rose by 7.7% year on year in May—rates last seen in late 2008. Higher inflation has also eaten into earnings. Overall earnings declined in nominal terms by 1.7% year on year in the first quarter but by a steeper 2.3% in real terms based on EU-harmonized consumer price inflation. The current consensus is that the increase in commodity prices is related to post-pandemic supply issues, and may therefore be shortlived. However, it is still likely to have a negative impact on spending power for the remainder of this year.

Table 13

Average monthly earnings of employees
seasonally adjusted; % change over the same period of the previous year unless otherwise stated

	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
Average monthly earnings (€)	2,017	1,990	2,015	1,995	1,961
% change over same period of previous year	1.1	-1.3	1.3	-1.0	-1.7
Real earnings based on national CPI	3.0	1.5	3.7	0.5	-2.9
Real earnings based on HICP	2.4	2.3	3.8	1.1	-2.3
Memorandum items					
National consumer price inflation	0.0	-0.8	-2.2	-0.5	0.1
EU-harmonized consumer price inflation	0.6	-1.6	-2.3	-1.1	-0.5

Source: Cystat.

—while employment growth remains weak—

Another factor to consider is that employment is not expected to provide a particularly strong boost to demand. While total employment levels were 0.3% higher in the first quarter of 2021 than in the same quarter of 2020, employment declined in the two largest categories, with jobs in wholesale and retail trade sector falling year on year by 0.7% and in the accommodation and food services sector by 1.2%. This is despite the fact that the government has said it has provided support to around one-third of jobs during the pandemic (see Fiscal performance and forecast).

Table 14

Employment among major categories Absolute number; national accounts basis	**2020 Q1**	**2020 Q2**	**2020 Q3**	**2020 Q4**	**2021 Q1**
Wholesale & retail trade	70,483	71,310	71,996	72,127	69,961
Accommodation & food services	42,259	48,292	52,227	46,228	41,754
Public administration & defence	33,472	33,625	33,468	34,058	33,598
Manufacturing	35,749	35,962	36,004	36,113	36,058
Construction	37,642	37,753	37,869	38,355	38,114
Professional services & technical-scientific	31,531	31,529	31,669	31,679	32,005
Education	32,925	32,323	28,343	33,025	33,677
Total	**432,251**	**440,896**	**442,785**	**442,271**	**433,486**
% change over same period of previous year	2.4	-1.2	-2.0	-1.3	0.3

Source: Cystat.

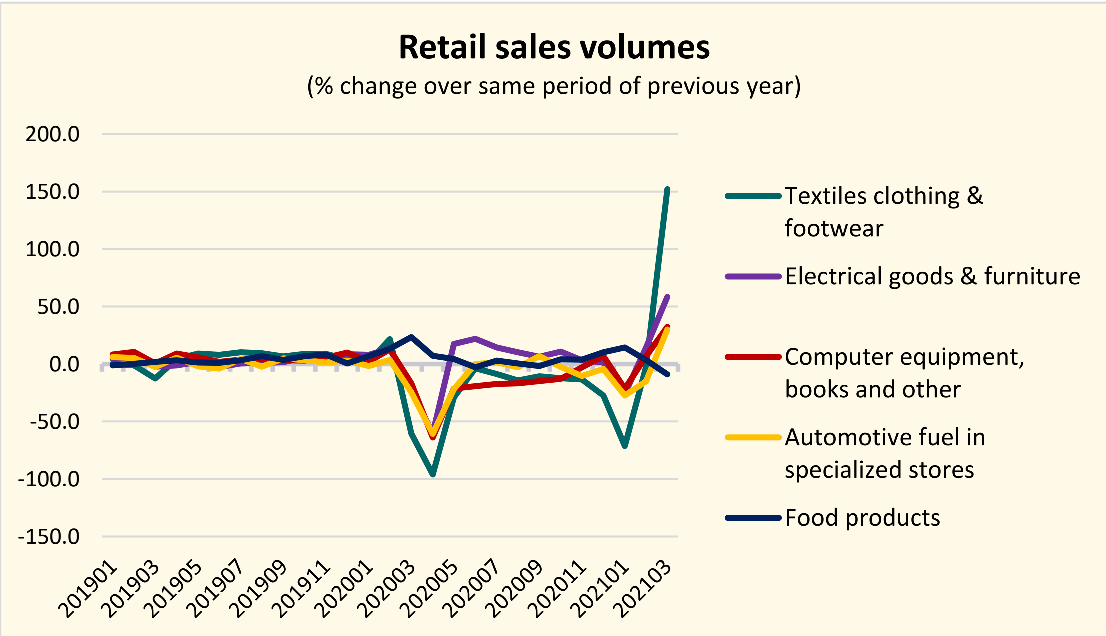
—therefore we have revised up our forecast but expect growth of 3% in 2021

