Cyprus Economic Update

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Highlights

- Euroland economic growth increased in the third quarter of 2007, with growth hitting 0.7% compared to 0.3% in the previous quarter. The third quarter expansion was driven primarily by investment growth. Consumer spending growth also contributed to the overall GDP expansion.

- Euroland growth is projected to moderate in 2008 owing to the impact of tighter credit conditions, past interest rate rises, and an appreciation of the euro reflecting a loss in confidence in the US dollar and lower US interest rates.

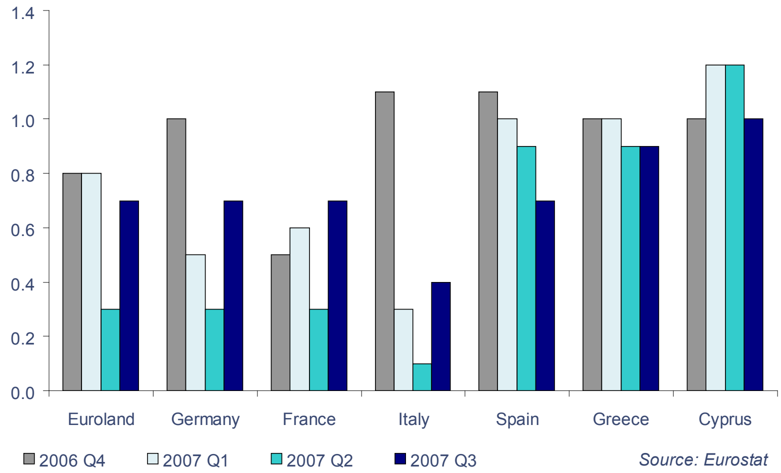
- The Cyprus economy continued to grow apace in the third quarter, albeit at a decelerating rate. The expansion was driven by domestic demand, with both consumer spending and investment growing robustly.

- Employment gains are projected to continue next year, supporting continued consumer spending growth. Inflation is likely to moderate from current highs during 2008.

- We expect the Cyprus economy to grow by 4.2% in 2007 and by 4.1% in 2008.

- Cyprus adopted the euro on 1 January 2008 at a conversion rate of 1 euro = 0.585274 Cyprus pounds.

Chart 1: GDP growth, q-o-q % change

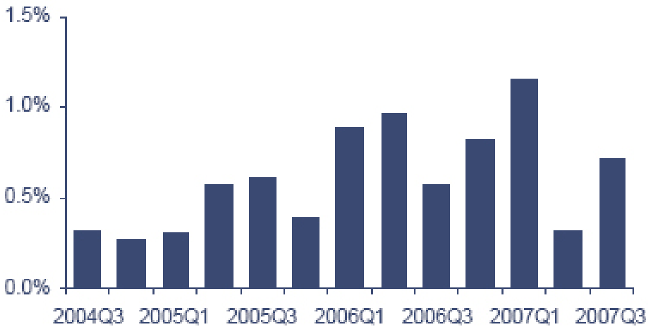


Source: Eurostat

Euroland overview

Economic activity in the Euroland accelerated in Q3 2007, with GDP expanding by 0.7% compared to the previous quarter (see Chart 2 below). This signalled a significant acceleration in activity from Q2, when growth was much more subdued at 0.3%. Growth in France and Germany picked up to 0.7% in Q3, following growth of 0.3% in Q2. Economic activity in the Italian economy picked up in Q3, albeit to the slightly slower pace of 0.4%, while Spanish economic growth slowed to 0.7%, down from 0.9% growth in the previous quarter.

Chart 2: GDP growth (q-o-q, %)



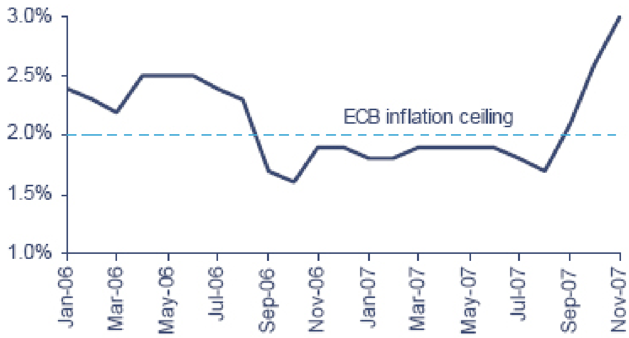
Source: Eurostat

Euroland growth continues to be driven by strong domestic demand, with both consumer spending and investment growing strongly. Consumer spending grew by 0.5% in Q3, with strength in Euroland labour markets supporting earnings and spending growth. Investment appeared to be unaffected by adverse developments in international capital markets over the summer, with capital outlays rebounding from a period of stagnation in Q2 and growing by 0.9% in Q3.

After remaining muted over the first half of 2007, Euroland inflation has surged in recent months, driven upwards by rapidly rising prices for food and commodities, particularly oil. Initial estimates suggest that Euroland inflation reached 3% in November, up from 2.6% in October (see Chart 3 above right).

Despite the run-up in inflation, the ECB chose to leave its base interest rate unchanged at 4% at its December meeting. The ECB qualified this decision by noting that while risks to inflation remained on the upside, risks to growth were weighted firmly on the downside. This is directly linked to the uncertainty that surrounds the adverse impact of the on-going global credit crunch on the Euroland economy.

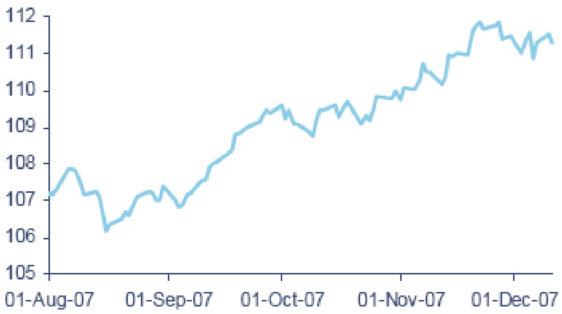
Chart 3: Consumer price inflation (y-o-y, %)



Source: Eurostat

Conditions in money markets remained abnormal in December and early January, owing to the reluctance of banks to lend to each other. Short-term interest rates, particularly the three-month benchmark rate, are currently significantly above the ECB's target rate despite repeated liquidity-boosting operations by the ECB. Evidence suggests that liquidity concerns are now beginning to lead banks to tighten credit requirements on loans to businesses and consumers, which has the potential to slow economic growth in the short run.

Chart 4: Euro nominal effective exchange rate (index)



Source: ECB

The euro strengthened considerably against the currencies of the Euroland's main trading partners over Q3 and has appreciated further in recent months (see Chart 4 above). On a nominal effective basis the euro has appreciated by over 5% since the beginning of September 2007. While exports continued to grow strongly in Q3 – growing by 2.5% over the quarter – the strength of the euro is likely to undermine exports growth during 2008, as will the expected economic slowdown in key export markets.

The outlook for growth in 2008 is decidedly less positive than in 2007. Turmoil in financial markets is likely to continue, with the result that lending to both consumers and businesses will become more costly and harder to obtain. This, in turn, should act as a brake upon consumer spending and investment growth during most of the year.

Euroland labour markets are currently in a healthy state, but the rising rate of inflation is likely to limit real wage growth as slowing growth curtails employment gains. Inflationary pressures will limit the ECB's ability to cut interest rates in response to slower growth, with the result that the key policy interest rate is likely to persist at current levels through to the end of 2008. Additionally, the strength of the euro, combined with slowing growth in the US, point to weaker external demand in the short term. Overall, we anticipate that the Euroland economy will grow by around 2.1% in 2008 after an estimated 2.6% growth in 2007.