Give all of the above, we have revised up our forecast for real GDP growth in 2021 but still expect it to be lower than the government forecast. We are now forecasting a real GDP growth rate of 3.0% in 2021, compared with 2.6% previously, while noting that forecasts are subject that more uncertainty than usual given the distortions created by the large swings in 2020. While we expect stronger quarterly growth rates in 2022 than in the second to fourth quarters of 2021, indicating a return to normality, these will translate into a lower growth rate overall in 2022.

Table 15

Real GDP growth forecast Seasonally adjusted; % change over period indicated	**20Q2**	**20Q3**	**20Q4**	**21Q1**	***21Q2***	***21Q3***	***21Q4***	***22Q1***	**2020**	***2021***	***2022***
Previous year	-12.5	-4.6	-4.4	-1.6	*11.6*	*2.1*	*1.1*	*-0.5*	-5.1	*3.0*	*1.3*
Previous quarter	-13.0	9.5	1.1	2.0	*-1.2*	*0.1*	*0.2*	*0.4*	-	-	-

Source: Cystat; Sapienta Economics forecasts in italics.



Exports of goods hold up well in the first quarter

Domestically produced exports of goods held up well in the first quarter, rising in euro terms by 10.3% year on year, thanks largely to manufacturing exports, as well as industrial products of mineral origin, which come mainly from the VTTV oil terminal. Total exports including re-exports that are not domestically produced fell by 24.4% year on year, however, which explains the 16.2% contraction in real terms of exports of goods on a national accounts basis (see Table 11). Imports for home consumption declined in the first quarter by 5.8%, despite the increase in durables imports that were probably related to the abovementioned retail sales. In value terms, the decline was concentrated in transport equipment, which could suggest that the car sales in the first quarter came mainly from older stock.

Table 16

External trade in goods
€ million unless otherwise indicated

	Jan-Mar 2020	Jan-Mar 2021	% change
Imports for home consumption			
Consumer goods, of which:	520	495	-4.9
non-durables	361	335	-7.0
durables	74	86	16.5
Intermediate inputs	451	508	12.6
Capital goods	110	122	10.8
Transport equipment & parts	631	522	-17.2
Fuels & lubricants	180	130	-27.5
Unclassified	12	18	42.2
Total imports for home consumption	**1,904**	**1,794**	**-5.8**
Domestically produced exports			
Raw agricultural products, of which:	22	24	8.2
potatoes	8	11	42.1
citrus fruits	7	6	-15.2
Industrial products of agricultural origin	83	85	2.3
halloumi cheese	67	67	0.1
Minerals	1	1	-21.6
Industrial products of mineral origin	52	60	15.3
Manufacturing, of which:	126	146	15.7
pharmaceuticals	82	85	4.4
scrap metal, glass & paper exc. precious metals	9	18	97.0
Total domestic exports incl unclassified	**287**	**317**	**10.3**
Memorandum items			
Total imports inc re-imports	2,075	1,916	-7.7
Total exports in re-exports	735	555	-24.4
Trade balance	**-1,340**	**-1,361**	**1.5**

Source: Cystat.