Table 1: Euroland GDP growth outlook

Growth rate (%)	2006	2007[e]	2008[f]
Euroland	**2.8**	**2.6**	**2.1**
Austria	3.3	3.1	2.6
Belgium	3.0	2.6	2.0
Cyprus	**4.0**	**4.2**	**4.1**
Finland	5.0	4.4	2.9
France	2.0	1.8	1.9
Germany	2.9	2.6	2.2
Greece	**4.3**	**3.7**	**3.2**
Ireland	5.7	4.9	3.5
Italy	1.9	1.8	1.3
Luxembourg	6.2	5.2	4.9
Netherlands	2.9	3.0	2.6
Portugal	1.3	1.7	1.9
Slovenia	5.7	5.7	4.7
Spain	3.9	3.6	2.7
UK	2.9	3.1	1.9

Source: Eurostat; PricewaterhouseCoopers estimates (e) and forecasts (f).

Greece

Greek economic growth remained robust in Q3, with the economy expanding by 0.9% for the second quarter in a row. On a year-on-year basis, the Greek economy grew by 3.8% in Q3, a slight moderation compared to the previous quarter.

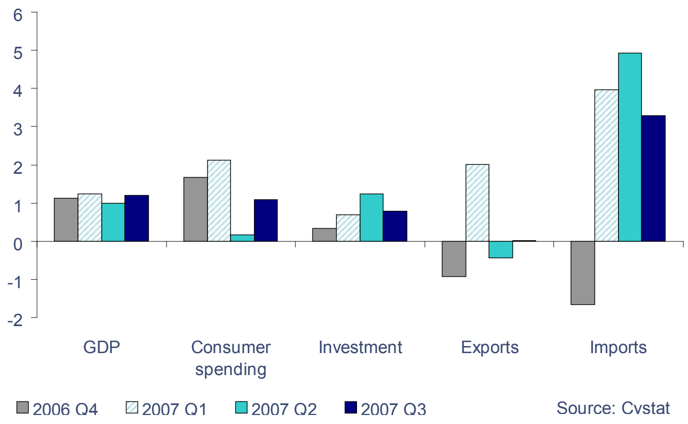
The slightly weaker annual rate of growth in Q3 was driven by a weak exports growth combined with strong imports growth. Consumer spending growth picked up slightly, owing to rising employment and gradually improving consumer confidence over the quarter.

Looking forward, business and consumer expectations concerning future activity and employment are positive and improving in the services sector, particularly within retail trade. Moreover, the manufacturing PMI remained at a high level through to November, boding well for economic growth in Q4. Further employment gains are likely to underpin consumer spending growth in 2008, while slowing demand from Greece's main trading partners should see exports growth moderate further. Overall, we expect the Greek economy to have grown by 3.7% in **2007** and anticipate a slower pace at 3.2% in **2008**, which is still well above the expected Euroland average growth rate.

Cyprus
Recent developments

Growth in the Cyprus economy accelerated to 1.2% in Q3 2007, driven primarily by increased consumer spending and continued strong business investment growth (see Chart 5 below).

Chart 5: Cyprus GDP (q-o-q, % change)



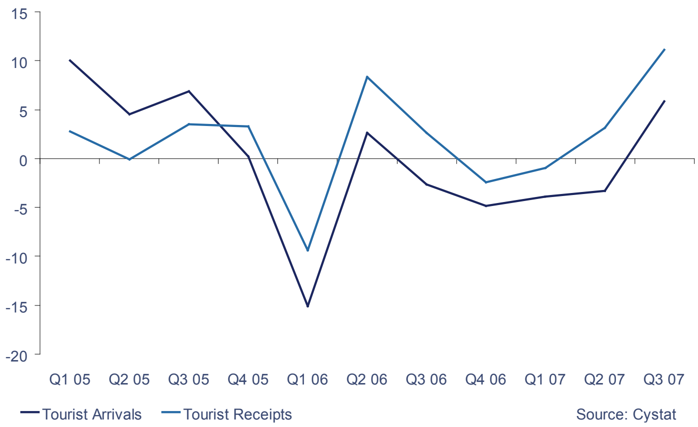
Consumer spending growth accelerated in Q3, with robust retail sales growth and new car purchases. Strong, double-digit, private sector credit growth has helped support consumer spending throughout 2007.