Current-account deficit widened in the first quarter

The current-account deficit widened to €922m in the first quarter of 2021 from €752m in the same period of 2020 (see Table 17), primarily as a result of the abovementioned decline in total exports of goods. (The figures on total exports and imports in Table 16 differ from those in Table 17 because goods measured on a balance-of-payments basis owing to the different treatment of excuse duties.) Exports of services also fell, mainly because of the impact on tourism of the pandemic. However, the services surplus increased, largely because travel debits (outbound travel) also declined. The large swings in the financial account are mainly related to equity investments, which in turn are dominated by of special purpose entities (SPEs). Since SPE transactions have been included in the balance-of-payments, in accordance with IMF methodology, it has become almost impossible to discern the level of foreign direct investment in the domestic economy. What the first-quarter figures do show is a reduction in the liabilities of unlisted companies to €583m in the first quarter of 2021, from €1.4bn in the first quarter of 2020. However, these transactions are unlikely to be related to the domestic economy. The current-account deficit in 2020 was already very large, at 11.9% of GDP. In a regular recession, a current-account deficit typically shrinks owing to a reduction of import demand. However, in 2020 this effect was also exacerbated by the pandemic-related restrictions on travel.

Table 17

Balance of payments
€ m

	2020 Year	2020 Jan-Mar	2021 Jan-Mar	YoY % change
Exports of goods fob	2,964	837	577	-31.1
Imports of goods fob	7,141	2,011	1,831	-8.9
Trade balance (fob-fob)	**-4,177**	**-1,174**	**-1,255**	**6.9**
Exports of services	11,135	2,763	2,532	-8.3
Transport	2,794	695	686	-1.3
Travel	576	151	42	-72.0
Financial services	3,931	1,012	964	-4.7
Telecoms, computer & information services	2,599	618	C	-
Other business services	491	95	95	-0.3
Imports of services	8,254	2,280	1,765	-22.6
Services balance	**2,881**	**482**	**767**	**59.0**
Primary income balance inc. investment	-877	44	-338	-861.5
Secondary income balance inc. remittances	-303	-104	-96	-7.7
Current-account balance	**-2,476**	**-752**	**-922**	**22.7**
% of GDP	-11.9	-	-	-
Capital account balance	18	2	4	158.8
Financial account balance exc reserves	-2,173	-304	-1,198	294.3
Reserves (– indicates increase)	33	28	-12	-141.8
Net errors & omissions	286	446	-280	-162.9

Note: C = primary confidentiality.
Source: Central Bank of Cyprus.

Economy of northern Cyprus* Next section Previous section

**Areas not under the effective control of the government of the Republic of Cyprus*

New loan of $500m with Turkey will be repayable in US dollars

No new statistics have been published on the public finances of the unrecognized Turkish Republic of Northern Cyprus (TRNC). As noted in our May report, public finances started to improve in April, at least in nominal (not inflation-adjusted) terms, thanks largely to the arrival of funds from Turkey. Revenue in real terms is still likely to be under pressure, however, owing to rising inflation rates caused both by the weakness of the Turkish lira and an increase in global commodity prices. Consumer price inflation reached 17.5% in May, compared with 8.6% in May 2021 (see Charts). The Turkish Cypriot authorities approved a $500m loan agreement with Turkey on 4 June. While the loan was granted in Turkish lira, the terms of the agreement reportedly stipulate that repayments will be made in three years' time in US dollars, which raises exchange-rate risks. In the past, the Turkish Cypriot authorities have not serviced loans (as distinct from aid) from Turkey, making neither interest nor principal payments. However, this may be about to change.

We assume that tax revenue continued to recover after April, thanks to lockdown measures being eased and a resumption of tourism. The number of arrivals reached 10,661 in April (latest available data), compared with just 67 arrivals in April 2020. The maximum number of daily flights was raised from six to 10 on 25 June and there are hopes that caps can be lifted in July. The authorities are also hoping to raise tax revenue from gambling, which the economy and energy minister, Erhan Arıklı, said generated $2bn per year. Turkish Cypriots complain frequently that the casinos, which are mainly Turkish-owned, pay little or no tax. Any tax revenue from higher education is likely to remain depressed however, as face-to-face education is not expected to resume in full until September.