Strong credit growth has supported demand in the real estate sector, with knock on effects for construction activity. Indeed, building permits and cement sales grew strongly in the year to September 2007.

Investment growth slowed slightly in Q3, as transport equipment investment contracted for the third quarter in a row. However, on a positive note, machinery and equipment investment remained robust and residential investment picked up in Q3. Exports growth stagnated in Q3, reflecting weaker intra-EU trade flows over this period. However, the intra-EU slowdown was partially offset by a pick up in exports to countries outside the EU.

Industrial production and manufacturing output grew reasonably strongly in Q3, maintaining the momentum from Q2. In particular, strong growth in value added from the construction sector in Q3 confirmed the on-going strength of the real estate sector in Cyprus. The services sector performed well in Q3, owing to robust output growth in the trade, hotels and restaurant sectors. Healthy real estate and financial and business services growth also contributed to the Q3 services expansion.

Chart 6: Tourism in Cyprus (y-o-y % change)

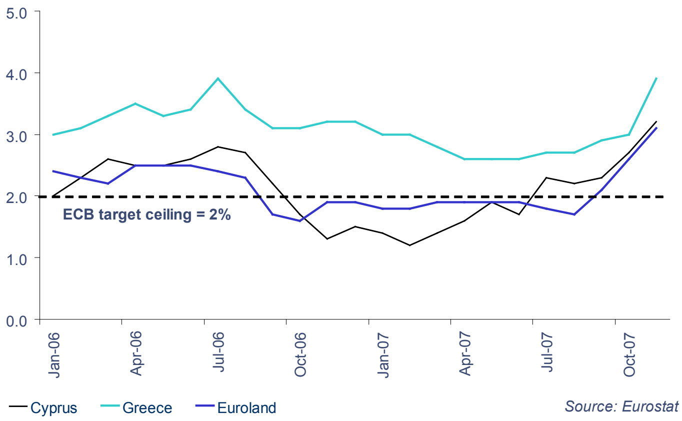


The tourism sector in Cyprus benefited from the summer influx of visitors to the island in Q3 (see Chart 6 above). Tourist arrivals surged during the quarter with more than 1 million tourists visiting Cyprus from July to September, the highest quarterly tourist arrivals in recent years. The current strength of the tourism sector means that the contraction in arrivals in 2006 will be reversed in 2007, with arrivals in the

January-November period already up on 2006 as a whole. Tourist receipts also surged in Q3.

Inflation has picked up in Cyprus since June, with the latest data showing inflation at 3.2% in November on the EU's harmonised measure. By comparison, Euroland inflation is estimated to have stood at 3.1%, while Greek inflation was higher at 3.9% (see Chart 7 below).

Chart 7: Inflation rates (y-o-y % change)



Source: Eurostat

The pick up in Cypriot inflation has been driven by a combination of strong domestic demand, together with high food and oil prices. In addition, the rapid growth in money supply, in particular credit channelled to the construction sector and to consumption, has contributed to the increase in real estate prices and the noticeable widening of the trade deficit.

Interest rates were cut to 4% in December by the Central Bank of Cyprus. The decision to cut rates was made in order to achieve harmonisation with the official interest rates of the ECB ahead of adopting the euro on 1 January 2008. Cyprus was formally allowed to adopt the euro on 1 January 2008 by the Council of Finance Ministers of the EU in July. The conversion rate will be 1 euro = 0.585274 Cyprus pounds, which corresponded to the central exchange rate within the EU's ERM II exchange rate mechanism in July. With Malta also adopting the euro on 1 January, 15 countries will be using the euro as their currency from 2008.