Table 18

Turkish Cypriot central budget outturns
₺ million; excludes social insurance

	2019 Year	2020 Year	% change	2020 Jan-Apr	2021 Jan-Apr	% change
Total revenue, of which:	7,403	8,160	10.2	2,090	2,320	11.0
Taxes, of which:	4,970	4,869	-2.0	1,288	1,341	4.1
Income tax	n/a	1,752	n/a	489	452	-7.6
Corporation tax	n/a	500	n/a	98	122	24.5
Value-added tax (VAT)	n/a	598	n/a	183	179	-2.0
Excise duties on fuel	787	864	9.7	203	180	-11.1
Collections of receivables (deposit insurance fund)	166	120	-27.6	105	146	38.8
Grants from Turkey (a)	579	1,050	81.5	54	166	206.8
of which: defence (Turkish Cypriot military)	512	704	37.6	54	166	206.8
Credit from Turkey (b)	0	564	-	0	100	-
Total expenditure, of which:	7,688	8,696	13.1	2,137	2,646	23.8
Personnel expenses	2,846	2,691	-5.5	742	838	12.8
Transfers to households	1,724	1,875	8.8	508	638	25.6
Pensions	1,032	1,125	9.0	343	387	12.9
Defence (Turkish Cypriot military)	512	704	37.5	117	165	41.2
Balance inferred	***-285***	***-536***	-	***-47***	***-326***	-
Memorandum item						
Consumer price inflation rate (%)	-	-	25.7	-	-	12.4

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

Source: KKTC Maliye Bakanlığı; Sapienta inferences in italics.

Policymaking is likely to be hampered by coalition rows and a court ruling—

However, any policies to reform public finances seem likely to be hampered by a general malaise in the three-party coalition comprising the National Unity Party (UBP), the Democratic party (DP) and the Rebirth Party (YDP). A row over the distribution of ministries prevented the Turkish Cypriot parliament from meeting on 28 June for its last session before the summer recess because it failed to reach a quorum. Another development that will complicate attempts to limit spending came on 24 June, when the constitutional court ruled against an indefinite freeze on the cost-of-living allowance used for indexing public-sector wages to inflation. Six public-sector unions won a challenge against the ruling coalition's decision, on the grounds that the decision was made by decree instead of via parliament.

Trouble also continues to brew over electricity. The electricity provider, KIBTEK. The electricity union, EL-SEN, has been protesting about the non-payment of arrears by public bodies for some time and KIBTEK decided cut off supply to some municipalities, mosques and other public bodies on 23-24 June. The chairman of KIBTEK said that municipalities have unpaid electricity debts of ₺255m (around €25 million at current exchange rates) and mosques ₺6m. However, he also noted that private consumers have debts of ₺262m. Lack of electricity capacity is also hampering attempts to increase photovoltaic electricity production. Mr Arikli said at an event in Istanbul on 7 June that electricity demand northern Cyprus would rise from 350 MW to 750 by 2030. One way in which the Turkish Cypriot authorities plan to raise capacity is via a submarine electricity cable from Turkey. However, since Turkey is part of the European Network of Transmission System Operators (ENTSO-E)—the European electricity grid—Mr Arikli also admitted that the idea was coming up against resistance from ENTSO-E.

—which may complicate moves on Varosha

One of the likely reasons for the general malaise in the coalition is forthcoming elections. After some debate about whether to have elections in August, it now seems that early parliamentary elections will take place in April 2022. The forthcoming elections, as well as general policy on the Cyprus problem by Turkey and the Turkish Cypriot leader and president of the unrecognised TRNC, Ersin Tatar, partly explain the rush to develop Varosha in breach of UN Security Council resolutions (see Political analysis and outlook). However, if Varosha is developed, it seems as though the economic gains will accrue to mainly to Turkish companies, not least because the funds for all infrastructure projects, including Varosha, all come from Turkey. The municipality of Konya has been charged with the project management and Turkish Cypriot companies have complained that Turkish companies are being granted all of the contracts. Similar complaints about ceding all control of the economy to Turkey have been made about the construction of the new pandemic hospital, which has been handed to the control of the health ministry in Turkey, and a tender public roads in villages, which was also opened in Turkey.

Banks in northern Cyprus remain highly liquid

Figures for the first quarter of 2021 show that Turkish Cypriot banking system remains highly liquid, with an overall deposit/loan ratio of almost 150% and a foreign-exchange deposit to foreign exchange loan ratio of 189%. Non-performing loans (more than 90 days past due) continue to creep up in absolute terms, reaching the equivalent of €158m at the end of March. The coverage ratio (provisions as a proportion of NPLs) is fairly high at 56.7%, although not as high as the peak of 68.6% in December 2018. We understand that NPLs do not include loans in arrears to public organizations, which mainly affect the Koop bank.

Table 19

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

	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Gross loans	23,472	24,487	27,305	28,758	29,969
In Turkish lira	11,368	11,837	13,013	14,522	14,211
In foreign exchange	12,107	12,650	14,292	14,237	15,758
Deposits	34,245	35,247	40,117	41,788	44,775
In Turkish lira	13,101	13,416	14,074	14,518	14,915
In foreign exchange	21,150	21,859	26,043	27,270	29,860
NPLs (90+ days past due) (a)	1,491	1,481	1,495	1,556	1,534
NPLs in € million equivalent (a)	€207	€193	€164	€171	€158
NPL ratio (%) (a)	6.4	6.0	5.5	5.4	5.1
Coverage ratio (%)	55.6	55.5	55.9	56.5	56.7
Memorandum item					
TRY per EUR (end-period)	7.2063	7.6761	9.0990	9.1131	9.7250

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

Exports continue to increase while imports decline

External trade figures show that exports of goods continued to rise in the first quarter of 2021, increasing in US dollar terms by 23.9% year on year in January-March, having expanded by 23% in 2020. Among the largest products, dairy and citrus fruits are doing well. In addition to Turkey, most of the markets for dairy and citrus products are primarily sold in the Gulf. However, exports of goods remain tiny compared with imports, which are several multiples larger. Imports declined year on year in dollar terms by 16.5% in the first quarter of 2021, reflecting depressed demand as a result of the pandemic and the weaker lira.

Table 20

Northern Cyprus: trade in goods by main product
$ million

	Jan-Dec 2019 ($ m)	Jan-Dec 2020 ($ m)	YoY % change	Jan-Mar 2020 ($ m)	Jan-Mar 2021 ($ m)	YoY % change
Total exports inc others	**82**	**101**	**23.0**	**37**	**46**	**23.9**
Dairy products	39	44	12.9	11	13	17.0
Citrus products	19	27	42.2	19	20	8.7
Raki	0.7	0.2	-70.9	0	0.1	-25.7
Scrap	5	6	19.5	2	4	136.8
Citrus concentrate	2	2	41.8	1	0	-83.1
Total imports inc others	**1,588**	**1,221**	**-23.1**	**317**	**265**	**-16.5**
Fuels	170	90	-47.3	33	19	-40.9
Motor vehicles	118	126	6.6	32	22	-30.6
Construction iron	41	31	-25.6	8	9	23.0
Clothing	48	29	-38.8	8	4	-46.8
Alcoholic beverages	38	18	-53.1	5	3	-41.8
Trade balance	**-1,506**	**-1,119**	**-25.7**	**-280**	**-219**	**-21.9**

Source: Ticaret Dairesi.

Table 21

Northern Cyprus: selected short-term statistics
% change over the same period of the previous year

	Latest period	YoY % change in latest period	YoY % change for year-to-date
Consumer price inflation	May	17.5	12.7
Tourism arrivals	Apr	15,812	-88.4
of which from Turkey	Apr	23,600	-93.5
Plastic card spending south of the Green Line	2021Q1	-89.7	-58.3
Plastic card spending north of the Green Line	2021Q1	-92.8	-67.7
Imports of goods (expressed in US dollars)	Mar	5.9	-16.5
of which from Turkey	Mar	7.1	-13.3
Exports of goods (expressed in US dollars)	Mar	102.7	23.9
of which to Turkey	Mar	136.3	52.9

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

Charts [Previous section]