The Cypriot labour market has enjoyed a positive performance so far in 2007. Unemployment has trended downwards gradually for more than a year, declining from 4.3% in October 2006 to 3.8% in October 2007 on the EU's Harmonised measure. Tight labour market conditions have continued through to 2008, and labour shortages continue to be reported in some sectors such as construction. Vacancies outstanding have increased steadily from July to September.

Future prospects

Looking ahead, we expect the Cyprus economy to grow by 4.1% in **2008**, after growing by an estimated 4.2% in **2007**. Economic growth is likely to be driven by a continued strong domestic economy.

Consumer spending in particular is likely to perform robustly in 2008. Reasonably low interest rates and favourable developments in the labour market are likely to support consumer spending growth over this period. In addition we expect business investment to grow healthily, as businesses capitalise on liberalisation in the energy and telecommunications sectors and infrastructure improvements in the transport and energy sectors.

We expect continued employment gains in 2008, on the back of demand from the services sector. Consequently, tight labour market conditions and an associated elevated level of vacancies are expected to remain over the forecast horizon.

Inflation is likely to remain quite high over the next few months, before slipping back only marginally in 2008. Upside risks to the rate of inflation stem from robust domestic demand, high oil and food prices and rapidly expanding domestic credit growth.

Cyprus looks set to enjoy a smooth transition from pounds to euros. However, formally adopting the ECB's interest rate in 2008 may yield an additional upside risk to inflation in the short to medium term, given the recent harmonisation to ECB interest rates which required a further cut in Cypriot official interest rates from 4.5% to 4%.

Table 2: Main Economic Forecasts: Cyprus

Gross domestic product (GDP)	2004	2005	2006	2007^e	2008^f
Real growth (annual % change)					
GDP	4.2	4.0	4.0	4.2	4.1
Consumer spending	6.3	4.0	4.2	4.9	3.4
Government	-5.5	3.4	7.4	2.2	5.5
Investment	10.0	6.0	7.3	3.4	4.7
Export	5.1	4.7	4.5	1.5	4.3
Imports	9.6	3.1	6.6	9.4	5.3
Contribution to growth (%)					
Consumer spending	4.1	2.6	2.8	3.2	2.2
Government	-1.0	0.6	1.2	0.4	0.9
Investment	1.8	1.1	1.4	0.7	0.9
Exports	2.6	2.4	2.4	0.8	2.2
Imports	-5.0	-1.7	-3.6	-5.3	-3.1
Domestic demand	6.6	3.2	5.3	8.7	5.0
Net exports	-2.4	0.7	-1.3	-4.5	-0.9
Economic structure (% of GDP)					
Consumer spending	65.9	66.0	66.1	66.5	66.1
Government	16.9	16.8	17.3	17.0	17.2
Investment	18.7	19.0	19.6	19.5	19.6
Export	51.8	52.1	52.4	51.0	51.1
Imports	54.7	54.3	55.6	58.4	59.1

Source: Cystat; PricewaterhouseCoopers estimates (e) and forecasts (f)

Consumer price inflation	2004	2005	2006	2007^e	2008^f
HICP (annual % change, average)	1.9	2.0	2.2	2.1	2.5
HICP (annual % change, end of year)	3.9	1.4	1.5	3.1	2.0

Source: Cystat; PricewaterhouseCoopers estimates (e) and forecasts (f)

Size of the economy	2004	2005	2006	% of 2006 world total
Population (millions)	0.7	0.8	0.8	0.01%
GDP, current prices (US$ billions)	16	17	18	0.04%
GDP, PPP terms (US$ billions)	20	21	22	0.03%
GDP per capita, current prices (US$)	21,343	22,378	23,676	
GDP per capita, PPT terms (US$)	26,609	27,765	29,105	

Source: IMF

Definitions

EU – European Union
ECB - European Central Bank
HICP - Harmonised Index of Consumer Prices
Cystat - Statistical Office of Cyprus

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